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## **\$7 Billion Allocation of New Markets Tax Credits Available for Business Investment, Charitable Endeavors, and Real Estate Development in Low-Income Communities**

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On November 17, 2016, the U.S. Department of the Treasury's Community Development Financial Institutions Fund (CDFI Fund) announced that 120 organizations nationwide will receive a total of \$7 billion in New Markets Tax Credit awards, the single largest credit allocation round in the New Markets Tax Credit Program's history.<sup>1</sup>

Often overlooked or misunderstood, the federal New Markets Tax Credit Program (NMTC Program) can be an important source of financing for real estate projects, operating businesses, or charitable organizations in economically disadvantaged urban neighborhoods and rural communities.

The goal of the NMTC Program is to promote private investment in operating businesses and real estate

in low-income communities and underserved populations by allowing individual and corporate investors to receive a tax credit against their federal income tax, in exchange for making equity investments in specialized financial intermediaries called Community Development Entities. Examples of NMTC Program projects include financing small businesses, improving community facilities such as daycare centers, and increasing home ownership opportunities.

Since it was established in December 2000,<sup>2</sup> the NMTC Program has generated more than \$42 billion of vital investment in distressed communities nationwide,<sup>3</sup> resulting in the creation or retention of more than 500,000 jobs and the construction or rehabilitation of more than 164 million square feet of commercial real estate.<sup>4</sup> As of the end of FY 2015, the NMTC Program had generated \$8 of private investment for every \$1 of federal funding.<sup>5</sup>

The 2017 allocation round is expected to open in the first quarter of 2017,<sup>6</sup> and the majority of the tax credits in each allocation round are allocated to projects very quickly thereafter. Developers, companies, and charities that do not prepare immediately for the next round of financing may find it is too late, no matter how great their project's potential to elevate a community in need.

<sup>2</sup> By Subtitle C of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

<sup>3</sup> U.S. Department of the Treasury Press Release, at <https://www.treasury.gov/press-center/press-releases/Pages/jl0615.aspx>. In the 13 rounds to date, the CDFI Fund has made 1,032 allocation awards totaling \$50.5 billion in tax credit authority. *Id.* Congress has authorized total allocation authority of \$60 billion for the period 2001 through 2019. *See* §45D(f).

<sup>4</sup> U.S. Department of the Treasury Press Release, at <https://www.treasury.gov/press-center/press-releases/Pages/jl0615.aspx>.

<sup>5</sup> CDFI Fund, *New Markets Tax Credit Program*, at <https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx>.

<sup>6</sup> On December 2, 2016, the CDFI Fund released the qualified equity investment (QEI) issuance thresholds that will be in place for the 2017 allocation round: <https://www.cdfifund.gov/Documents/QEI%20Issuance%20Thresholds%20for%20the%20CY2017%20Allocation%20Round%20FINAL.pdf>.

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<sup>1</sup> *See* U.S. Department of the Treasury Press Release, at <https://www.treasury.gov/press-center/press-releases/Pages/jl0615.aspx>. Information on the geographic location of the allocation recipients and their investment activities is available at <https://www.cdfifund.gov/Documents/FINAL%202015%202016%20NMTC%20Award%20Book%20Nov2016.pdf>.

## WHAT IS THE NEW MARKETS TAX CREDIT?

Investing in a Community Development Entity (CDE) that has a NMTC allocation allows an investor to claim a tax credit against federal income tax<sup>7</sup> equal to 39% of the investment, which is referred to as a qualified equity investment (QEI). The New Markets Tax Credit (NMTC) is claimed over a seven-year period, with 5% of the investment amount claimed in each of the first three years and 6% of the investment amount claimed in each of the next four years.<sup>8</sup> If the investor redeems the investment before the end of the seven-year term, NMTCs claimed by the investor will be recaptured with interest.<sup>9</sup>

## ELIGIBILITY AND REQUIREMENTS

The NMTC Program is administered jointly by the CDFI Fund and the IRS. The tax rules governing eligibility for the tax credit are contained in §45D and Reg. §1.45D-1, which are administered by the IRS. Rules governing the award and use of tax credit allocations under the program are issued by the CDFI Fund. Violation of the CDFI Fund requirements will not cause a recapture of the tax credits, but may result in a Community Development Entity's loss of its certification or forfeiture of unused credit allocation.<sup>10</sup>

Although the tax rules do not require that funds be used to provide loans or equity investments on favorable terms or at below-market rates, the rules of the CDFI Fund require this, so that in practice, the majority of the subsidy provided by the tax credit benefits borrowers in low-income communities.<sup>11</sup>

A CDE is a domestic for-profit or nonprofit corporation or partnership that is an intermediary vehicle for the provision of loans, investments, or financial counseling in low-income communities. To qualify as a CDE, an organization must:

- Be a domestic corporation or partnership at the time of the certification application;
- Demonstrate a primary mission of serving, or providing investment capital for, low-income communities or low-income persons;
- Maintain accountability to residents of targeted low-income communities through representation on a governing board of or advisory board to the entity; and
- Be certified by the Treasury Department as being a CDE.<sup>12</sup>

CDEs have a broad and diverse range of investment objectives that may seek to assist particular geographic regions, develop specific industries, improve the environment, or increase the availability of services (i.e., healthcare or daycare for underserved populations) or access to healthy food in food deserts. While such a wide range of investment objectives helps ensure that there are potential CDEs for many different types of projects, it can also be difficult for project leaders to identify which of the more than 120 CDEs would be a good partner for facilitating investment.

A CDE that has applied for and been awarded an allocation from the U.S. Treasury can receive capital from investors and provide the tax credit to such investors, up to the maximum amount of its allocation award.<sup>13</sup> A CDE must use its allocation within five years of receipt.<sup>14</sup> Any unused allocation is automatically returned to the Treasury and can be reallocated by the CDFI Fund.<sup>15</sup>

To qualify for the NMTC, an investor must hold a "qualified equity investment" (QEI).<sup>16</sup> A QEI, in general, is any equity investment<sup>17</sup> in a CDE if:

- The investment is acquired by the investor at its original issue (directly or through an underwriter) solely in exchange for cash;

<sup>7</sup> However, the new markets tax credit may not be used to offset the alternative minimum tax. The credit is not allowed in any year in which the investor is subject to the AMT. See §38(b)(13), §38(c)(1).

<sup>8</sup> See §45D(a). The investor may also receive additional economic benefits, such as interest payments, from the investment. Unless otherwise indicated, references to "§" are to the Internal Revenue Code, as amended, and references to "Reg. §" are to the Treasury regulations thereunder.

<sup>9</sup> See §45D(g).

<sup>10</sup> A draft Allocation Agreement containing boilerplate provisions of the terms and conditions of the agreement that must be entered into between the CDFI Fund and a CDE that has received an allocation under the NMTC Program can be found at the CDFI Fund website, <https://www.cdfifund.gov/Documents/Template%20CY%202015-2016%20Allocation%20Agreement%20with%20Highlights%20for%20Website.pdf>.

<sup>11</sup> See *New Markets Tax Credit Program Fact Sheet*, at [https://www.cdfifund.gov/Documents/NMTC%20Fact%20Sheet\\_Jan\\_2016v2.pdf](https://www.cdfifund.gov/Documents/NMTC%20Fact%20Sheet_Jan_2016v2.pdf).

<sup>12</sup> §45D(c)(1). CDE certification is intended for community development financing intermediaries. Businesses seeking NMTC-enhanced financing should not apply for CDE Certification, but should instead contact CDEs directly.

<sup>13</sup> Allocation authority generally is awarded once each year by the CDFI Fund based on applications received for that round. The maximum allocation that may be awarded for any calendar year in 2010 through 2019 is \$3.5 billion. See §45D(f)(1)(G).

<sup>14</sup> §45D(b)(1) (flush language). Several of the requirements of section 3.2 of the allocation agreement require compliance in three years. The NMTC Allocation Agreement can be found at the CDFI Fund website, <https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/allocation-step.aspx>

<sup>15</sup> §45D(b)(1) (flush language).

<sup>16</sup> §45D(a)(1).

<sup>17</sup> An equity investment is any stock in a corporation, and any capital interest in a partnership.

- Substantially all (at least 85%) of the cash is used by the CDE to make qualified low-income community investments (defined below); and
- The investment is designated by the CDE as a QEI on its books and records using any reasonable method.<sup>18</sup>

A “qualified low-income community investment” (QLICI) is generally a loan to, or equity investment in, a qualified active low-income community business (defined below), usually with a term of at least seven years<sup>19</sup> and with a low interest rate or otherwise favorable terms. The qualified low-income community investment is the means by which the benefits of the NMTC Program are extended to the qualified active low-income community business. A QLICI is defined by the Internal Revenue Code as:

- Any capital or equity investment in, or loan to, any qualified active low-income community business;
- The purchase from another qualified CDE of any loan made by such entity which is a QLICI;
- Financial counseling and other services specified in regulations prescribed by the Treasury Secretary to businesses located in, and residents of, low-income communities; and
- Any equity investment in, or loan to, any qualified CDE.<sup>20</sup>

A “qualified active low-income community business” (QALICB) is a corporation (including a non-profit corporation) or partnership that actively conducts a “qualified business” with a minimum nexus to a low-income community, and which satisfies certain asset tests.<sup>21</sup> A sole proprietorship and a portion of a business conducted by a corporation or partnership can also be a qualified active low-income community business.<sup>22</sup> Rental of residential rental property is not a qualified business.<sup>23</sup> A qualified business also does not include any trade or business consisting of the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale

of alcoholic beverages for consumption off premises.<sup>24</sup>

The QALICB has the necessary nexus to a low-income community if it meets the following requirements:

- at least 50% of its gross income must come from the active conduct of a qualified business in any low-income community;
- at least 40% (85% if the QALICB does not have employees) of its tangible property (owned or leased) must be used in a low-income community; and
- at least 40% of the services performed by its employees (if any) are performed in a low-income community.<sup>25</sup>

For a QALICB that has employees, the gross income requirement is deemed satisfied if either the tangible property test or services test is satisfied at the 50% level. If the QALICB does not have employees, the tangible property test must be satisfied at the 85% level, and thus the gross income test is deemed satisfied in all such cases.

A “low-income community” is any census tract that has a poverty rate of at least 20% or that has a median income that does not exceed the higher of 80% of the median income of the metropolitan area or of the statewide median income.<sup>26</sup> In addition to investments located in low-income communities, investments can qualify for NMTCs by using other statutory provisions designed to target certain areas or populations, including provisions for high-migration rural counties, low-income targeted populations, and Gulf Opportunity Zone targeted populations.<sup>27</sup> A “targeted population” means individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments.<sup>28</sup>

The availability of other federal tax benefits, such as the rehabilitation credit and depreciation deductions, generally does not limit the availability of the new markets tax credit.<sup>29</sup>

<sup>18</sup> §45D(b)(1), §45D(b)(3).

<sup>19</sup> See §45D(g)(1).

<sup>20</sup> §45D(d)(1).

<sup>21</sup> §45D(d)(2); Reg. §1.45D-1(d)(4).

<sup>22</sup> §45D(d)(2)(B), §45D(d)(2)(C); Reg. §1.45D-1(d)(4)(ii), §1.45D-1(d)(4)(iii).

<sup>23</sup> Reg. §1.45D-1(d)(5)(ii).

<sup>24</sup> Reg. §1.45D-1(d)(5)(iii)(B).

<sup>25</sup> §45D(d)(2)(A)(i)–§45D(d)(2)(A)(iii); Reg. §1.45D-1(d)(4)(i)(A)–§1.45D-1(d)(4)(i)(C).

<sup>26</sup> §45D(e)(1).

<sup>27</sup> See §45D(e)(2); *New Markets Tax Credit CDE Certification Glossary of Terms*, <https://www.cdfifund.gov/Documents/CDEcertificationGlossary.pdf>.

<sup>28</sup> Reg. §1.45D-1(d)(9).

<sup>29</sup> See Reg. §1.45D-1(g)(3).

## REALIZING THE BENEFITS OF THE NMTC PROGRAM

Whether arising from unfamiliarity with the NMTC Program or the mistaken belief that their project would not qualify, some project leaders and investors have not taken advantage of the NMTC Program despite its age and proven track record. Some communities may have missed out on five years of positive social and economic benefits that would have resulted if the project leader had sought NMTC financing earlier. In some cases, where a project would be truly transformative, the last piece of necessary capital may still be secured through NMTC financing.

Nationwide, the NMTC Program has created nearly 750,000 jobs in economically distressed communities and leveraged almost \$75 billion in capital for busi-

nesses, community services, and facilities.<sup>30</sup> Projects in all 50 states have benefitted from NMTC financing, including charter schools, medical centers, industrial facilities, and commercial office complexes. In nearly every case, NMTC financing made the difference in determining whether the project was actually implemented, and the economically disadvantaged communities in which they are located now enjoy the benefits.

Developers, businesses, and charities should consult their tax advisers now to prepare for the next round of NMTC financing.

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<sup>30</sup> New Markets Tax Credit Coalition, *NMTC Leaders Applaud 5-Year Extension of Community Development Tax Credit* (Dec. 16, 2015), at <http://nmtccoalition.org/2015/12/16/nmtc-leaders-applaud-5-year-extension-of-community-development-tax-credit/>.