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New Markets Tax Credit: An Introduction

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New Markets Tax Credit: An Introduction

Summary

The New Markets Tax Credit (NMTC) is a non-refundable tax credit intended to encourage private capital investment in eligible, impoverished, low-income communities. NMTCs are allocated by the Community Development Financial Institutions Fund (CDFI), a bureau within the United States Department of the Treasury, under a competitive application process. Investors who make qualified equity investments reduce their federal income tax liability by claiming the credit. The NMTC program, enacted in 2000, is currently authorized to allocate $19.5 billion through the end of 2008. To date, the CDFI has made 294 awards totaling $16 billion in NMTC's allocation authority. The final authorized round of allocations, for the remaining $3.5 billion in NMTC allocation authority, is currently underway.

In the 110th Congress, legislative attention has focused primarily on extending the NMTC program authorization past its currently scheduled 2008 expiration. H.R. 2075 and S. 1239 propose to extend the NMTC through 2013. Both bills propose an additional allocation authority of $3.5 billion per year through 2013, indexed for inflation. H.R. 3907 proposes to make the NMTC permanent.

This report will be updated as warranted by legislative changes.

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Overview

The New Markets Tax Credit (NMTC) was enacted by the Community Renewal Tax Relief Act of 2000 (P.L. 106-554, 113 Stat. 2763) to provide an incentive to stimulate investment in low-income communities (LIC). The original allocation authority eligible for the NMTC program was $15 billion from 2001 to 2007.[1] Congress, subsequently, has increased the total allocation authority to $19.5 billion and extended the program through 2008.[2] Qualified investment groups apply to the U.S. Department of the Treasury's Community Development Financial Institutions Fund (CDFI) for an allocation of the New Markets Tax Credit. The investment group, known as a Community Development Entity (CDE), seeks taxpayers to make qualifying equity investments in the CDE. The CDE then makes equity investments in low-income communities and low-income community businesses, all of which must be qualified. After the CDE is awarded a tax credit allocation, the CDE is authorized to offer the tax credits to private equity investors in the CDE.

The tax credit value is 39% of the cost of the qualified equity investment and is claimed over a seven-year credit allowance period.[3] In each of the first three years of the investment, the investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is 6% annually. Investors must retain their interest in a qualified equity investment throughout the seven-year period.

Program Components

The process by which the NMTC affects eligible low-income communities involves multiple agents and steps. **Figure 1** illustrates the key agents in the NMTC process.

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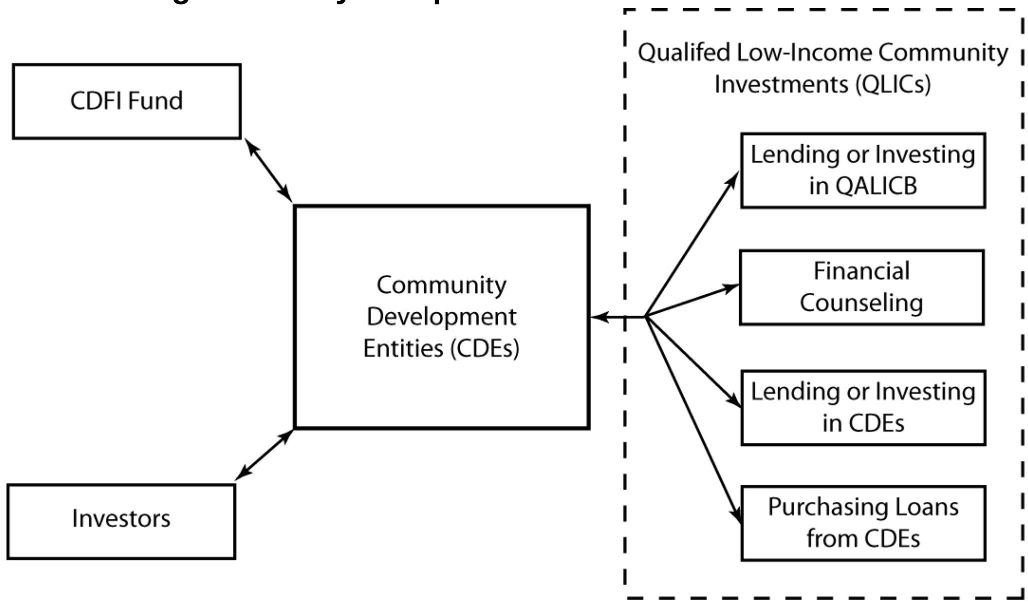
[1] Congress provided a schedule limiting the NMTC allocation authority for calendar years 2001 through 2007. The schedule allowed for $1.0 billion in allocation authority in 2001, $1.5 billion in 2002 and 2003, $2.0 billion in 2004 and 2005, and $3.5 billion in 2006 and 2007.

[2] The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) authorized an additional $1 billion of NMTC equity for qualified investments in areas affected by Hurricane Katrina, and The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the NMTC for an additional year (through 2008) with an additional $3.5 billion of NMTC allocation authority.

[3] In present value terms, the credit is equal to approximately 30% of the eligible investment at a 6.7% discount rate.

Figure 1. Key Components of the NMTC Process



Source: CRS analysis of NMTC program components

The multiple steps and agents are designed to ensure that the tax credit achieves its primary goal: encouraging investment in low-income communities. For example, the Treasury Department's CDFI reviews NMTC applicants submitted by CDEs, issues tax credit authority to those CDEs deemed most qualified, and plays a significant role in program compliance.

Community Development Entities (CDE)

A CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investment funding, or financial counseling in low-income communities (LICs). To become certified as a CDE, an organization must submit an application to the CDFI that demonstrates that it meets three criteria: (1) it is a domestic corporation or partnership duly organized under the laws of the jurisdiction in which it is incorporated, (2) it has a primary mission of serving low-income communities, and (3) it maintains accountability to residents of these low-income communities. A CDE may demonstrate meeting the third criterion by filling at least 20% of either its advisory or its governing board positions with representatives of low-income communities.[4]

Only CDEs may apply for the NMTC. Upon receipt of NMTC allocation, CDEs attract investors using the credits. While both for-profit and nonprofit CDEs may apply for the NMTC, only for-profit CDEs may pass the NMTC on to investors. To ensure that projects are selected on economic merit, nonprofit CDEs awarded

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[4] In addition, all Community Development Financial Institutions or Specialized Small Business Investment Companies automatically qualify as CDEs. To be recognized as CDEs, these entities are required to register through the CDFI Fund website.

NMTCs must transfer their allocations to for-profit subsidiaries prior to offering NMTCs to investors.

As **Figure 1** illustrates above, CDEs play a critical role in a properly functioning NMTC process. CDEs are the intermediaries between the potential low-income community investments and the CDFI during the application process. CDEs also present investors with investment opportunities and provide the CDFI the majority of its compliance data.

Qualifying Low-Income Communities

Under the tax code's NMTC provisions, only eligible investments in qualifying low-income communities are eligible for the NMTC. Qualifying low-income communities include census tracts that have at least one of the following criteria: (1) a poverty rate of at least 20%; (2) is located in a metropolitan area, a median family income below 80% of the greater of the statewide or metropolitan area median family income; or (3) is located outside a metropolitan area, a median family income below 80% of the median statewide family income. As defined by the criterion above, about 39% of the nation's census tracts covering nearly 36% of the U.S. population are eligible for the NMTC. Additionally, designated targeted populations may be treated as low-income communities.[5] Further, the definition of a low-income community includes census tracts with low populations and census tracts within high migration rural counties. As a result of the definition of qualified low-income communities, virtually all of the country's census tracts are potentially eligible for the NMTC.

Qualified Investors and Investments

All taxable investors are eligible to receive the NMTC. As noted above, investors receiving the credit can claim the NMTC over a seven-year period, starting on the date of the investment and on each anniversary, at a rate of 5% for each of the first three years and a rate of 6% for each of the next four years, for a total of 39%. Once the investor begins claiming the NMTC, the credit can be recaptured if the CDE (1) ceases to be a CDE, (2) fails to use substantially all of the proceeds for eligible purposes, or (3) redeems the investment principal.[6]

Almost all qualified equity investments (QEI) in low-income communities or serving low-income populations could be eligible to receive the NMTC. These eligible investments are referred to as qualified low-income community investments (QLICIs). QLICIs are categorized in four ways: (1) loans or investments to qualified active low-income community businesses (QALICB), (2) the provision of financial counseling, (3) loans or investments in other CDEs, and (4) the purchase of loans

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[5] See Internal Revenue Bulletin 2006-29, Notice 2006-60, issued July 17, 2006, for a more complete description of the definition of designated targeted populations.

[6] According to IRS regulations, the "substantially all" requirement is met if at least 85% of investor proceeds are used to make eligible investments in the first six years of the NMTC period and at least 75% in year seven of the investment.

from other CDEs.[7] All QLICIs, including QALICBs, are explicitly prohibited from investing in residential rental property and certain types of businesses, such as golf courses and casinos.

NMTC Allocation Process and Compliance

To receive an allocation, a CDE must submit an application to the CDFI, which asks a series of standardized questions about the track record of the CDE, the amount of NMTC allocation authority being requested, and the CDE's plans for any allocation authority granted.

The application covers four areas: (1) the CDE's business strategy to invest in low-income communities, (2) capitalization strategy to raise equity from investors, (3) management capacity, and (4) expected impact on jobs and economic growth in low-income communities where investments are to be made. In addition, priority points are available for addressing the statutory priorities of investing in unrelated entities and having demonstrated a track record of serving disadvantaged businesses or communities. The application is reviewed and scored to identify those applicants most likely to have the greatest community development impact and ranked in descending order of aggregate score.

Tax credit allocations are then awarded based upon the aggregate ranking, until all of the allocation authority is exhausted. In each of the four completed NMTC rounds, significantly more CDEs applied for allocations than were able to receive allocations, with only 22% of applicants receiving allocations. Additionally, allocation authority of $107 billion was requested, compared with the $12.1 billion in allocation authority available.[8]

Prior to receiving the authority to offer tax credits to investors, every CDE allocatee must sign an allocation agreement. The allocation agreement clarifies the terms and conditions of the allocation authority, such as the total tax credit authority, service areas, authorized uses of the allocation, and CDE reporting requirements. Failing to meet the terms of the allocation agreement subjects the CDE to the potential revocation of allocation authority.

Additionally, the Internal Revenue Service (IRS) monitors compliance with the tax consequences of NMTC allocations, focusing on the "substantially all" requirement.

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[7] For a business to be a QALICB, it must be located in a qualifying census tract, derive at least 50% of gross income from activity conducted in a LIC, have at least 40% of both the use of tangible property and services provided located or performed in the LIC, and have less than 5% of the aggregate unadjusted bases of the property attributable to collectibles or non-qualified financial property.

[8] See U.S. Government Accountability Office, *TAX POLICY: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, GAO-07-296, January 31, 2007, for detailed breakdowns of application and allocation statistics.

As specified in the IRS regulations, CDE allocatees must issue tax credits to investors within five years of signing their allocation agreements and invest the QEIs in QLICIs within 12 months of signing their allocation agreements. If these requirements are not satisfied, the CDE loses the authority to allocate the unused NMTC. In addition, CDEs that receive principal payments from their QLICIs have 12 months to reinvest those funds in QLICIs to avoid recapture.

NMTC Investment Activity

Once an allocatee signs its allocation agreement and receives its NMTC allocation authority, it may begin soliciting capital from investors. Column 2 of **Table 1** lists the total allocation awarded to date by the NMTC, by funding round. Investors receive the right to claim NMTCs on a portion of their investment, by acquiring stock or a capital interest in a CDE with an allocation. The CDE, in turn, must invest the proceeds in qualified low-income community investments. Investors have, to date, invested $9,608,612,441 in CDEs. Columns 3 and 4 list the remaining available NMTC allocation, in dollars and as a percentage, that have not yet been allocated to an investor, by round. Note that allocatees for Round 5 of the NMTC were announced on October 5, 2007.

Table 1. NMTC Qualified Equity Investment, by Allocation Round

Allocation Round (Year)	Total Allocation	Remaining Available Allocation	Percent Remaining
Round 1 (2001-2002)	$2,491,000,000	$84,976,220	3.4%
Round 2 (2003-2004)	$3,500,000,000	$360,824,051	10.3%
Round 3 (2005)	$2,000,000,000	$355,799,861	17.8%
Round 4 (2006)	$4,100,000,000	$1,680,787,427	41.0%
Round 5 (2007)	$3,909,000,000	$3,909,000,000	100%
Total[a]	$16,000,000,000	$6,391,387,559	39.9%

Source: CRS analysis of NMTC Qualified Equity Investment Report (February 4, 2008)

a. Columns may not sum to total, due to rounding.

Legislative Developments

Modifications to the NMTC program have been made in the past two Congresses. In the 108th Congress, the American Jobs Creation Act of 2004 (P.L. 108-357, 118 Stat. 1418) included provisions expanding the authority of the

Secretary of the Treasury to treat certain other tracts and targeted populations as low-income communities.[9]

During the 109th Congress, the Gulf Opportunity Zone Act of 2005 (P.L. 109-135, 119 Stat. 2577) was enacted to provide tax relief to businesses and individuals affected by Hurricane Katrina. The bill, which created the Gulf Opportunity Zone (or GO Zone), provided an additional $1 billion in allocation authority to CDEs with a significant mission in the recovery and redevelopment of low-income communities in the Katrina GO Zone.[10]

Also during the 109th Congress, the Tax Relief and Health Care Act of 2006 (P.L. 109-432, 120 Stat. 2922) extended the NMTC for one year, through 2008, with an additional allocation of $3.5 billion and mandated Treasury to promulgate regulations to ensure that non-metropolitan counties receive a proportional allocation of investments under the NMTC.

In the 110th Congress, H.R. 2075 and S. 1239 have been introduced.[11] Both bills would amend the Internal Revenue Code of 1986 to extend the NMTC through 2013 and would authorize allocations of $3.5 billion, indexed for inflation, for each of the years.

Also during the 110th Congress, H.R. 3907 has been introduced and referred to the House Committee on Ways and Means. The bill would make the NMTC permanent.

Policy Considerations

The New Markets Tax Credit Program is currently set to expire at the end of 2008. As mentioned above, H.R. 2075 and S. 1239 have been introduced in the 110th Congress proposing to extend the NMTC through 2013. The following policy considerations could be pertinent to any consideration of these bills.

The NMTC is primarily intended to encourage private capital investment in eligible low-income communities. However, the source of the investment funds has implications for the effectiveness of the program in achieving its objective. From an economic perspective, the impact of the NMTC would be greatest in the case where the investment represents new investment in the U.S. economy that would not have occurred in the absence of the program. Conversely, the impact of the NMTC is diminished to the extent the tax credit is applied to investment that would have otherwise occurred or been funded by a shift in investment from more productive

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[9] The term “Targeted Population,” as defined in 12 U.S.C. 4702(20), means individuals, or an identifiable group of individuals, including an Indian tribe, who (1) are low-income persons (Low-Income Targeted Population) or (2) otherwise lack adequate access to loans or equity investments.

[10] The Gulf Opportunity Zone (GO ZONE) is defined as those areas in Alabama, Mississippi, and Louisiana that have been designated by the federal government as warranting assistance due to Hurricane Katrina.

[11] H.R. 2075 has been referred to the House Committee on Ways and Means, and S. 1239 has been referred to the Senate Finance Committee.

alternatives.[12] To date, only one study has empirically assessed the question of whether NMTC investment is funded through shifted investment or whether it represents new investment, finding mixed results.[13]

Although important, understanding the source of NMTC investments alone is not sufficient to determine the effectiveness of the NMTC. A comprehensive review of the program would require an accounting of both the social and economic costs and benefits of the NMTC, an undertaking which may pose considerable challenges. For example, this would include examining the efficiency and opportunity costs of the NMTC investments, while a comprehensive accounting of the NMTC benefits would need to identify and value "spillovers" such as its effect on neighboring businesses and communities. The CDFI Fund is working with a contractor on a comprehensive review of the NMTC, which may include an assessment of the effectiveness of the NMTC.

Finally, the NMTC is one of several programs designed to improve conditions in low-income communities. In a 2004 assessment of the NMTC, the Office of Management and Budget noted that the goal of the NMTC overlaps that of several other tax credits and numerous programs administered by the Departments of Housing and Urban Development and Commerce.[14] Given this overlap and the desire to target federal funds to their most productive uses, it follows that information on the performance of the NMTC relative to other programs with a similar goal would be of use. To date, however, no comparative, empirical study of this nature has been undertaken.

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[12] However, from a policy perspective, the desire to minimize the distortion of investment choice caused by the NMTC is usually balanced against other objectives, such as equity.

[13] U.S. Government Accountability Office, *TAX POLICY: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, GAO-07-296, January 31, 2007.

[14] See U.S. Office of Management and Budget, "Detailed Information on the New Markets Tax Credit Assessment," updated January 29, 2008, [http://www.whitehouse.gov/omb/expectmore/detail/10002230.2004.html].