

## **Guidance for the Application Processes of the New Markets Tax Credit Program**

*In a recent national video teleconference, CDFI Fund representatives discussed criteria used in the Fund's review of CDEs' requests for certification and certified CDEs' applications for allocations.*

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The "new markets tax credit" (NMTC) program was enacted in December 2000, under the Community Renewal Tax Relief Act, as part of the Consolidated Appropriations Act of 2001.<sup>1</sup> The program provides tax incentives intended to encourage \$15 billion in new equity investment to help spur economic growth in low-income communities across the U.S. and its territories.

The NMTC program permits taxpayers to receive a credit against their federal income taxes for making qualified equity investments in designated "community development entities" (CDEs) with expertise and a successful track record in promoting economic development in low-income communities. Substantially all of the investor's qualified equity investment must, in turn, be used by the CDE to provide investments in low-

income communities. The income tax credit will total 39% of the investment and is to be claimed over a seven-year credit allowance period. A credit of 5% of the total paid for the stock or other capital interest is allowed in each of the first three years of the credit period, and a 6% credit may be claimed in each of the final four years.

The NMTC program targets "low-income communities," which generally means a census tract with at least 20% of households below the poverty level, or with median family income that is not more than 80% of the statewide median (or, for metropolitan-area census tracts, not more than 80% of the greater of the statewide or metro-area median family income). The NMTC also may be used in "target areas," which are communities within a census tract that does not meet the poverty or median-income standard. These communities themselves must meet the poverty rate or median-income requirements, must have preexisting boundaries such as established neighborhoods or political or geographic boundaries, and must demonstrate a lack of investment capital. In seeking an allocation, a CDE may propose to serve one or more low-income communities or target areas.

### **Administration by the CDFI Fund**

The Community Development Financial Institutions (CDFI) Fund administers the NMTC program in coordination with the IRS and the U.S. Treasury Department's Office of Tax Policy. The Fund's mission is to expand the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities across the U.S. The Fund originally was authorized by the Riegle Community Development and Regulatory Improvement Act of 1994.

In connection with the Fund's mission, financial services can include activities such as help in developing a business plan, assistance with business financials, and operating assistance to nonprofit organizations. Financial services do not include traditional personal financial advisory services.

Under authority granted by Congress, the CDFI Fund has oversight for allocating the \$15 billion of new equity investment. The allocations are being made available competitively over the life of the NMTC program, phased-in through 2007 (for the first two rounds of allocations, the 2001-2002 periods and the 2003-2004 periods were combined). The total desired equity investment is available as follows:

Year	Maximum
2001	\$1.0 billion
2002	\$1.5 billion
2003	\$1.5 billion
2004	\$2.0 billion
2005	\$2.0 billion
2006	\$3.5 billion
2007	\$3.5 billion
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Total	\$15 billion

**Example.** Under the competitive process, applicants (i.e., qualified CDEs) request the authority to grant tax credits to investors for equity investments that the investors will make in the successful applicant organizations. For example, the CDFI Fund may award a first-round equity investment allocation of \$1 million to a particular CDE. The CDE, in turn, may offer tax credits to ten investors who each invest \$100,000 in the CDE. The credit that each investor can claim would be calculated as follows:

Year	Credit Percentage	Credit Claimed
1	5%	\$5,000
2	5%	\$5,000
3	5%	\$5,000
4	6%	\$6,000
5	6%	\$6,000
6	6%	\$6,000
7	6%	\$6,000
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Total	39%	\$39,000

## **CDFIs.**

By stimulating the creation and expansion of diverse "community development financial institutions" (CDFIs, which generally are deemed to meet the requirements, discussed below, to be a qualified CDE), and by providing incentives to traditional banks and thrifts, the CDFI Fund works toward building private markets, creating healthy local tax revenues, and empowering local residents. The Fund provides relatively small infusions of capital to institutions that serve distressed communities and low-income individuals. The Fund's activities leverage private-sector investments from banks, foundations, and other funding sources.

CDFIs generally are private-sector banks, thrifts, and credit unions with a primary mission of community development. CDFIs also include housing and small-business loan funds and community development funds. These specialized financial institutions work in market niches that have not been adequately served by traditional financial institutions. The CDFIs provide a wide range of financial products and services, including mortgage financing for first-time home-buyers, financing for needed community facilities, commercial loans and investments to start or expand small businesses, loans to rehabilitate rental housing, and financial services needed by low-income households and local businesses.<sup>2</sup>

## **The CDFI Fund's Tests for CDE Certification**

Qualified CDEs can include community development financial institutions, community development venture capital funds, small business investment corporations, community loan funds, specialized small business investment companies, and similar entities. In order to qualify under the NMTC program, a CDE must be a domestic corporation or partnership that has as its primary mission to serve or provide investment capital for low-income communities or low-income persons. In addition, it must maintain accountability

to residents of low-income communities through representation on its governing or advisory board. Finally, the entity must be certified as a CDE by the Treasury Department, acting through the CDFI Fund.

In connection with these requirements, the CDFI Fund has outlined certain guidelines for its review of CDE certification.<sup>3</sup> For example, under the legal entity test, the CDE must be a domestic corporation or partnership for federal tax purposes and must have a valid and distinct federal employer identification number.

### **Primary mission.**

Under the primary mission test, the CDFI will examine the CDE's organizational structure through documents that should indicate the CDE's purpose or objectives. These documents can include bylaws, articles of incorporation or organization, partnership agreements and board resolutions.

As part of the CDFI's certification application form, a CDE must submit a "Certification of Authorized Representative," declaring that the CDE will at all times direct at least 60% of its activities (including loans, investments, and related technical assistance) to low-income persons, to persons or organizations located in low-income communities, or to other organizations serving such persons or residents. An "authorized representative" is an officer or any other individual who has authority to sign for and make representations on behalf of the applicant CDE.

### **Accountability.**

Under the accountability test, the CDE should be able to demonstrate and identify its service area. Examples of service areas include local areas (neighborhoods, cities, counties, metropolitan areas, Indian reservations, etc.), statewide areas, multiple states, particular regions of the country, or a national area. A certified CDE can restate its service areas and submit the revision to the CDFI for approval.

The "Certification of Authorized Representative" also must attest to the CDE's maintenance of accountability to the residents of the service areas through their representation on its governing board or advisory board. The applicant CDE must demonstrate that at least 20% of its board members are representative of low-income communities in the designated service area. To be deemed representative, a board member must either live in the low-income community or represent the interests of residents in the low-income community. For example, a small business owner whose business is located in the community, an employee or board officer of a local charitable organization, or an employee of a government agency that provides services to the low-income community may be deemed to represent the interests of local residents and will help the CDE achieve a passing score in this segment of the application.

For a CDE that serves a statewide or other larger-than-local area, the applicant must demonstrate that at least 20% of its board members are representative of a cross-section

of low-income communities in the state or states that it serves. For this purpose, multiple advisory boards are allowed; a separate accountability chart for each board must be submitted with the application, however. Alternatively, the CDE may select board members from organizations that represent the interests of a cross-section of low-income communities (e.g., a statewide organization or a nationwide nonprofit community service development organization).

Where the accountability test is fulfilled through local resident representation on an *advisory board*, the applicant CDE must provide a written narrative describing (1) how advisory board members are selected; (2) how often the advisory board convenes (which must be at least annually); (3) how the board solicits feedback from the community it serves, and how often such information is collected; and (4) how the board will use the information to inform the actions of the governing board in developing the organization's policies (e.g., an advisory board representative sits on the governing board, an advisory board member presents reports to the governing board, etc.).

### **Deemed CDEs; nonprofit CDEs.**

CDFIs and "specialized small business investment companies"<sup>4</sup> automatically qualify as CDEs. Each such entity must register with the CDFI Fund, however, in order to be certified as an approved CDE.

Both nonprofit and for-profit CDEs may apply for NMTC allocations. Nonprofits cannot take on investors, however. Thus, a nonprofit CDE will have to set up a for-profit affiliate in which taxpayers may invest. The nonprofit CDE then may transfer its NMTC allocation to its for-profit affiliate, with prior approval from the Fund.

### **Evaluating Allocation Requests**

The CDFI Fund will analyze and evaluate each certified CDE's allocation application. The allocation requests will go through a competitive review process to identify those CDEs best suited to have the greatest community development impact. The review will include an examination of each applicant's business strategy for investing in low-income communities, its capitalization strategy for raising equity from investors, its management capacity, and its targeting of areas of highest distress and the impact on jobs and economic growth in low-income communities where investments are made.

Under the review criteria, a maximum of 110 points are scored on an application. Up to 25 points can be awarded under each of four sections:

- (1) Business investment strategy.
- (2) Capitalization strategy.
- (3) Management capacity.
- (4) Community impact.

An additional ten "priority" can be earned under the business investment strategy section by applicants that can (1) outline a prior successful track record in providing capital or technical assistance to disadvantaged businesses or communities (five points), or (2) demonstrate the intent to invest in businesses whose majority owners are unrelated parties to the CDE (five points).

### **Business investment strategy.**

The CDFI Fund's evaluation of a certified CDE's business investment strategy will include an analysis of the CDE's eligible activities (called "qualified low-income community investments"). Eligible activities include loans to or capital or equity investments in "qualified active low-income community businesses"; purchases of eligible loans made by other CDEs; certain financial counseling and related services to businesses and residents in low-income communities; and any equity investment in, loans to, or counseling of other qualified CDEs.

Under IRC Section 45D(d)(2), a "qualified active low-income community business" (QALICB) is a corporation or partnership that, for the tax year at issue, meets all the following requirements:

- (1) At least 50% of the entity's total gross income is derived from the active conduct of a qualified business in a low-income community.
- (2) A substantial portion (at least 40%) of the use of the business's tangible property (whether owned or leased) occurs in a low-income community.
- (3) A substantial portion (at least 40%) of the services provided by the business's employees are performed in a low-income community.
- (4) Less than 5% of the average of the aggregate unadjusted bases of the business's property is attributable to collectibles (e.g., art and antiques), other than those held for sale in the ordinary course of business (i.e., inventory).
- (5) Less than 5% of the average of the aggregate unadjusted bases of the business's property is attributable to nonqualified financial property (e.g., debt instruments with a term in excess of 18 months).

A business carried on as a sole proprietorship that would meet the above five tests if incorporated, also can be a QALICB.

In applying the gross income test, the CDFI Fund will consider income derived from products that are either manufactured or sold in a low-income community. The CDFI Fund will interpret the tangible property test so that a business that is located in a qualified area but provides services elsewhere will meet the test. If a project is spread over eligible and ineligible census tracts, the Fund will consider the QALICB requirements for the portion of the project that is within the eligible census tract. The regulations ease compliance issues by establishing a "reasonable expectations" test. A business should be a QALICB throughout the entire period of the CDE's investment or loan if, at the time the loan or investment is made, the CDE reasonably expects that the

business will meet the QALICB requirements. This standard will not apply, however, if the CDE has ownership control over the business receiving the loan or investment.

The NMTC program guidelines indicate that activities deemed ineligible to be treated as QALICBs include (1) residential rental property deriving 80% or more of its income from residential dwelling units; (2) businesses operating golf courses, race tracks, or gambling facilities; (3) certain farming businesses; and (4) stores where the principal business is the sale of alcoholic beverages.

The business investment strategy also will have the opportunity to score favorable points if:

- It involves products and services that are flexible and non-traditional in form.
- It can demonstrate a high leverage rate for its borrowers or investees.
- It has a successful track record of providing products and services similar to those it intends to deploy with qualified equity investment proceeds.
- It has a strong pipeline of proposed projects.
- It can demonstrate that its NMTC strategy will add substantial value to the proposed activities.

### **Capitalization strategy.**

In evaluating a certified CDE's capitalization strategy, the CDFI Fund's scoring criteria generally will take into consideration the CDE's prior performance in securing equity investments from investors and its plan for doing so in the future, including a demonstration that the CDE will issue qualified equity investments in the near term. The CDE should illustrate that a majority of the economic benefits of the allocation will be passed along to borrowers and investees.

The CDFI Fund also will examine whether the CDE is offering products and services that are substantially different from those of its investors. In addition, the CDE should demonstrate that it intends to deploy more than 85% of its allocation proceeds in qualified low-income community investments.

### **Management capacity.**

The CDFI Fund will consider the qualifications of the CDE's board members, management team, and other essential staff. To receive favorable scoring in this area, an applicant CDE should emphasize its staff's relevant experience, particularly in the low-income community that is targeted. The CDE also should point to its track record of raising capital, especially from profit-motivated investors. In addition, the CDE should confirm that it has the capacity to manage the addition of NMTC-approved activities to its current portfolio of projects. The CDE also should demonstrate a meaningful involvement with the low-income community decision makers and show that it can coordinate with local community plans.

## **Community impact.**

The CDFI Fund's analysis of community impact will have a great effect impact on the entire application because this area embodies the overall goals and objectives of the NMTC. To score favorably under this part of the application, the CDE should demonstrate that a high percentage of its qualified low-income community investments will be made in areas of higher distress as opposed to areas of normal activity. Also helpful would be the CDE's ability to articulate a credible detailed and quantifiable impact on the community it intends to serve. The CDE should demonstrate that it has a strategy that will impact or energize other investments in the low-income communities that will be served.

## **Other review steps.**

The CDFI Fund generally will prioritize allocations during the panel phase of the review process. The Fund generally will rank applicants first by their combined scores in the business investment strategy and community impact sections. Thus, for an applicant to have a good chance of receiving an allocation, these two sections should be thoughtfully and carefully constructed.

Generally, the CDFI Fund will accept CDE applications on a rolling basis. For each round of competition, applications must be postmarked by a date (typically in September) to be specified by the Fund.<sup>5</sup>

## **Some additional requirements for the successful CDE applicant.**

The law requires that a certified CDE meet certain time requirements in carrying out its activities. For example, a CDE must offer NMTCs to its investors within five years of receiving an allocation. A CDE must invest "substantially all" (generally 85%) of its qualified equity investment proceeds in qualified low-income community investments within 12 months. In addition, during the first six years of the NMTC credit period, a CDE that receive returns of capital has 12 months to reinvest those funds in qualified low-income community investments. Reinvestment is not required in the final year of the seven-year credit period.

To demonstrate that it has properly invested "substantially all" of its qualified equity investment proceeds, a CDE may employ either of two tests:

- (1) Under the "direct tracing" method, a CDE is required to trace the qualified equity investment allocations to specified qualified low-income community investment projects. This approach typically will involve substantiation through the accounting records.
- (2) Under the "safe harbor" method, a CDE must demonstrate that 85% of its aggregate gross assets are invested in qualified low-income community investments and deployed in qualified activities.

The NMTC may be subject to recapture during the seven-year credit period if the CDE ceases to be qualified; if the qualified equity investments fail the "substantially all" requirement; or if the CDE redeems the investments from the investors. A CDE's filing for bankruptcy is not an event that triggers credit recapture.

## **Historical Applications, Allocations**

The \$15 billion NMTC program has the potential to stimulate economic and community development and job creation in the nation's low-income communities by attracting capital from the private sector.

During the 2001-2002 combined competition, the first round of allocations, the CDFI Fund could grant CDEs the authority to issue up to \$2.5 billion in equity for which NMTCs could be claimed. The Fund reviewed approximately 345 applications requesting a total of nearly \$26 billion in potential equity investments, and selected 66 CDEs to receive allocations for that first round. The 66 CDEs are authorized to issue to their investors, in the aggregate, \$2.5 billion in equity, for which NMTCs can be claimed. Thus, the average allocation award per CDE was approximately \$38 million. Actual allocations ranged in size from \$500,000 to \$170 million, with the median allocation award at \$18 million. Six organizations each received allocation awards of at least \$100 million, and 24 organizations each received \$10 million or less. The 66 allocation recipients anticipate making investments in at least 40 different states and the District of Columbia. Twenty-seven (or 41%) of the allocation recipients will focus on local markets (e.g., a citywide or countywide area) within one state (22 allocatees) or multiple states (five allocatees). Seventeen (or 26%) of the allocation recipients will focus investment activities within a statewide service area. The remaining 22 allocation recipients (or 33%) will invest nationally or in a multistate area. Twenty-one of the 66 allocation recipients (more than 30%) indicate that they will target investments predominantly to rural communities.

In the consolidated 2003-2004 round of competition, more than 271 CDEs applied for allocations, requesting over \$30 billion in potential equity investments. The CDFI Fund selected 62 CDEs, which are authorized to issue to investors, in the aggregate, \$3.5 billion in equity, for which NMTCs can be claimed. The average allocation award was approximately \$56.5 million. Actual allocations ranged in size from \$2 million to \$150,000 million, with the median allocation at \$50 million. Of the 62 approved CDEs, 23 (or 37%) are nonprofit organizations or subsidiaries of nonprofit organizations, receiving a total allocation of \$1.3 billion. Twelve of the 62 (or 19%) are certified CDFIs or subsidiaries of certified CDFIs, with a total allocation of \$508 million. Another 12 are non-CDFI banks or bank holding companies, with a total allocation of \$614 million. Eight (or 13%) of the selected CDEs are governmentally controlled entities, which were awarded \$432 million. Among the 62 winners, 32 (or 52%) are described as "mission-driven" entities or subsidiaries of mission-driven organizations; they received allocations totaling \$1.7 billion.

The 62 CDEs selected in the 2003-2004 round of competition are headquartered in 30 different states and the District of Columbia but anticipate making investments in at least 44 different states, as well as in D.C. Twenty (or 32%) of the allocation recipients will focus on local markets (e.g., a citywide or countywide area) while 15 (or 24%) will focus their investment activities within a statewide service area. Nine (15%) of the recipients will invest in multistate service areas, while the remaining 18 (or 29%) will focus on a national service area.<sup>6</sup>

## **Conclusion**

The process by which NMTC equity investment allocations are made ultimately will rest on the scoring methodology employed by the CDFI Fund review panel. Thus, the successful strategies a certified CDE can articulate in its application will substantially increase the chances of securing an allocation. By comparison, the CDE certification process is not where the emphasis should be placed. That is not to say applying for the CDE certification should be taken lightly. Rather, the CDFI apparently has placed its emphasis on the allocation application sections.

The NMTC program objectives are to promote rapid and meaningful economic development that will complement the individual state-designated enterprise zones and the benefits associated with those zones, as well as to provide another tool in addition to other federal incentive programs already in place. If the NMTC program proves to be viable, it may be extended as a sound federal economic tool for the for-profit investor while serving the primary function of increasing development in those areas most in need.

While, on the surface, the application process may seem daunting and confusing and not very user-friendly, one should keep in mind that no one business or institution has an advantage in securing the allocations available. Thus, as additional ammunition in the arsenal of economic development, the NMTC is worth consideration, as the benefits can often outweigh the procedural effort.

## **Sidebar**

Practice Note: Summarizing the NMTC Process

The following steps, in brief, illustrate the general process, under the "new markets tax credit" (NMTC) program, for seeking approved status as a "community development entity" (CDE) and requesting allocations of potential equity investments against which the NMTC may be claimed.

- (1) Entities apply to the Community Development Financial Institutions (CDFI) Fund (a part of the U.S. Department of Treasury) for certification as a CDE.
- (2) In a competitive application process, certified CDEs request equity investment allocations from the CDFI Fund.

(3) The Fund selects CDEs to receive allocations based upon the scores awarded to each CDE under the Fund's application review process.

(4) CDEs use the awarded allocations to offer NMTCs to taxpayers in exchange for their cash investments in the CDE.

(5) The CDEs, in turn, use the investment proceeds to make investments in qualified businesses in low-income communities.

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[1](#)

H.R. 4577, 12/21/00; P.L. 106-554. The NMTC is codified at IRC §45D.

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[2](#)

For more background on CDFIs, see, e.g., Lupke, "The New Markets Tax Credit—A Community-Based Developer's Perspective on a Much Needed Tool," 13 J. Multistate Tax'n 14 (Nov/Dec 2003).

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[3](#)

Representatives of the CDFI Fund discussed its review criteria at a national video teleconference presented at more than 80 locations around the country on 8/24/04. See the Fund's website at [www.cdfifund.gov](http://www.cdfifund.gov). The teleconference was held following Treasury's announcement, on 8/5/04, of the opening of the third round of competition for the allocation of tax credits under the NMTC program. The awarding of allocations are expected to be announced in April 2005.

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[4](#)

SSBICs are defined in IRC §1044(c)(3).

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[5](#)

For CDE certifications for the 2004 allocation process, applications had to be postmarked no later than 9/8/04 and received by the CDFI no later than 9/15/04.

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[6](#)

These statistics regarding the first two rounds of NMTC program allocations were provided by the CDFI Fund at its national video teleconference presented on 8/24/04. See note 3, *supra*.

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