

## What Are the Ongoing Requirements of a CDE?

The NMTC program has extensive reporting and compliance requirements in addition to recapture avoidance. These requirements derive from several sources, including the Internal Revenue Code; Treasury Regulations; CDFI Fund guidance; the CDE's Allocation Agreement (which may be more restrictive than statutory or regulatory requirements); and transaction-specific agreements and documents.

All CDEs must fulfill certain minimum reporting requirements, including;

- Reporting all QEIs to the CDFI Fund and investors;
- Completing an annual Community Investment Impact System ("CIIS") survey; and
- Completing and filing annual audited financial statements.

In addition, the CDFI Fund conducts periodic site visits to confirm compliance with NMTC program and Allocation Agreement requirements. Tax credit investors also frequently require periodic reporting on compliance matters.

UFA offers a complete range of NMTC services, including: application preparation and filing; CDE formation; transaction structuring; structured financing; and asset and compliance management. For more information about the NMTC program and UFA's services, please contact us.



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# NEW MARKETS TAX CREDITS

## What Are New Markets Tax Credits ("NMTCs")?

The NMTC program was enacted by Congress in 2000 to spur the investment of \$15 billion of private capital in businesses located in or serving low-income communities throughout the country. In 2005 Congress expanded the program by \$1 billion to cover areas devastated by Hurricanes Katrina and Rita. The program was also extended for one year by adding a sixth allocation round totaling \$3.5 billion. The NMTC program is administered by the U.S. Treasury Department's Community Development Financial Institutions Fund ("CDFI Fund").

The tax credit is claimed by investors who make Qualified Equity Investments ("QEIs") in privately managed investment vehicles called Community Development Entities ("CDE") that have received NMTC allocation authority. Any taxable investor who makes a QEI in a CDE is eligible for the tax credit. NMTC investors include banks and thrifts, corporations, individuals, insurance companies, investment banks, venture capital and other investment funds.

An investor making a QEI into an eligible CDE receives tax credits equal to 39% of the amount invested. The NMTCs are claimed over seven years. The investor receives a federal tax credit equal to 5% of the QEI for each of the first three years and 6% for each of the remaining four years. The CDE is required to use "substantially all" (at least 85%) of the proceeds from the QEI to make Qualified Low-Income Community Investments ("QLICI") in Qualified Active Low-Income Community Businesses ("QALICB"). QLICIs typically take the form of loans and equity investments, although there are other eligible types of QLICIs. The ultimate goal of the NMTC program is to enhance the availability of privately-sourced capital for businesses in economically distressed, underserved areas.

## What Is a Community Development Entity ("CDE")?

A CDE is a specially created entity certified by the CDFI Fund. A CDE may be formed as a domestic corporation, a partnership, or a limited liability company. To qualify as a CDE, an organization's primary mission must be to serve or provide investment capital for low-income communities or low-income persons, and the CDE must have a governing or advisory board that maintains accountability to residents of low-income communities.

## What Is a Qualified Equity Investment ("QEI")?

A QEI is a cash investment for stock of or capital interest in a CDE, which uses "substantially all" of the investment proceeds to make QLICIs. By virtue of making a QEI, the investor may claim NMTCs.

## What Is a Qualified Low-Income Community Investment ("QLICI")?

There are four types of investment that qualify as QLICIs:

- A capital investment in or loan to a QALICB;
- Purchase of a loan from another CDE that originates the loan to a qualified business;
- A loan to or equity investment in another CDE that in turn makes qualifying investments in eligible businesses;
- Financial counseling or technical advice to an eligible business or resident in a low-income community.

## What Is a Qualified Active Low-Income Community Business (“QALICB”)?

A business must meet the following eligibility requirements to qualify as a QALICB:

- The business must be located in either (a) a census tract with a poverty rate of at least 20% or (b) a census tract with a median income that does not exceed 80% of the benchmark median income.
- The business must have a substantial connection to that location. Specifically, it must demonstrate that: (a) a substantial portion of the income of the business is derived from activity in a low-income community; (b) a substantial proportion of the property of the business is located in a low-income community; and (c) a substantial portion of the services performed for the business by its employees are performed in a low-income community. The level of activity and business presence necessary to demonstrate a connection to the community varies depending on the nature of the QLICI and the business. In addition, the business must meet additional requirements to qualify.

The NMTC program steers investment capital to areas of higher distress by rewarding CDEs that invest in QALICBs located in communities that exceed the minimum eligibility requirements. Indicators of higher distress include (a) a poverty rate exceeding 30%, (b) median income less than 60% of the benchmark median income, (c) unemployment rate that is 1.5 times the national average, or (d) other indicia identified by the CDFI Fund.

## What Are the Risks to the Investor?

The most significant risk facing NMTC investors is that their tax credits will be “recaptured” if certain requirements are not continuously satisfied during the seven years following the initial investment. If a recapture event occurs, the Internal Revenue Service will reclaim all credits claimed by an investor for prior years, as well as all future credits available to the investor from a given transaction. Recapture can occur if, during the seven year period:

- The CDE ceases to be qualified as a CDE;
- The CDE redeems or “cashes out” any portion of the QEI;
- The CDE ceases to meet the “substantially all” test, which requires that at least 85% of the proceeds of a QEI are invested in a QALICB or other qualified investment; or
- A principal purpose of the transaction (or series of transactions) is to achieve a result inconsistent with the purposes of the NMTC statute.

## How Does a CDE Receive NMTCs?

NMTCs are awarded to CDEs through a competitive, multi-step application process managed by the CDFI Fund. Applicants must demonstrate the capacity and capability to use proceeds from allocated NMTCs to invest in or make loans to qualifying businesses in disadvantaged communities.

An applicant must first be certified by the CDFI Fund as a qualified CDE. In addition, the applicant must timely file an Allocation Application, through which it demonstrates that it has the requisite eligibility, capacity, experience and skills to administer an NMTC allocation.

The application focuses on the CDE’s capability to deliver significant benefits to low-income communities by gathering detailed information about the CDE’s competencies in four areas:

- Business Strategy;
- Community Impact;
- Management Capacity; and
- Capitalization Strategy.

A successful applicant must enter into an Allocation Agreement with CDFI Fund before it can provide tax credits to its investors. The Allocation Agreement sets out the terms and conditions under which the CDE can deploy NMTC-derived capital.

The NMTC application process is extremely competitive. In 2007, 258 CDEs applied for a total of \$27.9 billion in tax credit authority. The CDFI Fund awarded just \$3.9 billion in NMTCs to 61 CDEs.

## How Is a NMTC Transaction Structured?

NMTC transactions are often structured using the tax credit-derived capital to leverage traditional sources of financing. The transaction structure remains in place during the seven year compliance period. A leveraged transaction is structured as follows:

- (1) A lender provides a loan to a special purpose fund (the “Investment Fund”);
- (2) The taxpayer makes an equity investment in the Investment Fund;
- (3) The Investment Fund makes a QEI in the CDE, for which it receives tax credits equal to 39% of the amount of the investment;
- (4) The CDE uses at least 85% of the QEI to make QLICIs in QALICBs, typically in the form of loans or equity investments.

### Example of a NMTC Real Estate Transaction Structure

