An Overview of the New Markets Tax Credit Program

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An Overview of the New Markets Tax Credit Program

One of the biggest federal programs established in recent decades has been the New Markets Tax Credit program, which has sought largely to incentivize development and investment in low-income areas nationwide. The program actually operates as a tax deduction, offering a rather generous rebate to those who guide equity investments to local entities that are charged with investing in local housing projects, business developments, and other incentives that can help turn poorer communities around. The program has been in place since 2000 and it has become a boon to developers across the country, particularly in areas of major cities that have long suffered from blight and overall decline in property values, business presence, and per capita incomes.

Though the program was designed with the best of intentions, most developers and investors find its provisions challenging to navigate. The program is laid out in a very specific way, with different lays of responsibility and accountability. Those who don't take the time to fully read every part of the tax initiative and the legal guidelines will quickly find themselves ineligible for tax refunds or credits, largely eliminating the benefit of investing in NMTC funds and entities.

As with all government programs, there is nothing "short and sweet" about the New Markets Tax Credit program. There are, however, some basic terms, guidelines, and considerations that can make it easier to get started with a local investment entity. This will help kick start real estate investments, business investments, and other key elements designed to revive America's most struggling communities, without the legal headaches and loopholes that could otherwise stop developers in their tracks.

A Look at the Program: Inner Workings, Tax Benefits, and Key Terms

To fully understand how the New Markets Tax Credit program works, real estate professionals, developers, and investors, should have a basic understanding of its goals and provisions, its benefits for development, and the terms that they'll need to know when getting started with NMTC paperwork. The resolution establishing the NMTC was passed by Congress in a strongly bipartisan vote during 2000, with the goal to raise urban and blighted investments, increase the number of jobs available in these areas, and significantly raise the quality of life. The bill was designed to highlight the fact that some of the best opportunities for American businesses were not in overseas cities but within the United States itself, with plenty of markets providing budget-friendly areas for investment. This fact was specifically highlighted by then Vice President Al Gore in a meeting with Congressional leaders.

After a series of debates, the program did pass and its provisions went into effect at the start of the following tax year. The New Markets Tax Credit program relies almost entirely on a structured tax rebate system that equates to a full 39 percent refund of any investments used to fund real estate or business investment in areas designated by state and local governments as most in need. The program does not return the full 39 percent refund all in one year, however, but instead issues a partial refund of the investment over the course of seven years. The structure is as follows for those expecting a refund within the New Market Tax Credits program:

- A 5 percent rebate is issued to investors or developers for the first three years after that investment is made

- A larger 6 percent annual refund is issued for the final four years of the seven-year refund program totaling the 39 percent rebate after investment.

The reason for this longer rebate structure is generally to ensure that developers are guiding longer -term projects to fruition, rather than building quickly without a long-term plan for local benefits. This has so far worked out quite well in areas where the NMTC has been put to use. Because developers have an incentive to make sure their investment is well-utilized for at least 7 years, the result is generally a more lasting impact on local communities that continues successfully after the tax credit has ended and the developer has likely moved on to other projects.

Administration and Application Process for New Market Tax Credit Investments

Unlike a traditional tax deduction, it's not possible for developers to build something, invest in it, and then just claim the balance of the deduction as part of their personal tax return. Instead, the program is administered by the Department of the Treasury by an agency known as the Community Development Financial Institutions (CDFI) Fund. The CDFI reviews all of the applications submitted by developers nationwide and, once per year, issues an "allocation" of tax credit funds and approved projects.

Each year, the amount of this allocation varies based on the fund's overall fiscal health and the success of prior projects, as well as the promise of applications submitted to the agency. Once allocated, the tax refund can then by claimed by the developer on an annual basis. Applications that are rejected by the agency do not qualify for any tax rebates under the New Market Tax Credits program, though they can be resubmitted for the next fiscal or calendar year, and the agency can decide to approve a modified version of an earlier plan at their discretion. It should be noted that most developers work with Community Development Entities, or CDEs, that are responsible for submitting proposals and applications to the agency as part of the program, on behalf of individual developers, as part of a "pool." While this is not required, it's a standard that has easily become the norm.

Working Within the New Markets Tax Credit Program: Terms to Know and Embrace

As with all federal programs, the New Markets Tax Credit comes with its own vocabulary that can be particularly confusing and vexing to those who are not familiar with them. These terms all apply to various funds and financial entities designed to aid developers during the application process and the actual development of new housing, business facilities, or other local projects. Here's what to know.

1. Community Development Entity (CDE)

A Community Development Entity is considered a corporation by the CDFI Fund, and it essentially acts as an intermediary between developers and the funds that they wish to secure as part of the tax program. In almost all cases, the CDE is responsible for accepting development and funding applications, and then submitting those applications to the CDFI for final approval or rejection. A Community Development Entity must be certified by the CDFI Fund before it can be legally licensed as such, and this involves an inspection of the entity's corporate licensure, paperwork, and operations. Generally, the CDFI Fund issues three sweeping requirements that must apply to each CDE for certification:

- It must already be a legal entity when filing an application for certification
- The CDE's primary goal must to be help and benefit a low income community as designated by the NMTC bylaws
- It must have some form of accountability that can be invoked by residents of the targeted low income community

If these three requirements are met by the CDE, it will be certified by the CDFI Fund and it can then begin filing applications for funding approval with the Department of the Treasury. If any problems result from the certification process, they will have to be satisfactorily resolved and the CDE-in-waiting will need to apply again once that has taken place.

2. Low Income Community (LIC)

The New Markets Tax Credit program refers to any economically disadvantaged area in the country as an LIC, or low income community. These are the areas eligible for the tax credit, and the law spells out the exact criteria used to define any low income community in the country:

- The poverty rate in a given area must meet a minimum threshold of at least 20 percent, or

- The MFI, or median family income, within a given area must not exceed 80 percent of the statewide median family income in rural areas, or the metropolitan median family income for urbanized areas within a metropolitan area designated by the census.

These two considerations are verified by data in the United States Census, conducted once every ten years. If neither of the conditions can be made, then the market being served is not eligible for any funding under the New Markets Tax Credit.

3. Qualified Equity Investment (QEI)

Because the New Markets Tax Credit is setup to reward equity investments in projects designed to serve low income communities, a QEI is the first major hurdle to clear when filing for a tax credit on an annual tax return. The filer must prove that equity was invested into a local project meant to satisfy some great need of the area's low income residents. The qualifications of an approved qualified equity investment are extensive, and are listed in section 45D of the larger NMTC program legislation passed by Congress and certified by the Department of the Treasury.

4. Qualified Low Income Community Investment (QLICI)

The qualified equity investment mentioned above refers strictly to the funds guided toward low-income community projects. Those projects are known as QLICIs, or qualified low income community investments. A QLICI is instrumental in helping developers qualify for the tax credit provided for under NMTC legislation. Generally, a QLICI is identified by the Department of the Treasury by using one or more of the following criteria:

- An investment or loan made to any qualified low income community business. This is made via equity, capital, or a favorable loan designed to jumpstart that business.

- The purchase of an existing qualified loan from any other CDE in the country that was a qualified low income community investment at the time the loan was purchased. This is subject to extensive regulation within the New Market Tax Credit program bylaws, and different laws apply depending on two factors:

  a. Whether or not the purchased loan was made before the community development entity was certified by the Department of the Treasury

  b. Whether or not the loan has been purchased by a QLICI multiple times in the past

- Offering financial counseling services to qualified low income community investment businesses, residents, or other entities that either cater to low income residents or are low income themselves.

- A loan to, or investment in, another CDE serving a nearby low income community, but only if that CDE uses the loan exclusively for qualified investments in a low income community project.

5. Qualified Low Income Community Business (QALICB)

Low income community businesses can qualify for the New Markets Tax Credit program if they meet one of the following criteria set out by the program's laws and guidelines, as enforced by the Department of the Treasury:

- A minimum of 50 percent of all business income comes from active operation in a qualified low income community as defined in census data

- At least 40 percent of all business property is located and maintained with any qualified low income community or area

- A minimum of at least 40 percent of all business services performed by employees are conducted within a defined low income community under the most recent census data, so long as the business does not hold a large amount of collectables like antiques, art, and other works

- If less than 5 percent of all business and property is in collectables like art and antiques

Under these conditions, business owners in low income communities are judged to be making significant local investments in jobs, the quality of life, and the betterment of a low income area. Meeting one or more of the above provisions would qualify the business for a series of tax benefits, lasting at least seven years, under the current provisions of the tax credit program.

Impact of the New Market Tax Credit Program: A Significant Difference in Investment

The New Markets Tax Credit program was one of the first programs to deeply incentivize investment in areas that had long been abandoned by new housing and business developments. The program led to significant new investments in urban areas during the first decade of the 21st century, leading to a veritable turnaround for a number of major urban centers nationwide. Some of the largest grants in the program were delivered to cities like Philadelphia and Baltimore, largely to help stem the tide of lost industrial jobs and declining populations in low income areas. Today, both cities are steadily gaining residents and raising the median income in challenged areas.

The impact has been felt all across the country in cities with similar stories, including smaller cities and depressed rural towns. The total sum of government investment, via tax credits, in low income areas is currently more than $33.1 million. When combined with local business incentives, state government programs, and a wide array of other initiatives, this constitutes one of the largest infusions of money into impoverished areas in American history.

The program's legacy can also be seen in state programs that operate in a similar manner. In Ohio, for instance, the state has developed the Ohio New Market Tax Credit program that adds additional state benefits to those received as part of the federal legislation. Neighboring Pennsylvania has created its Keystone Opportunity Zone program, designed as a ten year tax abatement on new commercial and residential properties built within state-identified low income communities. Nationwide, this may be the most lasting legacy of the NMTC.

An Uncertain Road: The Program is Subject to Quick and Immediate Expiration

The New Markets Tax Credit program was not designed as something that would last for decade after decade. Instead, it was given a firm, eleven-year expiration date. Under the legislation as passed by Congress in 2000, the NMTC was set to expire on the last day of December in 2011. The program did expire then, and all refunds made to CDEs under the provisions of the NMTC were stopped.

A year later, at the end of 2012, Congress passed the American Taxpayer Relief Act, which retroactively extended the program through the end of 2013. Developers who missed out on a scheduled investment refund in 2012 were entitled to both that year's refund and their most latest refund, either at the 5 percent or 6 percent levels, for a total retroactive refund of between 10 percent and 12 percent.

Going forward, the future of the New Markets Tax Credit is uncertain at best. An era focused more on eliminating the national debt rather than encouraging investment in infrastructure could pose problems for an NMTC extension at the end of 2013. That would likely lead to a serious financial hit on developers, as well as legal entanglements with CDEs and other local groups. Of course, state-level investment incentives would be untouched even if the federal legislation were allowed to expire.

Hoops, Hurdles and Headaches: Developers Face Some Unique Challenges

Beyond the prospect of the New Markets Tax Credit simply being allowed to expire, there are some other legal and financial considerations to be made by developers when considering whether or not to engage with the Department of the Treasury and secure the tax incentives allowed for by the NMTC. Indeed, the program is quite well known for slowing down the overall pace of development by those who invest in low income communities, generally because of the large number of agencies, and administrative red tape, allowed for in the program.

Developers who are looking to invoke the provisions of the tax program should remember that they first need to be either a qualified business or in possession of a qualifying community investment. This must be certified by a CDE and sometimes by the Treasury. Furthermore, any funds used in a qualified business or development must be termed as qualified equity, which requires another round of approval and uncertainty for those engaging in routine developments.

Finally, the application submitted to the CDE for a tax refund under the program must also be submitted to the Community Development Financial Institutions Fund for final approval and disbursement. This can take quite a long time, especially when compared to the traditional process of merely securing development funds from a traditional financial institution. Development can proceed while the NMTC application is being approved, but many banks will simply not finance a project until they know exactly how much money is needed and whether or not they can take on the full, non-tax-exempt cost of the development.

It should be noted that developers not only need to submit their plans for a development, but they also need to conduct a study of the how that development would impact the local area. This impact study is a key part of any CDE application and it isn't cheap to conduct. It also takes time, which can further slow down a development.

The general rule of thumb when invoking the New Markets Tax Credit program is simply to be patient and to allot for a significant amount of time while securing funding, approval, and any bank loans regarding the project. Another key rule is to be thorough in every aspect of studying, planning, and funding the project. Without careful attention to every detail, applications will easily and repeatedly be denied by the Community Development Financial Institutions Fund.

A Promising Program with a Few Concerning Implications

Overall, it's hard to argue against the positive nature and the good intentions of the New Market Tax Credit. The program was designed to infuse impoverished areas with business and opportunities, and it has largely succeeded in that goal throughout the country. Invoking the program will require a great deal of time and hard work, however, so well-meaning developers should prepare themselves to interact with community groups, CDEs, and federal government agencies for the long haul.

Developers should also keep in mind that the program could be allowed to expire at any time, with immediate financial consequences. In fact, that has already happened, once, in 2011. With proper planning for all scenarios, the NMTC can still be a major community asset for struggling areas all across the country, both urban and rural.