

REINHART

ALERT

April 2003

NEW MARKETS TAX CREDIT

\$2.5 Billion Allocation

On March 14, 2003, the U.S. Treasury through its Community Development Financial Institutions Fund ("CDFI") announced the allocation of \$2.5 billion of tax credit authority under the New Markets Tax Credit ("NMTC") program. There will be additional allocations of \$1.5 billion for 2003, \$2 billion for 2004 and 2005, and \$3.5 billion for 2006 and 2007. The allocations represent the amount of investment for which NMTC may be claimed.

The Community Renewal Tax Relief Act of 2000 established the NMTC program. The purpose of the NMTC is to attract private capital to facilitate economic and community development in low-income areas. The NMTC compliments the Section 42 low-income housing tax credit ("LIHTC") which is designed to encourage development of affordable rental housing.

Under the NMTC program, investors receive a federal tax credit equal to 39% of their investment taken over a seven-year period. The investor receives a 5% tax credit on each of the first three years of the investment and a 6% tax credit on each of the next four years, for a total credit of 39%.

Because the NMTC only returns 39% of the investor's equity, the ultimate investments in the low-income community will be expected to generate a return of capital and profit. In contrast, the LIHTC allows investors to take a tax credit based on an eligible basis which includes not only their equity but also debt. Accordingly, the LIHTC is a much deeper credit and returns 125% of the investor's equity (assuming LIHTC is priced at \$.80 on the \$1.00).

Investors may leverage their equity investments. In Revenue Ruling 2003-17, issued January 23, 2003, the IRS ruled that investments may be leveraged with borrowed funds. Under this ruling, an investor combined its equity with borrowed funds and made an equity investment generating NMTC. The IRS allowed the investor to calculate its NMTC not only on the equity portion of the investment but also on the portion derived from borrowed funds.

NMTC Program Fundamentals

To obtain the NMTC, investors must make an equity investment in a qualified community development entity ("CDE"). The CDE must then invest substantially all (at least 85%) of such equity in qualified low-income community investments ("QLICI"). The "substantially all" test must be met for each annual period during a seven-year investment period.

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A QLICI may be:

- An equity investment in, or loan to, a qualified active low-income community business ("QALICB") (described below)
- The purchase of a loan made by another CDE to a QALICB
- An equity investment in, or loan to, another CDE
- Financial counseling or other similar services to businesses and residents located in low-income communities.

A QALICB is a corporation or partnership if, for the taxable year, all of the following conditions are met:

- At least 50% of the total gross income of the entity is derived from the active conduct of a qualified business within a low-income community.
- A substantial portion (at least 40%) of the use of the tangible property of the entity is within a low-income community.
- A substantial portion (at least 40%) of the services performed for the entity by its employees is performed in a low-income community.
- Less than 5% of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain collectibles.
- Less than 5% of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain nonqualified financial property.

The 50% gross income condition is deemed satisfied if either (i) at least 50% of the tangible property is used within the low-income community or (ii) at least 50% of the services performed are performed within the low-income community. This qualification is designed to help businesses with sales and customers outside

of the low-income community. There is no requirement that employees of a qualified business be residents of a low-income community.

A "qualified business" means generally any trade or business (including nonprofits) but does not include operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, race track or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. A "qualified business" may include rental of real estate located in a low-income community if the property is not considered residential. A property is considered "residential" if 80% or more of its gross income is rental income from dwelling units. Accordingly, a mixed-use property could qualify for the NMTC if more than 20% of its gross income is rental income from commercial or retail use. Residential housing developed for sale (as compared to rental) may also qualify for the NMTC.

A "low-income community" is generally determined by census tract data and may be urban or rural.

CDE Qualification

Only a qualified CDE may obtain an allocation of NMTC. To become a qualified CDE, an entity must be a domestic corporation or partnership and meet all of the following conditions:

- Its primary mission must be to serve or provide investment capital (equity or loans) to low-income communities or low-income persons.
- It must maintain accountability to residents of low-income communities through their representation on its governing board or on an advisory board.
- It must be certified as a CDE by the CDFI.

The "primary mission" condition is met if at least 60% of the products and services will be directed to low-income persons, communities or organizations serving such persons or communities. The "accountability" condition is satisfied if at least 20% of the members of its governing board or advisory board represent the low-income community.

A qualified CDE must designate one or more target areas which it intends to serve. If it serves multiple target areas, it must demonstrate accountability to the low-income communities in each area. Target areas may be local (for example, a neighborhood or municipality), multiple local (more than one neighborhood or municipality), statewide, multistate or national.

A qualified CDE receiving an allocation has up to five years to allocate the NMTC to qualified investments.

Who Should Be Interested In The NMTC Program?

Municipalities, banks, nonprofit organizations, real estate developers and venture capital funds will benefit from the NMTC program.

- Municipalities may use the NMTC to attract private capital to revitalize economically distressed communities. The program also allows municipalities to control where the capital is invested through control of their CDEs. As an example, the Phoenix Community

Development and Investment Corporation (a subsidiary of the City of Phoenix) received the largest allocation (\$170,000,000) in the first round.

- Banks may use the NMTC to increase their yields (by means of the NMTC) on loans made through their CDEs to businesses in low-income communities. In addition, NMTC investments are favorably considered for CRA performance evaluation. Finally, loans made through a CDE are more liquid because they may be purchased by another CDE as a QLICI.

- Nonprofit organizations may use the NMTC to attract private capital to promote economic and community development in their target areas.

- Real estate developers may use the NMTC to attract private capital to develop commercial or mixed-use real estate projects in low-income communities.

- Venture capital funds may use the NMTC to attract equity investment since the NMTC will generate an immediate return to the investor.

We would welcome the opportunity to meet with you to explore how your organization might benefit from the NMTC program. If you have an interest, kindly contact me at 414-298-8114 or jerich@reinhartlaw.com.

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