Tax Credits Have Financial Institutions Thinking about Developing New Markets

By Kip A. Weissman

During the waning days of the Clinton administration, the Community Renewal Tax Relief Act of 2000 (the Act) was enacted to promote private investment in designated low-income communities. This legislation attracted little notice within banking circles until very recently, in part because of significantly unresolved implementation issues.

Now that details of the U.S. Treasury Department's implementation plan have begun to emerge, it has become apparent that community financial institutions are ideally positioned to take advantage of the powerful incentives for low-income investment contained in the Act.

New Markets Tax Credit Overview

The centerpiece of the Act is the New Markets Tax Credit (NM Tax Credit). The amount of this tax credit is 39 percent of the original investment. Accordingly, in a typical NM Tax Credit transaction, an investor will earn a $39 tax credit for each $100 invested.

Under applicable IRS rules, the NM Tax Credit will be earned by investors over seven years as follows: 5 percent in the issue year and each of the following two years, and 6 percent in each of the remaining four years. As a result, the projected after-tax returns of loans and other investments made under this program are likely to be very attractive.

The amount of NM Tax Credit investment authority, which has been allocated by Congress, is $15 billion, with $1.5 billion allocated for 2003. This budget should support over $40 billion of investments in low-income communities.

The federal banking agencies have decided to allow Community Reinvestment Act (CRA) credit for investments qualifying for NM Tax Credits. Under this decision, even an NM Tax Credit loan made out of an institution's assessment area will receive CRA credit, as long as it has an impact on the assessment area.

Community Development Entities

The required investment vehicle for obtaining the NM Tax Credit is the community development entity. CDEs are government certified, for-profit corporations, partnerships, or other entities whose primary purpose is to serve and provide investment capital for low-income communities. To attain CDE status, a corporate or partnership must maintain "accountability" to a low-income community by including representatives of such community on its governing or advisory board. A CDE will be deemed to meet this accountability requirement if at least 20 percent of its governing or advisory board consists of persons residing or working in its service area.

An entity must apply to the CDFI Fund, an office within the Department of Treasury, to be designated as a CDE. This process is estimated to take two to three months from the date of submission of a properly completed application.

Permissible Investments

Only investments meeting certain criteria may qualify for the NM Tax Credit. First, the investment must be made in a business that derives at least 50 percent of its gross income from a designated low-income area.

Second, the business in which the invest-

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ment is made must maintain a substantial portion of its property and perform a substantial amount of its services in such a low-income area.

Finally, the NM Tax Credit may not be used to finance the acquisition or construction of residential real estate, although mixed use is permitted.

Based on the above, we expect that most NM Tax Credit investments will be loans to businesses operating in low-income areas. We also expect a number of major corporations to create separate subsidiaries for the purpose of operating in low-income areas and attracting financing subsidized by the NM Tax Credit.

Tax Credit Allocation

To receive the desired tax benefits, a CDE must request and receive a NM Tax Credit allocation for its proposed investments. An extensive application is required and will be considered by the CDFI Fund on an annual basis.

The CDFI Fund will allocate available tax credits on a competitive basis based on factors such as the CDE's financial strength, the experience of its principals, the financial viability of the proposed investments, the location of the underlying project and the projected impact on low-income communities. In view of the value of the NM Tax Credit, we expect this process to become increasingly competitive as market participants become more generally aware of it.

The NM Tax Credit program is a work in progress and, as of December 15, 2002, the CDFI Fund had not yet made any NM Tax Credit allocations. The CDFI Fund first opened the application process for tax credit allocations in June 2002 and is expected to begin awarding the first NM Tax Credits in early 2003.

The CDFI Fund is not currently accepting applications for NMTC Tax Credits. Although there has not yet been any formal announcement of the dates for 2003 tax credit applications, based on informal discussions with the CDFI Fund staff, we currently expect the 2003 application process to open sometime in the spring with a cutoff near Labor Day 2003.

Financial Institution Participation

We expect that financial institutions will participate in the program in several ways. First, community financial institutions will form their own CDEs (as wholly owned service corporations or operating subsidiaries) to secure tax credits to subsidize their low-income loans and other investments. To date, over 50 institutions have already created a CDE.

Second, financial institutions may also acquire NM Tax Credits by making investments in funds sponsored by third parties specializing in CDE investments.

Finally, some aggressive financial institutions may even determine to sponsor or manage their own CDE investment funds.

Many community financial institutions have found it difficult to make low-income business loans on a profitable basis. The NM Tax Credit is a new technique that may make an activity that is good for an institution's "soul" also beneficial to its shareholders.

Kip A. Weissman is a partner in the Washington, D.C. office of Jenkens & Gilchrist, P.C.