

**TEMPORARY REGULATIONS GOVERNING THE  
NEW MARKETS TAX CREDIT PROGRAM**

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**The New Markets Tax Credit (NMTC) program provides a 39 percent credit over seven years to taxpaying investors making equity investments in certified Community Development Entities (CDEs), which in turn will make loans, investments, and provide technical services to businesses in low-income communities.**

**On December 26, 2001, the Assistant Secretary of the Treasury for Tax Policy, and the Internal Revenue Service (IRS) issued temporary, or interim, regulations implementing the NMTC program.**

**The following summarizes the Treasury/IRS regulations and defines many key features of the tax credit. (Words in italics represent terms defined by the Treasury.)**

**QUALIFIED EQUITY INVESTMENT**

**Background:** The law defines a *qualified equity investment* as an equity investment in a CDE. The investment must be in cash; the tax-paying investor must claim the tax credit; and the CDE must use the investment for the purposes specified by the law. *Substantially all* of the cash derived from such investments must be used by the CDE for *qualified low-income community investments*. From the time the CDE receives an allocation of tax credits, it has up to five years to place the credits and receive *qualified equity investments*.

**Temporary Regulation:** The *temporary rule* tracks the law on the definition of *qualified equity investments*. In general, an investor cannot claim an equity investment in a CDE until the CDE has received an allocation from the CDFI Fund.

The regulation contains a “look back” provision that permits investments in CDEs made on or after April 20, 2001 to be deemed *qualified equity investments* if:

- A) the entity receiving the investment is certified as a CDE before January 1, 2003;
- B) the entity receives a tax credit allocation by January 1, 2003; and
- C) the investment satisfies the other requirements of the regulations.

In this case, the effective date of the investment is the date when the CDE receives the allocation.

The regulations prohibit the use of *qualified equity investments* to make investments in other CDEs. This provision prevents “double-dipping” on the NMTC. For example, CDE #1 is prohibited from using cash from its *qualified equity investments* to make a *qualified equity investment* in CDE #2 and thereby receiving a tax credit.

## SUBSTANTIALLY ALL

**Background:** The law requires that *substantially all* of the proceeds from NMTC investments be used to lend or invest in low-income communities. The statute provides two options to meet the *substantially all* requirement. Under the *safe harbor* standard, a CDE is deemed to meet the requirement if it can demonstrate that 85 percent of its aggregate gross assets are deployed in qualified activities. Alternatively, the Secretary of the Treasury may determine that the CDE meets the requirement, in which case the CDE must trace each dollar invested to a qualified activity.

**Temporary Regulation:** The temporary rule generally requires that either 85 percent of the cash received from the taxpayer in return for the tax credit must be directly traceable to *qualified low-income community investments* or 85 percent of the aggregate gross assets of the CDE must be deployed in qualified activities.

The rule provides some discretion and flexibility to a CDE:

- A) up to 5 percent of the cash received in *qualified equity investments* may be set aside for loan loss reserves and future investments;
- B) from the time it receives an NMTC investment, a CDE has up to one year to meet the *substantially all* test;
- C) the *substantially all* rate falls to 75 percent in the seventh year of the tax credit in order to allow a CDE to phase out its NMTC investment program; and
- D) the CDE need not reinvest periodic loan repayments and repayments for loans, capital, or equity received in the seventh year.

For periodic loan repayments, CDEs will have until the end of the calendar year following the year in which the principal is received to re-deploy funds in *qualified low-income community investments*. For equity investments, CDEs will have up to 12 months to reinvest the funds.

Calculations used to determine *substantially all* compliance will be on a cost basis. Under the direct-tracing option, the dollar total of the *qualified low-income community investments* is divided by the dollar total of the *qualified equity investments*. Under the *safe harbor* option, the dollar total of gross assets in *qualified low-income community investments* is divided by the aggregate gross assets of the CDE. The temporary regulations indicate that the government will only regulate cash received from a taxpayer in return for NMTCs. Interest income and profits from loans, equity investments, or capital are *not* included in the basis for the NMTC and are not part of the formula for *substantially all*.

## QUALIFIED ACTIVE LOW-INCOME COMMUNITY BUSINESSES

**Background:** The law limits CDE loans or investments to *qualified active low-income community businesses*, defining such businesses as deriving at least 50 percent of their gross income from the active conduct of business in a low-income community and having a substantial portion of their tangible assets and services located in a low-income community. In general,

businesses whose principal purpose includes collectibles or long-term lending are not deemed eligible.

**Temporary Regulation:** Businesses eligible to receive CDE investments are those corporations or partnerships (including sole proprietorships or unincorporated trades or businesses) that are active and located in low-income communities. In general, improved rental property, other than residential property, is eligible. Rental properties in which income from residential rental units does not exceed 80 percent of total income are also eligible. For the most part, a business whose principal purpose is development or holding of intangible property is not eligible. Most private financial institutions are not eligible.

A *qualified active low-income community business* must derive at least half its gross income from the eligible area. In addition, at least 40 percent of its tangible property as well as at least 40 percent of services performed by employees of the business are in a low income community. CDEs may provide investments to *qualified active low-income community businesses* that are owned in whole or in part by the CDE.

Alternatively, a business is deemed eligible if at least 50 percent of either services or tangible assets **and** 40 percent of either services or tangible assets (but not the same as previous) are located in any low-income community.

It is important to note that for businesses with multiple locations the regulations allow a CDE to treat each location as a separate entity for purposes of determining eligibility as a qualified business.

The regulations ease compliance issues by establishing a *reasonable expectations* test. A business should qualify as a *qualified active low-income community business* throughout the entire period of the investment or loan if the CDE reasonably expects that, at the time that the CDE made the *qualified low-income community investment* in the business, it would meet the qualification requirements. (This provision will not apply in cases in which a CDE has ownership control over the business receiving a *qualified low-income community investment*.) The *reasonable expectations* test simplifies the task of compliance for the NMTC. However, the regulations do not prescribe the standards by which a CDE could meet the *reasonable expectations* test.

Neither the law nor the regulations require that a business hire or propose to hire low-income community residents in order to qualify.

## **DIRECT DEVELOPMENT**

**Background:** The law and regulations permit a CDE to make *qualified low-income community investments* in businesses that it owns.

**Temporary Regulation:** The *temporary rule* stipulates that if a CDE owns (*directly* or *indirectly*) at least 33 percent of a business, is the largest single owner, and has a controlling interest in the business, the *reasonable expectations* test for eligibility of the business does not

apply and the business must meet the requirements of the definition of a *qualified low-income business* for the entire period in which the CDE controls the entity or when a CDE gains control of a business during the NMTC period, using a *qualified low-income community investment*.

## **QUALIFIED LOW-INCOME COMMUNITY INVESTMENTS**

**Background:** The law defines *qualified low-income community investments* as loans, equity investments, or capital to *qualified active low-income community businesses*. Included are loans made by CDEs, investments of loan in CDEs, financial counseling, and other services to businesses located in low-income areas and residents of low-income areas.

**Temporary Regulation:** The *temporary rule*:

- A) limits financial counseling and other services to *qualified active low-income businesses* and to residents of low income communities;
- B) stipulates that, in situations involving the purchase of loans from another CDE, the loan purchased must be a *qualified low-income community investment*. The entity from which the loan is purchased is a CDE at the time the loan is made or at the time the loan is purchased;
- C) permits a CDE to use the NMTC to purchase an entity that made a loan in 1999 so as long as the loan meets the other requirements of a *qualified low income community investment* and the entity selling the loan is certified as a CDE; and
- D) provides that a CDE may make *qualified low-income community investments* in other CDEs if the CDE receiving the investment uses the proceeds to make loans or investments in or provide financial counseling to *qualified active low-income community businesses*. Thus a CDE receiving an investment from another CDE cannot take advantage of the NMTC unless it carries out a program meeting the requirements of the NMTC statute and regulations.

## **RECAPTURE**

**Background:** The law requires *recapture* of tax credits in cases in which the CDE loses its status or falls out of compliance with the *substantially all* requirement, and when an investment in a CDE is redeemed. When a *recapture* event occurs, the investor holding a *qualified equity investment* generally loses the tax credit for all taxable years and owes interest to the beginning of the tax credit period.

**Temporary Rule:** The IRS has the authority to grant a waiver of the *recapture* requirement or an extension before the requirement is implemented. This will allow a CDE to explain the circumstances leading to a proposed recapture and to seek relief in the form of a waiver of recapture or an extension of time to come back into compliance.

## **USE OF NEW MARKETS TAX CREDIT WITH OTHER FEDERAL TAX SUBSIDIES**

**Background:** The law prohibits the use of NMTCs with other direct and indirect federal tax subsidies including the Low Income Housing Tax Credit and the exclusion from gross income

for certain bonds of the NMTC. The rule does not prohibit the use of NMTCs in projects in which there is also financing from federal tax exempt bonds, state tax exempt bonds, federal or state grant funds or loan guarantees.

The temporary rule seeks additional comment on the appropriate policy regarding the use of other federal tax benefits with the NMTC program.

#### **QUALIFIED LOW-INCOME COMMUNITY**

**Background:** The law identified certain census tracts with high incidences of poverty or low median incomes. In addition, the law provides eligibility for communities in unqualified census tracts that can meet either the poverty or median income threshold and have a demonstrated lack of investment capital.

**Temporary Regulation:** The *temporary rule* tracks the law: Any census tract with a poverty rate of at least 20 percent or, for tracts not located in metropolitan areas, with a median family income that does not exceed 80 percent of that statewide median family income. Alternatively, an applicant may designate a *target area*, defined as a community with pre-existing boundaries, such as established neighborhoods or political or geographic boundaries that also meets the poverty rate or median income standard **and** has a demonstrated lack of investment capital.