

NATIONAL COMMUNITY CAPITAL ASSOCIATION

CAPITAL FOR SOCIAL, ECONOMIC AND POLITICAL JUSTICE

COMMUNITY DEVELOPMENT

TRAINING & CONSULTING

POLICY

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FINANCING

THE NEW MARKETS TAX CREDIT

NCCA is please to announce that we received an \$8 million New Markets Tax Credit allocation. In total, 66 applicants received allocations in this first round announced by the CDFI Fund on March 14, 2003. Of these 66, 19, or \$670 million of the allocation, went to NCCA members representing 27% of the total \$2.5 billion allocation. Congratulations to those organizations that have received allocations.

NCCA will use its allocation to finance Member CDFIs that make qualifying NMTC loans and/or investments.

The New Markets Tax Credit program will spur the investment of \$15 billion of new private capital into CDFIs and other entities that make loans and equity investments in low-income businesses. This tax credit provides an opportunity for CDFIs to raise loan and investment capital at a lower cost, with the potential to bring billions of dollars of new capital to the industry.

- CDFIs: Accessing NMTC Resources Through NCCA
- Investors: Investment Opportunities Through NCCA
- How to Use New Markets Tax Credit Money
- NMTC Application and NCCA Issues for CDFIs
- Timeline and NMTC News
- Summary of NMTC Regulations
- Local Education Issues Related to NMTC [PDF]
- For more information: contact Beth Lipson at 215.320.4315 or beth@communitycapital.org

Links to Additional NMTC Resources:

- CDFI Fund Website
- NMTC Application [PDF]
- NMTC Notice of Allocation Availability [PDF]
- IRS Temporary Regulations [PDF]
- NMTC Statute [PDF]
- CDFI Fund CDS Definition Application [PDF]
- The NMTC Coalition
- Impact of the Administration's Dividend Tax Exemption Proposal on the New Markets Tax Credit, March 2003 [PDF]

CDFIS: ACCESSING NMTC RESOURCES THROUGH NCCA

National Community Capital received an \$8 million NMTC allocation to make loans to CDFIs (that are qualified CDEs). CDFIs will need to use the proceeds from our investment to invest in eligible businesses in low-income communities (which include non-profit and for-profit businesses, childcare centers, charter schools, community health facilities, housing developer—for homeownership, and commercial real estate). We are excited about the opportunity to increase our financing capacity to fund economic development in low-income communities.

Your CDFI may save significant costs and resources by working through National Community Capital to participate in the NMTC program rather than applying directly.

- **Applying for Allocation:** You will not need to take valuable staff time to apply for an allocation and work with the CDFI Fund to negotiate and close that allocation.
- **Legal Costs:** You will not need to start a for-profit affiliate to participate in the NMTC (as you would if you were applying directly for an allocation) or develop a prospectus for new potential equity investors.
- **Development Staff Time:** You will not need to spend staff time recruiting investors to capitalize your CDE and close investments.

NCCA will make low-cost debt financing available to member CDFIs eliminating the need for the CDFI to go through the steps involved in accessing the tax credit directly (i.e. establish a for-profit LLC, apply for CDE certification, apply for allocation, sell equity to investors, etc.). **Please Note: Applicants for financing must be National Community Capital Members.** If you are not yet a Member, please ~~apply for membership~~ as soon as possible. CDFIs must be approved for membership before their financing application will be considered. For information on the benefits of membership and how to become a member, ~~click here~~.

By working with NCCA, your CDFI can focus on its core activity of making loans and investments in low-income communities while accessing valuable NMTC resources. Please contact Beth Lipson at ~~www.communitycapital.org~~ if you are interested in learning more about NCCA's plans.

INVESTMENT OPPORTUNITIES THROUGH NCCA

National Community Capital is developing a CDFI Tax Credit Fund that will raise capital to provide financing to high-performing CDFIs to make qualifying loans and investments to community facilities, businesses, and housing developers in low-income communities.

The CDFI Tax Credit Fund will use the proceeds to make loans and equity investments in CDFIs throughout the United States that:

(1) Are Members of National Community Capital, a network of more than 140 performance-driven CDFIs.

(2) Demonstrate financial and portfolio strength, and strong

management capacity.

(3) Demonstrate an ability and pipeline to utilize the proceeds in New Markets Tax Credit-eligible projects.

For more information, contact Beth Lipson at beth@communitycapital.org or 215.320.4315.

HOW THE NEW MARKETS TAX CREDIT WORKS

On December 21, 2000, the Congress enacted the New Markets Tax Credit (NMTC), which is designed to generate \$15 billion in new private sector equity investments that will in turn spur business growth in low-income rural and urban communities. Investors that make up to \$15 billion in investments in community development entities will be eligible for tax credits. The investments eligible for tax credits are for the follow amounts: \$2.5 billion in 2002 (including \$1 billion rolled over from 2001), \$1.5 billion in 2003; \$2 billion in 2004 & 5; and \$3.5 billion in 2006 & 7. This exciting new legislation has the potential to bring billions of dollars of new capital to the CDFI industry.

Investors in a qualified community development entity (CDE) will receive a tax credit for their investment. That tax credit is spread over 7 years and equals 39% of the amount of the investment. If a taxable investor receives a tax credit for their investment, they should require a lower rate of return for that investment than they would in the absence of a tax credit. What that means for your CDFI is that if a taxable investor, such as a bank, makes an investment in your CDFI, that investor could receive an acceptable return in the form of a tax credit benefit even if you pay them a very low (even 0%) rate of return! Furthermore, an investor values a tax credit as they would tax-exempt income. For example, a bank investor in the 33% tax bracket would view a 5% tax credit as the equivalent of a 7.5% ($5\% / (1 - 33\%)$) pre-tax yield. Thus, the NMTC will help CDFIs raise more capital for their loan and investment programs at a lower cost, since 7.5% in and of itself is substantially higher than most CDFIs currently pay their lenders and investors in interest and dividends.

One factor which reduces the value of the tax is the tax credit reduces the basis of the investments, so that investors will need to pay capital gains tax when their investment principal is returned. For example, if an investor invests \$1 million, the tax credit reduces their investment basis by \$390,000 (39%), and they will be required to pay a capital gain tax on \$390,000 when their \$1 million investment is returned to them.

To access an NMTC allocation, you must be a Community Development Entity or CDE. A CDE is an organization that (i) has the primary mission of serving, or providing investment capital for, low-income communities or low-income persons and (ii) maintains accountability to residents of low-income communities through their representation on a governing or advisory board and (iii) receives certification as a CDE from the Department of Treasury. Community development financial institutions that have been certified by the CDFI Fund and specialized small business

investment companies are automatically deemed to be CDEs, and can register on-line at the CDFI Fund website. However, affiliates or subsidiaries of certified CDFIs will need to apply for CDE certification. CDCs, banks, and other organizations that meet the above criteria (or start an affiliate corporation that meets the above criteria) can apply to become a CDE as well.

CDEs will apply to the Treasury Department for an allocation of New Markets Tax Credits (NMTC). The credits will be awarded competitively based on a CDE's track record, capitalization strategy, management capacity, and community impact. The CDFI Fund will administer the NMTC program for the Treasury Department.

Once a CDE has secured an NMTC allocation, it will seek private equity investors. Equity investors in the CDE will qualify for a tax credit equal to 5% of their investment amount each year for the first 3 years of the investment and 6% of their investment amount for each of the next 4 years.

The CDE must use substantially all, or 85%, of the capital generated from the sale of NMTC equity to fund loans to, or equity investments in, for-profit or non-profit businesses that are operating in low-income census tracts (which the CDFI Fund approximated were 33% to 40% of all census tracts). Eligible businesses include commercial businesses, nonprofit childcare providers, charter schools, healthcare centers, housing developers (for homeownership) and commercial real estate projects, but exclude rental of residential properties. CDEs can also use the proceeds to provide financial counseling to eligible businesses, to invest in or lend to other CDEs (which in turn use the proceeds for qualified loans and investments in businesses) or to purchase qualified loans or equity investments from other CDEs.

There are many different ways in which CDFIs will be able to take advantage of New Market Tax Credits. The most common ways will be:

- For-profit CDFIs, such as banks and venture capital funds that qualify as CDEs, will be able to offer tax credits to their equity investors that invest directly in the CDFI.
- Non-profit and for-profit CDFIs may form a for-profit affiliate (that qualifies as a CDE), raise equity investments for the affiliate, and then use the capital to originate qualifying loans and investments. Alternatively, the for-profit CDE could purchase eligible loans and investments from its parent CDFI.
- CDFIs that engage in commercial real estate development may apply for allocations of the NMTC that will enable them to enhance returns for equity investors in those projects.
- CDEs that purchase qualifying loans from other CDEs will also be able to tap the NMTC. This means that CDFIs could ultimately benefit from a larger and more active secondary market for many of the loans they generate, even if they elect not to take advantage of the NMTC directly.
- Intermediaries (such as National Community Capital) can form for-profit affiliates, which will apply for an allocation of NMTC in order to invest in CDFIs that qualify as CDEs,

3 which in turn will invest in qualified businesses. Individual CDFIs that elect not to participate in the NMTC program directly will still be able to benefit by borrowing from or receiving equity investments from an intermediary.

NMTC APPLICATION AND NOAA: ISSUES FOR CDFIS

2 CDFIs are well-positioned to take advantage of the tax credit directly (by applying for an allocation), or indirectly (by receiving a loan/investment from an intermediary that receives an allocation or selling loans to an intermediary).

The application is favorable to CDFIs (relative to other types of entities applying for credits) in that CDFIs have a solid track record in providing loans and investments in economically disadvantaged communities. The NOAA and application address this issue in the following ways:

- NCCA has been working to have priority given to those groups with the greatest community impact. We were pleased that the NOAA states that applicants will score well if they are working in particularly economically distressed or otherwise underserved communities and if they show demonstrable community development and economic impacts that would not be achieved without NMTCs. The NOAA also notes that "the goal is to address limitations of financial markets by facilitating the flow of equity capital into areas not being adequately served by conventional lenders and investors". We believe that CDFIs are very well-positioned in terms of these community impact measures relative to other groups that may be applying for NMTCs.
- There are priority points available to those applicants with a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities.

The main area where CDFIs may have a disadvantage to other types of entities applying (i.e. commercial real estate funds, banks) is in the capitalization strategy.

- Applicants will be evaluated on their track record of obtaining investors in the past (including specifically for-profit investors), their current investor commitments as of the date of the application submission, and their plan for raising the remainder of its capital. Many applicants will have a long track record in recruiting for-profit equity investors, will have many of their prospective investors lined up, and will be paying higher returns than CDFIs may pay on their equity investments. CDFIs in our membership, do, however, have a long track record of recruiting bank investors who have traditionally paid very below-market rates for their debt and EQ2 investments, with no investor losses. CDFIs will need to demonstrate to banks and other for-profit investors that they can manage both credit risk associated with equity (not debt) investments and recapture risk.

HIGHLIGHTS OF THE APPLICATION MATERIALS

1. Evaluation Criteria:

The application and NOAA highlight the areas that will be evaluated in the NMTC application which will include:

1. **Business Strategy:** the applicant's experience in assessing demand on its proposed products, an applicant's experience in making investments in low-income communities, and the extent to which an applicant has already established a pipeline of identified or potential investees and projects.
2. **Capitalization strategy:** an applicant's track record of obtaining investors in the past (including specifically for-profit investors), its current investor commitments as of the date of the application submission, and its plan for raising the remainder of its capital.
3. **Management Capacity:** the experience of the applicant's management team, board of directors, and/or advisory board, with specific focus on their experience deploying capital, providing technical assistance, raising capital, fulfilling compliance requirements of other governmental programs, and with asset and risk management.
4. **Community Impact:** the level of community representation in developing and carrying out the applicant's business strategy, whether the applicant is working in distressed communities, and the impacts that would not be achieved without NMTCs.

The application requests the applicant's timeline for utilizing an NMTC allocation. While the statute gives CDEs 5 years upon which to close on NMTC equity investments after receiving an allocation, we believe that applying for an allocation that can be used in the next 2-3 years is more realistic and competitive.

Note: A non-profit can apply for an allocation, with the idea that if they receive an application, they will establish a for-profit CDE and transfer the allocation to the for-profit CDE. If you are a certified CDFI, you can register on-line to become a CDE in less than 5 minutes.

2. BEA Program:

- A bank cannot receive BEA credit and NMTC credit for the same investment in a CDE.

3. NMTC Application:

- The application is a detailed series of questions related to business strategy (including historical and projected loan volume), capitalization strategy and plans, management expertise and community impact. The application is an electronic application, and applicants will only submit materials requested. The applicant will not need to submit additional business plans, 5-year projections, or other materials. The application is user-friendly and clear.

4. Compliance Monitoring:

- We were hoping that more detailed information would be included in the NOAA and application about the Fund's plans in terms of monitoring (1) compliance with the NMTC program (i.e. what do you need to track to demonstrate that the businesses you invest in pass the tangible property and services test), and (2) impact of the program. The Fund has indicated that it plans to publish more information on monitoring and evaluation in Fall 2003.

TIMELINE AND WHAT'S NEXT

12-00: Congress enacted the New Markets Tax Credit as part of the Community Renewal Tax Relief Act of 2000 legislation on December 21, 2000.

04-01: On April 21, 2001, the CDFI Fund issued guidance on the NMTC program, and the IRS issued an advance notice of proposed rulemaking about the NMTC. These documents together provide some preliminary information on the application process to become a CDE and the criteria upon which applications for allocations of credits will be made. The documents also raise a number of issues for public comment, which ended on July 2, 2001.

12-01: CDFI Fund issued an application for and guidance on becoming a CDE.

12-01: IRS issued temporary regulations for the NMTC program. All information on the NMTC program can be accessed through the Fund's website at:

<http://www.cdfifund.gov/newmarkets/index.cfm>

6-02: CDFI Fund issued Notice of Allocation Availability (NOAA) and application.

8-02: First round applications were due.

3-03: CDFI Fund announced the recipients of the 2002 NMTC allocations.

Summer/Fall-03: Second round of NMTC applications will be due. The Fund has not announced the timeline for the next round of allocations.

SUMMARY OF NEW MARKETS TAX CREDIT REGULATIONS

The New Markets Tax Credit (NMTC) promises to change substantially the landscape for equity investments in CDFIs. The NMTC will substantially enhance the rate of return that a CDFI can offer its investors during the first seven years of that investment. A summary of the program is below.

A taxpayer who holds a "qualified equity investment" in a

Community Development Entity will receive a New Markets Tax Credit. Each year for the first 3 years of the investment, the NMTC will equal 5% of the investment amount. Each year for the next 4 years, the NMTC will equal 6% of the amount invested. Consequently, the NMTC is altogether equal to 39% of the face amount of the investment, or roughly 30% in net present value terms at the time the investment is made.

A Community Development Entity (CDE) is any corporation or partnership that (i) has the primary mission of serving, or providing investment capital for, low-income communities or low-income persons, (ii) maintains accountability to residents of low-income communities through their representation on a governing or advisory board and (iii) receives certification as a CDE from the Department of Treasury.

Community development financial institutions (CDFIs) that are certified by the CDFI Fund and specialized small business investment companies (SBICs) are automatically deemed to qualify as CDEs, and can register on-line for certification. However, subsidiaries or affiliates of CDFIs will need to apply separately for CDE certification.

A Qualified Equity Investment is any "equity investment" in a CDE if (i) the investor acquires that investment at its original issue solely in exchange for cash and (ii) substantially all of that cash is used by the CDE to make "qualified low-income community investments". That equity investment in the CDE must be made within 5 years after the date that the CDE enters into a NMTC allocation agreement with the CDFI Fund.

The CDE must use "Substantially All" of the cash from the equity investment to make Qualified Low Income Community Investments. Substantially All is defined as 85% or more. Substantially all can include loans and investments outstanding, the cost of financial counseling to businesses located in low-income census tracts, as well as loan loss reserves of up to 5% of cash investments. As a safe harbor, the CDE will automatically be deemed to have satisfied the requirement that it use substantially all the investment proceeds to make qualified low-income community investments if at least 85% of the aggregate gross assets of the CDE are invested in qualified low-income community investments. At the beginning of the credit period, a CDE will have 12 months to meet the substantially all test and the substantially all percentage drops to 75% in the 7th year of the tax credit. For repayments, a CDE will have 12 months following the repayment to re-deploy the funds. For partial loan repayments received during the year, the CDE will have until the end of the following calendar year to reinvest the funds.

An Equity Investment is (i) any stock (other than certain types of preferred stock), and (ii) any capital interest in a partnership.

A Qualified Low-Income Community Investments is (i) any capital or equity investment in, or loan to, any "qualified active low-income community business", (ii) the purchase from another CDE of any loan made by such CDE which is a qualified low-income community investment, (iii) financial counseling and similar services to businesses located in, and residents of, low-income

communities, and (iv) any equity investment in, or loan to, any CDE if the CDE uses the proceeds to invest in low-income community businesses or for financial counseling.

A Qualified Active Low-Income Community Business is any for-profit or non-profit corporation or partnership if (i) at least 50% of the total gross income of that business is derived from the active conduct of its business within any "low-income community", (ii) a substantial portion (defined as at least 40%) of the use of the tangible property of that business (whether owned or leased) is within any low-income community, (iii) a substantial portion (defined as at least 40%) of the services performed by that business' employees are performed in any low-income community, (iv) the business is not primarily holding collectibles, and (v) less than 5% of the average of the aggregate unadjusted bases of the business' property is attributable to certain types of financial assets. The gross income test is deemed to be satisfied if 50% is substituted for 40% for either the tangible property test or services test. The rental to others of real property shall be treated as a qualified business only if (i) the property is not residential rental property and (ii) there are substantial improvements located on such property. The term "qualified business" excludes (i) any business consisting predominantly of the development or holding of intangibles for sale or license, (ii) certain recreational facilities (iii) farms exceeding a certain asset size, and (iv) most financial institutions.

The regulations go a long way on easing compliance issues by establishing a reasonable expectation test. The regulations provide that an entity should qualify as a Qualified Active Low-Income Community Business throughout the entire period of the loan or investment if the CDE reasonably expects that, at the time the CDE makes the Qualified Low-Income Community Investment, the entity will satisfy the requirements. If a CDE owns (directly or indirectly) at least 33% of a business, is the single largest owner, and has a controlling interest in the business, the reasonable expectation test for eligibility does not apply.

A Low-Income Community is any census tract in which: (i) the poverty rate is at least 20%, or (ii) (a) in the case of a tract not located within a metropolitan area, the median family income for the tract does not exceed 80% of statewide median family income, or (b) in the case of a tract located within a metropolitan area, the median family income for the tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income. The Treasury Department can also designate any area within any census tract as a low-income community if: (i) the boundary of such area is continuous, (ii) the area would satisfy the definition of "low-income community" if it were a census tract, and (iii) inadequate access to investment capital exists in such area.

For each calendar year, the limit on the amount of investments that can be allocated by the Treasury Department for the NMTC is: (i) \$1 billion for 2001 (which will be rolled over to 2002), (ii) \$1.5 billion for 2002 and 2003, (iii) \$2 billion for 2004 and 2005, and (iv) \$3.5 billion for 2006 and 2007. In making allocations, the Department will give priority to any CDE: (i) with a record of having successfully provided capital or technical assistance to disadvantaged

businesses or communities, or (ii) which intends to make qualified low-income community investments in 1 or more businesses in which persons unrelated to that CDE hold the majority equity interest. If the allocation limit for any year is not reached, then the unused portion of the NMTC limit will carryover to subsequent years.

If, at any time during the 7-year period following a qualified equity investment, (i) the issuing CDE ceases to be a CDE, (ii) the proceeds of the investment cease to be used as required, or (iii) the CDE redeems the investment, the NMTC will be recaptured. The amount recaptured will be the amount of the NMTC that has been used by the taxpayer for that investment plus non-deductible interest thereon.

The basis of a qualified equity investment will be reduced by the amount of the NMTC allowed with respect to such investment.