New Markets Tax Credit
Spurring Investment for Business Growth in Urban and Rural Communities

What is the New Markets Tax Credit?

On December 21, 2000, the Community Renewal Tax Relief Act of 2000 was signed into law as a result of a bipartisan initiative of President Clinton and Speaker Hastert, and key Republican and Democratic Senators and Representatives. This landmark legislation includes the New Markets Tax Credit, which will spur the investment of $15 billion in new private capital into a range of privately managed investment vehicles that make loans and equity investments in New Markets businesses.

By making an equity investment in an eligible "community development entity" (CDE), individual and corporate investors can receive a New Markets Tax Credit worth more than 30 percent of the amount invested over the life of the credit, in present value terms. Eligible CDEs could include for-profit community development financial institutions (CDFIs), for-profit subsidiaries of community development corporations, SBA-licensed New Markets Venture Capital companies, and Specialized Small Business Investment Companies. A number of pioneering community-based institutions have demonstrated track records in finding viable market opportunities in areas often overlooked by traditional investors. By increasing their capital base, this tax credit will enable CDEs to lend and invest more, to attract additional outside capital, and to bring even more private-sector engagement to their market-priming activities.

Why Do Businesses in Low-Income Urban and Rural Areas Need Help in Accessing Capital?

Markets in America's inner cities and distressed rural areas possess enormous untapped economic potential. However, growing businesses in these communities are unlikely to attract the attention of venture capitalists who generally work within their existing relationships and communities. The smaller local venture funds that exist in some communities may have difficulty raising capital, developing deal flow, providing the requisite investment and management expertise, and managing the risks inherent in less diversified local economies. Greater distances in rural areas often mean that capital providers may incur higher costs for travel and information. That is even more true of businesses in isolated rural or inner-city communities that are cut off from mainstream business networks. In urban markets, information barriers may prevent investors and lenders from discovering and fully appreciating business opportunities.

Why is Equity Capital Especially Important to Businesses?

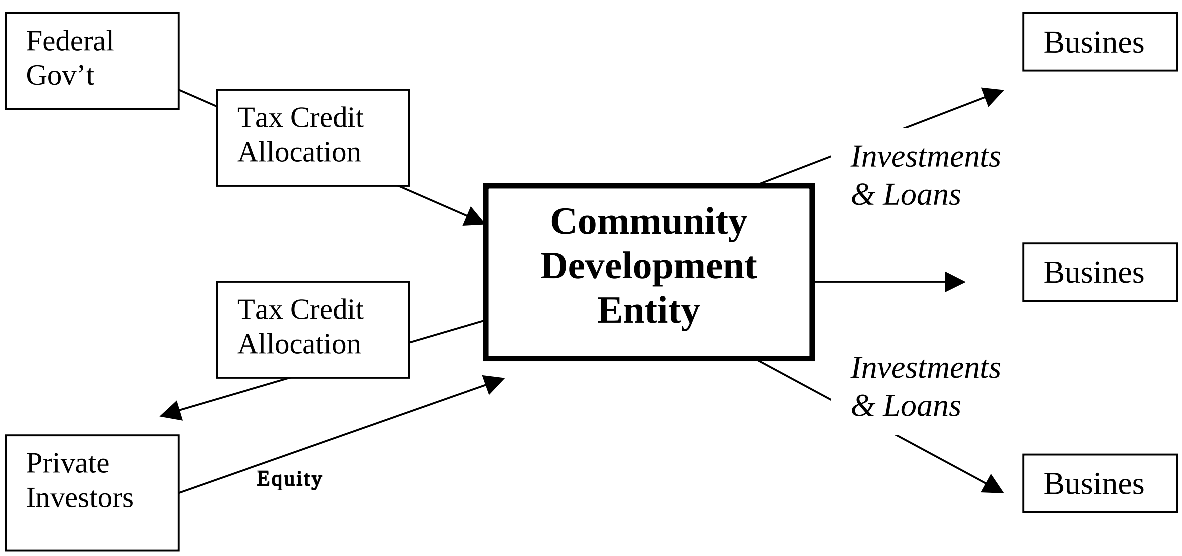
Equity capital can provide small businesses with "patient" capital – capital that can be used to grow a business before a return on the funds is due to the investor. A healthy equity capital base in a business relieves some short-term cash flow pressures, allowing the firm room to innovate and introduce new products, cultivate new sales leads, and hire and train new staff. In addition, equity capital can increase a small business's creditworthiness, which can lower its cost of financing and better enable it to leverage additional sources of financing. Finally, an equity cushion helps a firm absorb unforeseen setbacks and weather temporary economic downturns.

How Will the New Markets Tax Credit Work?

Eligible CDEs will apply to the Treasury Department's CDFI Fund for an award of New Markets Tax Credits. The application and selection will be based on objective criteria, including the expertise of the management team and the experience of the CDE in working with disadvantaged businesses and communities. Once a CDE is awarded tax credit allocations, the CDE is authorized to allocate its given amount of tax credits to private equity investors in the CDE.

When an equity investment is made in the CDE, investors will be able to claim a 5 percent credit on the investment amount for each of the first 3 years, and a 6 percent credit for each of the next 4 years. During the life of the investment, the tax credit will total over 30 percent of the investment, in present-value terms.

HOW NEW MARKET TAX CREDITS WORK



What Investors will be Eligible for the New Markets Tax Credit?

Any taxable investor – including an individual, a company, or an investment fund – that makes an equity investment in a qualified CDE is eligible for the tax credit. The kind of eligible investors that may be interested in New Markets Tax Credits include banks and thrifts, insurance companies, investment banks, venture capital and other investment funds, finance companies, individuals, corporations, and others.

What Businesses will Qualify for CDE Loans and Investments?

The CDE, using its local knowledge and expertise, will decide what businesses to invest in or lend to with the funds it raises with the New Markets Tax Credit. Almost all businesses located in low- or moderate-income areas could qualify for loans or equity investments. Based on the portfolio of existing successful business investors in New Markets areas, typical firms could include: small technology firms, inner-city shopping centers, manufacturers, retail stores or microentrepreneurs. A business must meet the following two eligibility requirements to qualify:

- First, the business must be located in either a census tract with a poverty rate of at least 20 percent OR a census tract with a median income that does not exceed the greater of 80 percent of the median income for the MSA, or 80 percent of the statewide median income.

- Second, the business must have a substantial connection to that location, as measured by the following criteria: at least 50 percent of the business's income must be derived from activity in a low-income community; a substantial proportion of the business's property must be located in a low-income community; the employees of the business must perform a substantial proportion of their work in the low-income community; and less than 5 percent of the business's assets can be held in unrelated investments.

These requirements may be met by the business unit receiving the investment, such as a branch plant or division of a company, rather than the entire corporate entity. This means that a company does not need to establish a new corporation in the eligible census tract, so long as the CDE's investment can be traced to the facility in the low-income census tract.

What Types of Community Development Entities will be Eligible for the New Markets Tax Credit?

The New Markets Tax Credit will build upon the knowledge and expertise of local institutions that understand the local business terrain and have a proven record of success in community and economic development. A wide range of for-profit community development entities will qualify including: community development banks or venture funds; community development corporations; small business investment companies focused on low- and moderate-income communities; New Markets Venture Capital companies; and other investment funds serving low- and moderate-income communities. Tax credits could also be awarded for investments in national or regional funds that invest in local community development entities. Similarly, tax credits could be provided for secondary market funds that purchase eligible loans or investments from the originating entity. The following are examples of some of the types of CDEs that the New Markets Tax Credit is designed to assist.

- **Community Development Financial Institutions (CDFIs)**
  CDFIs are specialized financial institutions that are located in, and serve low- and moderate-income areas. CDFIs provide a wide range of financial products and services including mortgage financing for first time home-buyers, financing for community facilities, commercial loans and investments to start or expand small businesses, loans to rehabilitate rental housing, and financial services needed by low-

income households and businesses. These institutions also provide technical assistance to small businesses and credit counseling to consumers. CDFIs include community development banks and thrifts, credit unions, loan funds, venture capital funds, and microenterprise loan funds. The Treasury Department's CDFI Fund certifies and funds CDFIs nationwide.

- **Community Development Corporations**
  Community development corporations (CDCs) that establish for-profit subsidiaries, limited liability companies, or partnerships may be eligible for equity investments by NMTC investors. Like CDFIs, CDCs have as their primary mission serving the economic and social needs of their communities. CDCs have an extensive history of serving distressed areas and utilizing tax credit tools, such as the low income housing tax credit, to build affordable housing.

- **New Markets Venture Capital Companies**
  The newly created New Markets Venture Capital (NMVC) companies, licensed by SBA, will target smaller firms in low-income areas with good growth prospects that will benefit from capital, managerial, and entrepreneurial assistance. NMVC companies will expect a slightly lower return than conventional venture capital firms, and they will be equipped to provide intensive business advice. NMVC companies must have $5 million minimum in private equity, plus $1.5 million raised from private sources to provide technical assistance during the investment period.

- **Small Business Investment Companies focused on Low- and Moderate-Income Areas**
  Small Business Investment Companies (SBICs) are private venture firms which are licensed by the SBA to invest in small growing businesses. In order to encourage SBICs to invest greater amounts of capital in inner cities and in rural areas, the SBA introduced a new investment category – "LMI Investments" – for financings made in low- and moderate-income geographies, or for financings in businesses that employ a significant percentage of people from such geographies. Any SBIC whose primary mission is making investments in LMI geographies, will be able to apply for the New Markets Tax Credit.

Further questions? Please consult the Treasury Department's CDFI Fund website, in late April 2001, at www.treas.gov/cdfi/.