Double Sided

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

President Clinton's FY 2000 budget includes a "New Markets Tax Credit" to help spur $6 billion in private sector investment for business growth in low and moderate income rural and urban communities. Businesses in our nation's inner cities and isolated rural communities often lack access to equity capital to grow and succeed. To help attract new capital to these businesses, President Clinton is proposing a new tax credit for equity investments in these communities. Investors would be able to claim a tax credit worth 25 percent of the amount invested, in present-value terms. Investments in a wide range of investment vehicles focused on serving these communities would be eligible for the credit. Over the next five years, these funds would be able to attract an aggregate of $6 billion in new equity capital eligible for the tax credit.

What investment funds can use the tax credit? To provide flexibility and attract a range of investors, investments in a wide range of vehicles would qualify. Under the proposal, the Treasury Department would allocate tax credits to investment vehicles whose primary mission is to serve low and moderate income communities. These might include community development banks or venture funds, community development corporations (including for-profit subsidiaries of nonprofits), small business investment corporations focused on low and moderate income communities, funds established under SBA's new programs - America's Private Investment Companies and New Market Venture Capital Firms - or other investment funds set up to serve low and moderate income communities. Tax credits could also be provided for investments in designated national or regional funds that, in turn, invest in local community development funds. Similarly, tax credits could be provided for secondary market investments for qualified purposes.

What businesses would qualify? The designated investment entities would make their own decisions, based on local knowledge and expertise, about what investments or loans to make to help create and grow businesses in low and moderate income communities, subject to certain rules designed to ensure that the businesses are operating in these communities. A wide range of businesses could be funded by these investment entities, from small technology firms to inner city shopping centers, from manufacturers with hundreds of employees, to retail stores.

How would the tax credit work? Investment funds would apply for designation. Designated entities would be given the authority to allocate a given amount of tax credits to investors. The entities would use the tax credits to attract investment capital, and then provide the investors with tax credit authorizations, worth approximately 25 percent of their investment (in present-value terms). On their tax returns, the investors would claim a 6 percent tax credit for each of five years of a mandatory minimum holding period on their investment. The investment funds would report to the Treasury Department on the tax credit allocations made and on the use of the investment for qualified purposes.

> "The New Markets Tax Credit is the most significant proposal for the economic development of distressed urban and rural communities in a generation." Michael Rubinger, President and CEO of Local Initiatives Support Corporation (LISC)

PROVIDE NEW MARKETS TAX CREDIT

Current Law

In general, there are limited tax incentives for investing and making loans to businesses in low-income communities. For example, current law provides for targeted tax incentives that are intended to encourage investment in specialized small business investment companies that are licensed by the Small Business Administration to make loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

Reasons for Change

Businesses in our nation's inner cities and isolated rural communities often lack access to equity capital to grow and succeed. To help attract new capital to these businesses, a new tax credit for equity investments in these businesses is proposed.

Proposal

In general.—Taxpayers would be allowed a credit against Federal income taxes for qualified investments made to acquire stock or other equity interests in a selected community development entity. The credits would be allocated to selected community development entities by the Department of Treasury, pursuant to regulations to be issued by that Department. For each year during the period 2000-2004, the Treasury Department would be permitted to authorize selected community development entities to issue an aggregate of $1.2 billion of equity interests with respect to which credits could be claimed under the proposal (a total of $6 billion of new equity investment). If the selected community development entity fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization would be canceled, and the Treasury Department would have up to two years to authorize another community development entity to issue equity interests for the unused portion.

The credit allowed to the investor (either the original purchaser or a subsequent holder) would be a six-percent credit for each year during the five-year period after the equity interest is purchased from the selected community development entity. A taxpayer holding a qualified investment would be entitled to a credit on each credit allowance date (meaning each one-year anniversary, during a five-year period, of the date the investment was originally purchased from the community development entity). The taxpayer's basis in the investment would be reduced by the amount of the credit. The credit would be subject to the general business credit rules.

Qualified investments.—"Qualified investments" which entitle the investor to a credit must be common stock or other similar equity interest acquired from a selected community development entity in exchange for cash.[7] The stock or other equity interest must not be redeemed (or otherwise cashed out) by the selected community development entity for at least five years. Substantially all of the proceeds of the investment must be used by the community development entity to make "qualified low-income community investments," meaning equity investments in, or loans to, qualified active businesses located in low-income communities.[8] Qualified low-income community investments could be made directly by a selected community development entity, or could be made indirectly through another community development entity.[9]

Community development entities.—"Community development entities" that could apply for credit allocations would include (but would not be limited to) Community Development Financial Institutions, Community Development Corporations, Small Business Investment Corporations-LMIs, New Market Venture Capital Firms, America's Private Investment Corporations, or other investment funds (including for-profit subsidiaries of nonprofit organizations). To be selected for a credit allocation, the community development entity's primary mission must be serving or providing investment capital for low-income communities or low-income persons, the entity must maintain accountability to residents of low-income communities (through representation on governing or advisory boards, or otherwise), and at least 60 percent of the aggregate gross assets of the entity must be invested in "qualified low-income community investments" or residential property located in low-income communities.[10]

As part of the credit allocation process, the Treasury Department would certify entities as eligible "community development entities." Certified entities would be required to file annual

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[7] To ensure that credits are available only for new equity investments in selected community development entities, the term "qualified investment" would not include any stock or other equity interest acquired from a community development entity which made a substantial stock redemption or distribution (without a bona fide business purpose therefor) in an attempt to avoid the purposes of the proposal.

[8] If at least 85 percent of the aggregate gross assets of the community development entity are invested (directly or indirectly) in equity interests in, or loans to, qualified active businesses located in low-income communities, then there would be no need to trace the use of the proceeds from the particular stock (or other equity ownership) issuance with respect to which the credit is claimed.

[9] A community development entity would be treated as indirectly making "qualified low-income community investment" when it purchases loans previously made by another community development entity which, in turn, uses the proceeds from the transaction to provide additional capital to qualified active businesses located in low-income communities.

[10] Expenditures made by a community development entity to provide financial counseling and certain other services to businesses located in, and residents of, low-income communities would also be treated as "qualified low-income community investment."

reports demonstrating that they continue to meet all the requirements for initial certification, and would be required to identify the amount (and purchasers) of equity interests with respect to which allocated credits may be claimed by the purchaser and to demonstrate that the entity monitors its investments to ensure that capital is used in low-income communities.

If an entity fails to be a community development entity during the five-year period following the taxpayer's purchase of an equity interest in the entity, or if the equity interest is redeemed by the issuing entity during that five-year period, then any credits claimed with respect to the equity interest would be recaptured and no further credits would be allowed.

Low-income communities.--For purpose of the credit, "low-income communities" would be defined as census tracts with either (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) median family income which does not exceed 80 percent of metropolitan area income (or for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income).

Qualified active businesses.--"Qualified active businesses" generally would be defined as businesses[11] which meet the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities; (2) a substantial portion of the use of the tangible property of such business is used within low-income communities; (3) a substantial portion of the services performed for such business by its employees are performed in low-income communities; and (4) less than 5 percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property (e.g., debt, stock, partnership interests, options, futures contracts) or to collectibles (other than collectibles held primarily for sale to customers).

For purposes of the credit, there would be no requirement that employees of a "qualified active business" be residents of the low-income community. Rental of improved commercial real estate located in a low-income community (e.g., an office building or shopping mall) would be a qualified active business, regardless of the characteristics of the commercial tenants of the property. In addition, a qualified active business that receives a loan from a community development entity could include an organization that is organized and operated on a non-profit basis. The purchase and holding of unimproved real estate would not be a qualified active business. In addition, a qualified active business would not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license, (b) operation of any facility described in sec. 144(c)(6)(B) (e.g., commercial golf course, country club, massage parlor, hot tub facility, suntan facility, liquor store); or (c) any business if a significant equity interest in such business is held by a person who also holds a significant equity interest in the community development entity.

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[11] As under current-law section 1394(b)(3)(D), the term "qualified active business" would include any trade or business which would qualify as such a business if the trade or business were separately incorporated.

Regulatory authority.—The Treasury Department would be granted authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations limiting the benefit of the proposed tax credit in circumstances where investments are directly or indirectly being subsidized by other Federal programs (e.g., low-income housing credit and tax-exempt bonds), and regulations preventing abuse of the credit through the use of related parties. The Treasury Department would issue regulations describing the certification process for community development entities, annual reporting requirements for such entities, and application of the low-income community investment requirements to start-up entities.

Effective date.—The proposal would be effective for qualified investments made after December 31, 1999.

Statement of Needs and Purposes

New Markets Venture Capital Program.

The SBA's Small Business Investment Company (SBIC) program has proven to be an exceptionally effective vehicle for meeting the growth capital needs of America's small businesses. Last year alone, SBICs invested $3.2 billion in 3,456 financings, 89 percent of which were equity oriented. This is estimated to be 45 percent of the total number of institutional venture investments made during 1998. However, despite this overall success, the SBIC program is much less effective in addressing the growth capital needs of the smaller businesses located in urban and rural areas. A new program is needed for that -- the New Markets Venture Capital program.

The proposed New Markets Venture Capital legislation would authorize SBA to provide financial assistance to entities that agree to make equity-type investments in and to provide technical assistance to smaller enterprises (as defined in 13 CFR §107.710(a)) located in low and moderate income (LMI) geographies (to be defined by SBA). These entities would be known as "New Markets Venture Capital companies" or "NMVCs."

Investment by NMVCs in smaller enterprises located in LMI geographies would be expected to build wealth and to provide increased employment opportunities in these locations. The NMVCs would provide specialized technical assistance to help the businesses grow.

SBA representatives have spent more than a year researching the concepts and structures of development venture capital, in the U.S. and abroad, to develop this proposal. Three separate

SBA-sponsored roundtables were convened, and numerous individual and small group meetings with practitioners and academicians were held. Representatives from banks, licensed SBIC/SSBICs, community development funds, and the academic and legal communities provided particularly valuable assistance in refining the concepts.

From these efforts, a number of conclusions were reached:

1. Need for venture capital in LMI geographies. The availability of equity-type capital is essential for viable small businesses to grow vigorously since it is the foundation upon which most debt financing is structured. While an embryonic venture capital community is starting to develop in many urban and rural areas, it is fragmented and seriously undercapitalized. An SBA program could contribute significantly to institutionalizing this activity and expanding it nationally, much as the SBIC program did for the general venture capital industry.

2. Structural flexibility of program. Any program that is developed to reach both urban and rural areas must be flexible enough to meet the special needs of the various types of targeted small businesses found in these different locations. The program also must be flexible enough to be delivered through different types of community-based venture development organizations, which tend to be uniquely structured.

3. Potential return on investment. Development-oriented venture investments in selected urban and rural small businesses should be able to provide a positive, although modest, financial return. Such a return is needed to sustain the investment vehicle.

4. Need for technical assistance. Intense, highly focused technical assistance to the small

business is essential if equity-type investments for this market are to be viable. Technical assistance encompasses one-on-one business or financial consulting as well as substantive assistance in all elements of business operations.

5. Minimizing cost of program. The cost of an NMVC program can be lowered through the utilization of existing local resources. Currently there are a number of organizations that successfully employ venture capital to develop and build viable small businesses in their communities with the objective of providing employment and creating value. The NMVC program should leverage off of the skills, experience, and entrepreneurial infrastructure that existing groups have already developed.

Overview of the Proposed Program

SBA would select firms to participate as NMVCs. Unlike SBICs, NMVCs would not be licensed by SBA. Instead, SBA would enter into an agreement with each NMVC setting forth the specific terms of that firm's participation in the program. Each agreement would be tailored to the particular NMVC's operations and would be based on the NMVC's own proposal, submitted as part of the NMVC's application form. SBA would provide two types of financial assistance to NMVCs – (1) guaranteed debenture leverage, and (2) grant funds to supplement the NMVC's own technical assistance resources. SBA would examine the NMVCs at regular intervals to determine compliance with the SBA contract.

Commencement of the Program

If the necessary legislation is enacted, SBA will announce the commencement of the NMVC program and will make application packets available to parties interested in applying to participate as NMVCs.

Criteria for Selection of Participants

It is proposed that program participants satisfy the following requirements:

Each NMVC must be a newly-formed for-profit entity, which may be a newly formed for-profit subsidiary of an existing entity, with at least $5 million of contributed capital or binding capital commitments from non-Federal investors.

Each NMVC's management team must be experienced in some form of community development or venture capital financing.

Each NMVC must have binding commitments (in cash or in-kind) for technical assistance and overhead, payable or available over a multi-year period not to exceed 10 years, in an amount equal to 30% of its committed and contributed capital. These commitments may be from any non-SBA source and the cash portion may be invested in an annuity payable semi-annually over a multi-year period not to exceed 10 years. This ensures that the NMVC has sufficient resources to perform its functions of oversight and technical assistance during the most critical years when monies are being invested. Based upon a showing of special circumstances and good cause, SBA could approve a company that has a viable plan to raise the required amount for marketing, management and technical assistance.

SBA would select the program participants. Specific selection criteria would be developed by SBA and would be designed to ensure that a variety of investment models are chosen and that appropriate public policy goals are addressed. Geographic dispersion would be taken into account in the selection process.

SBA's Commitment of Resources to the NMVCs

SBA's commitment of resources to each NMVC would combine SBA-guaranteed supplemental funding (leverage) and grant(s) to supplement the NMVC's technical assistance and overhead funds.

Leverage

It is expected that the leverage would consist of SBA-guaranteed debentures with a ten-year term, zero coupon for the first five years (i.e., no interest payable during the first five years). In other words, the instruments would be discounted at issuance, and after five years they would achieve their face value with interest payable semi-annually until maturity. The face value of the debentures would be payable at maturity.

The debenture interest rate would be established in a similar way to the SBIC debenture leverage (a spread over the 10-year Treasury rate).

At a 6% discount rate, the proceeds would be $74.41 per $100 face value.

Technical Assistance Grant

Each NMVC would be eligible for one or more grants, on a matching basis, in an aggregate amount equal to the amount the NMVC makes available for technical assistance. The technical assistance grant would be made available to the NMVC semi-annually over a multi-year period not to exceed 10 years. SBA also would be authorized to provide supplemental grants to NMVCs.

Total Program Amount

The program will require such subsidy budget authority as may be necessary to guarantee up to $100 million of debentures, and will require up to $30 million to make technical assistance grants, for the purposes of this program, to remain available until expended. At a 15% subsidy rate for the guaranteed leverage, the program would require a $45 million one-time appropriation -- $15 million for guarantees and $30 million for technical assistance grants.

The budget authority must be available for at least the three-year period required to establish the program, and preferably longer to allow the NMVCs to commence operations.

NMVC Program Administration and Oversight

Oversight of the NMVC program would be modeled after that developed for the SBIC program and administered by SBA's Investment Division. It would include a close working relationship between SBA analysts and NMVC management teams, detailed reporting requirements, frequent on-site examinations to evaluate performance and conformance with the operating plan, and careful analysis of the firm's economic impact.

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America's Private Investment Companies: HOW APIC WILL WORK

June 1999

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America's Private Investment Companies: HOW APIC WILL WORK

America's Private Investment Companies (APICs) will provide capital to large-scale businesses in low and moderate income areas, both urban and rural.[1] Just as America's support for the Overseas Private Investment Corporation (OPIC) helps promote growth in emerging markets abroad, the APIC program will encourage a dramatic increase in private investment in this country's untapped markets. It will be jointly administered by the **U.S. Department of Housing and Urban Development (HUD)** and the **U.S. Small Business Administration (SBA)** to combine HUD's expertise in large-scale revitalization with SBA's venture expertise and financing tools. APIC is part of the **New Markets Initiative** announced by The White House in January of this year.

The APIC program is designed to address the capital needs of a broad array of firms and industry sectors, including commercial real estate. For example, an individual APIC could help finance:

- Establishment of a new facility, such as a call center, data processing "back office," or factory, by a large company (or small company joint venturing with a large one).
- Expansion of an existing facility (or "campus"), the upgrading of equipment , or the expansion of staff by a mid-size manufacturing company seeking to increase production.
- Expansion of the service area of a mid-size service company, such as a trucking company, building contractor, or home health care firm.
- Development of a multi-tenant shopping center, or opening or expanding a large retail company in a new geographic area.
- Buyout of a company to be revitalized in its existing facility.
- Acquisition of the property of a departing large company and development of an incubator or industrial park.
- And more.

A requested budget authority of $36 million in credit subsidy for Fiscal Year 2000 will guarantee an estimated $1 billion in debt. Combined with $500 million in private equity, the program would have a total impact of $1.5 billion per year or $7.5 billion over the next five years. Designed to fit hand-in-glove with the proposed **New Markets Tax Credit**, an APIC selected to receive an allocation of tax credits could offer investors a tax credit on their equity (up to 6% per year over 5 years for a net present value of up to 25%).

[1]Eligible areas include those census tracts in which 20% or more of the population was in poverty or in which the median family income for the tract was less than 80 percent of the area median family income. For rural (nonmetropolitan) communities, "area" refers to the statewide median.

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The Steps: How the Program will Work

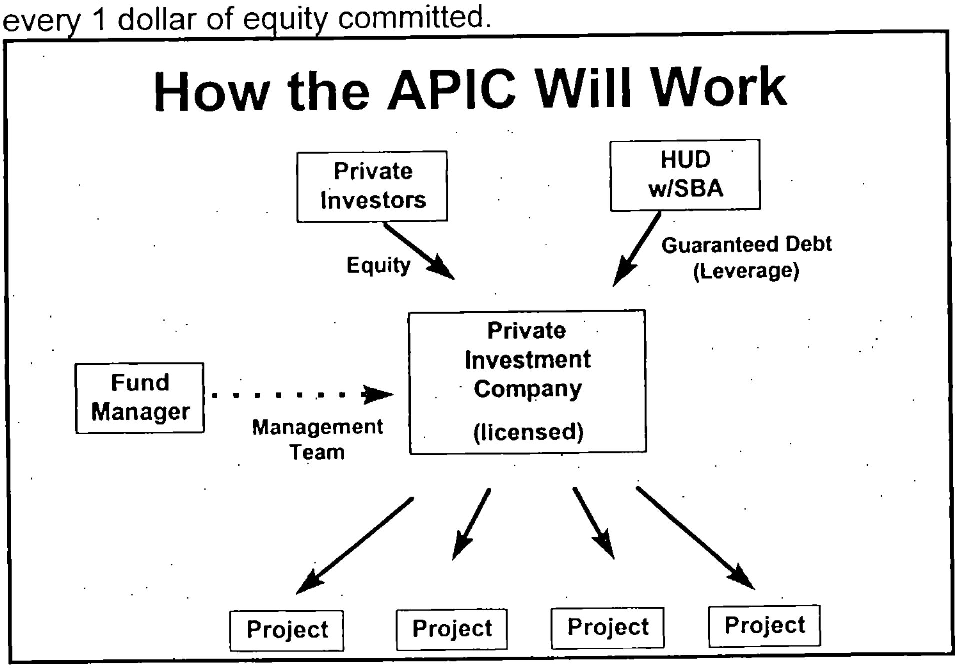
The APIC program is not a direct loan or grant program from government to the businesses. Instead, modeled after the successful SBA Small Business Investment Companies (SBICs) and OPIC Investment Funds programs, APIC will create a new generation of large-scale private investment companies that find and invest in promising untapped market opportunities in distressed areas. Low and moderate income areas of urban and rural America are especially starved for equity capital—the first money into a deal and the first at risk. APIC is designed to address that equity gap, in particular, although the investment companies will be able to invest both equity, debt and, if they choose, securities that combine the features of debt and equity.

Here's how APIC will work, step-by-step...

Step 1

The fund manager lines up potential investors willing to invest in an APIC.

Fund managers seeking to license and operate investment companies under the APIC program will begin by obtaining commitments of private equity capital. The program offers government-guaranteed leverage on that equity at a ratio of 2 dollars of debt for every 1 dollar of equity committed.



Who will these investors be? What's in it for them? APIC is designed to appeal to a wide array of investors—individuals as well as institutions. Investors could include:

- Corporations

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- Banks (such investments could receive favorable consideration under the Community Reinvestment Act)
- Insurance companies
- Pension funds
- States and local governments, plus other public and quasi-public economic development entities
- Individual investors, including "social investors"
- Foundations (as program-related investments)
- Other nonprofits

Benefits to the Investor, Protection for the Tax Payer. The program offers debt at favorable, government-guaranteed rates, which improves the return on investor equity. In addition, for individuals and for tax-paying institutions, an allocation of the New Markets Tax Credit could further boost return. The private equity investment, in turn, act as a "shield" for the tax payer dollar—every dollar of equity capital must be lost before any of the government-guaranteed debt is lost. This structure has created a tremendous financial discipline in the successful SBA and OPIC programs after which APIC is modeled—and leveraged significant job creation at very low cost to the tax payer.

How big will the funds and the deals they finance be? With a minimum equity capitalization of $25 million and an expected maximum of $150 million, APICs will create large-scale investment companies with combined capital (private equity plus government-guaranteed debt) of $75 - $450 million. It is expected that each APIC would carry about 9-12 large-scale deals (of about $5 - $50 million apiece) in its portfolio, diversifying and spreading risk across those projects. Finally, the investors' return is the blended return across these deals.

Together, the new and existing tools in the Administration's **New Markets Initiative** address the wide range of financing needs, from start-up through mature companies, and all are eligible for the New Markets Tax Credit:

Program	Agency	Business Target	Features
New Market Venture Companies	SBA (proposed)	Start-ups and existing businesses	Technical assistance, guaranteed debt
Small Business Investment Companies/LMI Investments	SBA (launched)	Small businesses up to $18M in net worth	Guaranteed debt and participating securities
America's Private Investment Companies	HUD/SBA (proposed)	Large, mature companies	Guaranteed debt
New Markets Tax Credit	Treasury (proposed)	*All of the above*	Tax credit on equity invested

Many prospective APICs will probably begin to identify deals before they have applied for a license—as part of developing an investment strategy and information network.

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Step 2

The Secretary of HUD invites applications for APIC licenses.

HUD will issue a "call for proposals" announcing selection criteria that will guide the licensing of each APIC. The key criteria will be:

- Quality of the management team (track record in direct equity investment and portfolio management, including expertise in community development settings).
- Quality of an investment strategy—a kind of "business plan" that describes how the APIC will focus its activity.
- A plan to achieve its public purpose goals that address such performance targets as high-wage jobs and community development impacts.

The first two criteria —financial expertise together with a strong plan – are the key factors driving licensing of SBICs by SBA and of OPIC's Investment Funds. The third criterion reflects the public policy aims of the APIC program: to create jobs and promote the development of low and moderate income areas.

Step 3

HUD and SBA jointly review proposals, and HUD selects those APICs that best respond to the call for proposals. The chosen investment companies receive a license, an allocation of credit subsidy commitments and, if further designated, an allocation of New Markets Tax Credits.

Each selected APIC will receive a license to operate under the terms of the program and receive: (a) an allocation of credit subsidy commitment (enough to guarantee debt up to twice the amount of the APIC's equity capital); and (b) APICs selected to also receive an allocation of New Market Tax Credits could offer investors tax credits on their equity investments.

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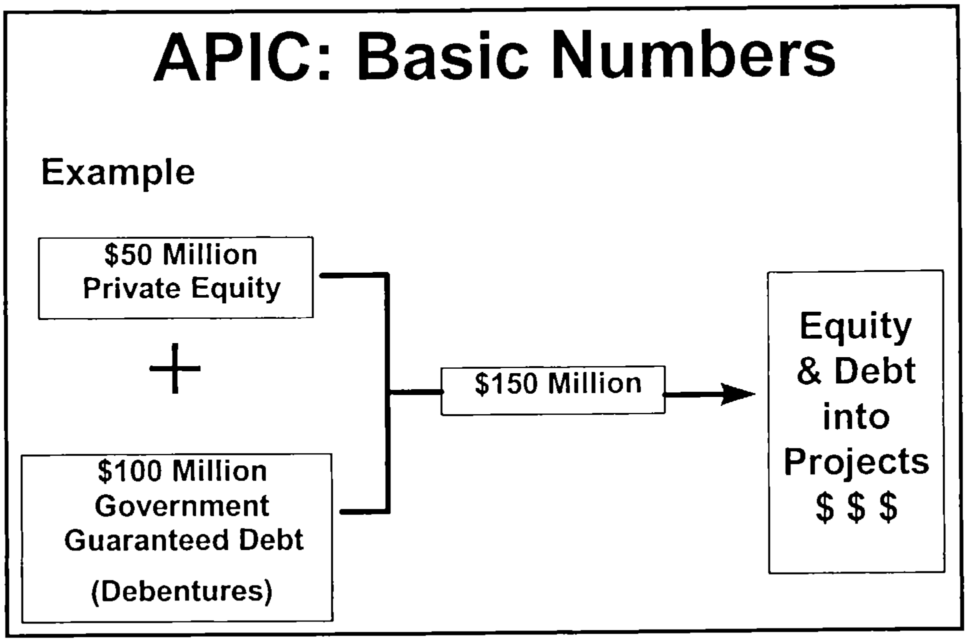

Step 4

The APICs find qualified investment opportunities (deals) in low and moderate income areas.

What will these deals look like? Just as APIC is designed to appeal to a wide array of investors, it is also designed to address the capital needs of a broad array of firms and industry sectors, including commercial real estate. The diversity of the potential financing deals highlighted on the first page show the range of ways that an APIC can promote growth in emerging markets.

Will state or local governments or other public entities play a role? Public and quasi-public entities with economic development objectives can play a number of important roles in the APIC program. As we've begun to outline above, they can assist by:

- Finding interested fund managers and encouraging them to develop an APIC proposal that addresses the needs of a particular region or sector.
- Investing as an equity partner in an APIC.
- Helping licensed APICs identify promising investments—acting as part of the APIC's information network. In this way, APICs will provide state and local governments and other stakeholders with a market-savvy vehicle to vet a wide variety of large-scale business development proposals.

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On the other hand:

- The program will <u>not</u> encourage states and localities to "pirate" large employers from one jurisdiction to another. The APIC legislation has been drafted to include an anti-pirating provision to ensure that the investment companies are helping to grow the economy and help businesses expand, not make unprofitable investments simply to move a firm from one place to another.

Step 5

The APIC prepares to issue debentures (debt) in order to raise funds to invest in a deal.

When an APIC has found a deal or deals that it wishes to invest in, the APIC will submit to HUD four basic certifications that the investment or investments meet program guidelines:

1. The project is in an LMI area.
2. The project meets the terms of the New Markets Tax Credit (is in a real operating business that employs people, for example).
3. For any debenture issue that includes an APIC's first funding of a project (but not for subsequent funding of the project), that the project meet the requirements for review under the National Environmental Policy Act (or is one of the broad array of "exempted" or "excluded" investment types not likely to have a significant impact on the human environment).
4. Beyond the features of the individual investment, the APIC itself must be in compliance with the terms of its license.

Like OPIC and SBA for their analogous programs, HUD will not conduct a project-by-project review of the APIC's proposed investment—HUD will not look at financial projections, for example, since the equity investors themselves will be focused on the potential financial risk and reward. The certifications, and HUD's expedited review of the same, are merely to ensure that the government guarantee on debt, which will enable large-scale investments that may have significant economic and human impacts, is indeed being extended to activities in keeping with the aims of the program.

Where the "leverage dollars" come from. Following HUD's review for sufficiency of the APIC's program certifications, the APIC would issue debentures, that the U.S. government would guarantee, to a financial intermediary (e.g., the Federal Home Loan Bank of Chicago plays this role in SBA's SBIC program). Upon buying the debentures, the intermediary would transfer the proceeds, less fees, to the APIC. Periodically, the intermediary would pool the debentures, and issue a trust certificate backed by the pool. The certificate would also be guaranteed and it would then be sold to investors on Wall Street. If less expensive than this market financing, the Federal Financing Bank in the U.S. Treasury is authorized to perform these debenture financing roles.

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Step 6

The APIC provides capital to the business, contributing to job creation and community development, and begins to repay the debentures.

The APIC is now in full operation with fund invested in active businesses. HUD expects to set terms of the debt financing (debentures) that respond to the cash flow realities of many promising investments in low and moderate income areas—especially the most distressed rural and inner-city communities. Favorable terms might include "zero coupon" or other features that defer interest payments early in the life of the investment to give it a chance to grow, or participating securities that include repayment features based on the APIC's overall profitability.

"Rolling over" investment proceeds. What if an APIC wishes to sell its interests in a given deal and "roll over" the proceeds into new qualified investments in targeted areas, instead of repaying the debenture right away? An APIC with significant "deal flow" (strong investment prospects outstanding) could re-invest in a new deal by following these steps. The APIC would first purchase Treasury securities with the proceeds of the sale of its investment. It would then submit to HUD the same certifications that apply to a new debenture issue, according to Step 5 above. Upon review for sufficiency and approval by HUD, the APIC would then sell the securities and apply the proceeds to the new investment. This manner of roll over of proceeds avoids the need to issue new debentures. It would also allow the APIC to maintain a larger, more risk-diversified portfolio than it would have if, when it sold off an investment, it had to repay debenture(s) outstanding.

Step 7

The APIC will regularly collect data on its investments and report progress.

Like any well-run private investment company, the APIC will collect data on the performance of the businesses in which it has invested. Periodically, each APIC will be reviewed by HUD for sound financial management practices, for financial solvency and exposure, and for performance against the APIC's self-defined public purpose goals—the goals defined at the time of the APIC's successful application for a program license.

Breaches of sound financial management, as well as fraud or mismanagement or violations of license terms, may lead to penalties. On the other hand, high performance consistent with APIC's public purpose goals may be rewarded, for example with the opportunity for greater leverage of the APIC's equity – perhaps 3 dollars of debt for every 1 dollar of equity committed.

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Step 8

The APIC "winds up"—selling its investments, paying off debentures, and returning profits to its investors.

The "life cycle" of an APIC will vary. If the SBICs are any indication, some APICs will make investments, watch them mature, and sell them off—perhaps long before the maximum debenture period of 21 years. Others will sell off their interests in particular businesses earlier still and then "recycle" the proceeds into new businesses that meet the program's targeting criteria. Ultimately, however, the APIC will sell off all interests, fulfill any remaining debt obligations, and return profits to its investors.

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Spurring Investment for Business Growth in Urban and Rural Communities

President Clinton's FY 2000 budget includes a "New Markets Tax Credit" to help spur $6 billion in private sector investment for business growth in low and moderate income rural and urban communities. Businesses in our nation's inner cities and isolated rural communities often lack access to equity capital to grow and succeed. To help attract new capital to these businesses, President Clinton is proposing a new tax credit for equity investments in these communities. Investors would be able to claim a tax credit worth 25 percent of the amount invested, in present-value terms. Investments in a wide range of investment vehicles focused on serving these communities would be eligible for the credit. Over the next five years, these funds would be able to attract an aggregate of $6 billion in new equity capital eligible for the tax credit.

What investment funds can use the tax credit? To provide flexibility and attract a range of investors, investments in a wide range of vehicles would qualify. Under the proposal, the Treasury Department would allocate tax credits to investment vehicles whose primary mission is to serve low and moderate income communities. These might include community development banks or venture funds, community development corporations (including for-profit subsidiaries of nonprofits), small business investment corporations focused on low and moderate income communities, funds established under SBA's new programs – America's Private Investment Companies and New Market Venture Capital Firms – or other investment funds set up to serve low and moderate income communities. Tax credits could also be provided for investments in designated national or regional funds that, in turn, invest in local community development funds. Similarly, tax credits could be provided for secondary market investments for qualified purposes.

What businesses would qualify? The designated investment entities would make their own decisions, based on local knowledge and expertise, about what investments or loans to make to help create and grow businesses in low and moderate income communities, subject to certain rules designed to ensure that the businesses are operating in these communities. A wide range of businesses could be funded by these investment entities, from small technology firms to inner city shopping centers, from manufacturers with hundreds of employees, to retail stores.

How would the tax credit work? Investment funds would apply for designation. Designated entities would be given the authority to allocate a given amount of tax credits to investors. The entities would use the tax credits to attract investment capital, and then provide the investors with tax credit authorizations, worth approximately 25 percent of their investment (in present-value terms). On their tax returns, the investors would claim a 6 percent tax credit for each of five years of a mandatory minimum holding period on their investment. The investment funds would report to the Treasury Department on the tax credit allocations made and on the use of the investment for qualified purposes.

"The New Markets Tax Credit is the most significant proposal for the economic development of distressed urban and rural communities in a generation." Michael Rubinger, President and CEO of Local Initiatives Support Corporation (LISC)

New Markets Initiative

New Markets Tax Credit

1999

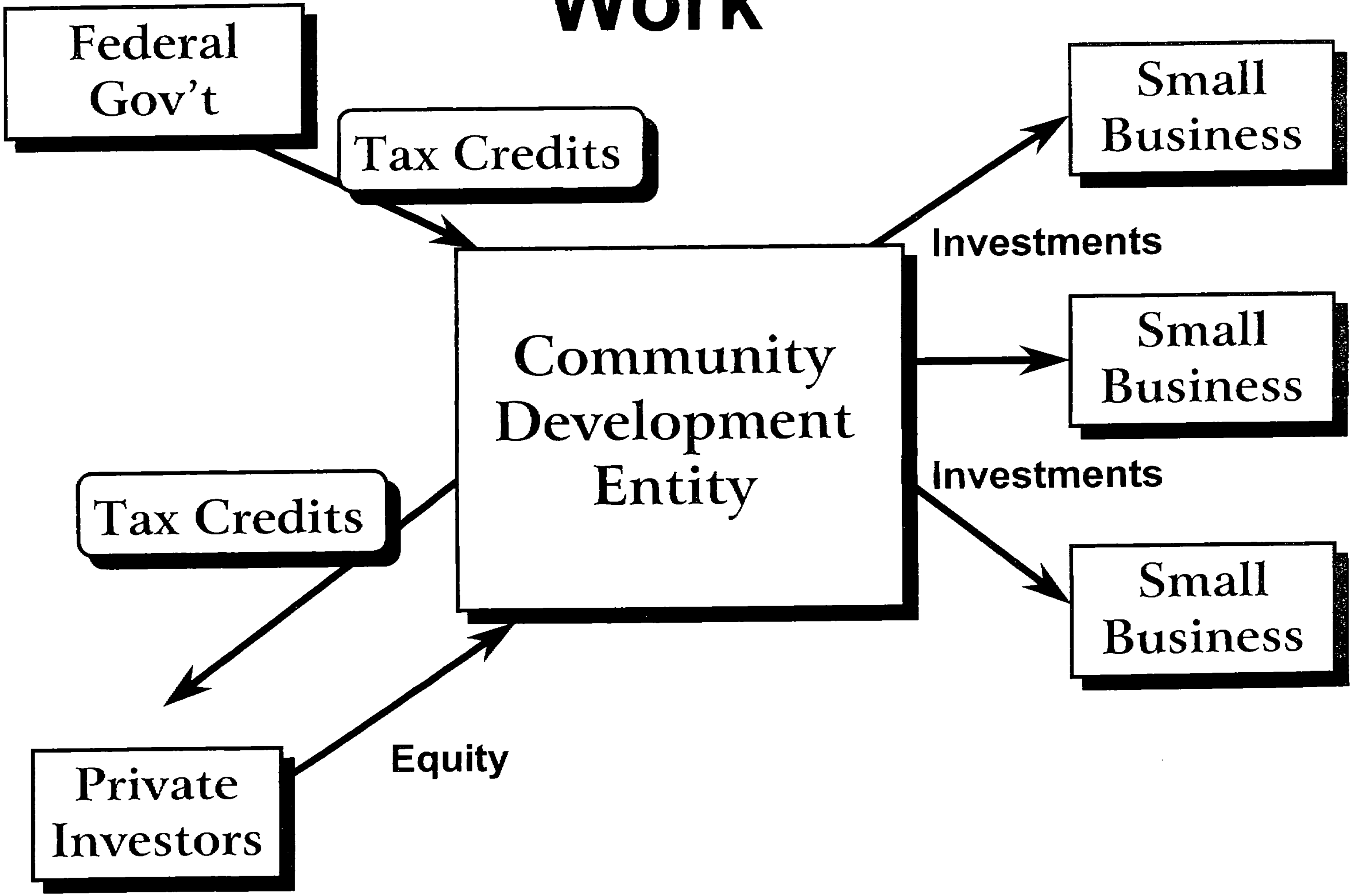
New Markets Tax Credit

- Attract $6 Billion in New Equity Capital to Businesses located in Economically Distressed Communities
- Build the Capacity of Institutions with Business Development Expertise and Knowledge of their Local Community
- Promote Partnerships between Skilled Community Development Entities and Mainstream Sources of Capital

New Markets Tax Credit: How Would it Work?

- Community Development Entities apply for designation.
- Designated entities allocate a given amount of tax credits to investors.
- Community Development Entities use the tax credits to attract investment capital.
- Investors claim a 6% tax credit for 5 years on their investment -- worth 25 % in present value terms.
- Designated Community Development Entities report tax credit allocations made and the use of investment to the Treasury Department.

How New Markets Tax Credits Work



What Community Development Entities Can Use the New Markets Tax Credit?

- **A Flexible Approach**
- **The Community Development Entity Must meet a 3-Part Test:**
  - Primary mission to serve or provide investment capital for low and moderate-income communities
  - 60% of gross assets invested in qualified investments or residential property located in low-income communities
  - Accountable to residents of low-income communities

New Markets Tax Credit

Qualified Business:
- Must be located in low or moderate-income area
- Must meet certain criteria to assure active business

Examples of businesses that may qualify include:
- Small technology firms
- Inner-city shopping centers
- Manufacturers
- Retail stores