

**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.

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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. Substantial⁸ 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

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.

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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 businesses¹¹ 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.

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.

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