New Markets Tax Credit: An Introduction

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Summary

The New Markets Tax Credit (NMTC) is a nonrefundable tax credit intended to encourage private capital investment in eligible, impoverished, low-income communities. NMTCs are allocated by the Community Development Financial Institutions Fund (CDFI), a bureau within the U.S. Department of the Treasury, under a competitive application process. Investors who make qualified equity investments reduce their federal income tax liability by claiming the credit. The NMTC program, enacted in 2000, is currently authorized to allocate $91 billion through the end of 2025.

This report will be updated as warranted by legislative changes.

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Overview

The New Markets Tax Credit (NMTC) was enacted by the Community Renewal Tax Relief Act of 2000 (P.L. 106-554) to provide an incentive to stimulate investment in low-income communities (LICs). The original allocation authority eligible for the NMTC program was $15 billion from 2001 to 2007.[1] Congress, subsequently, has increased the total allocation authority to $91 billion and extended the program through 2025.[2] Qualified investment groups apply to the U.S. Department of the Treasury's Community Development Financial Institutions Fund (CDFI) for an allocation of the New Markets Tax Credit.[3] The investment group, known as a Community Development Entity (CDE), seeks taxpayers to make qualifying equity investments in the CDE. The CDE then makes equity investments in low-income communities and low-income community businesses, all of which must be qualified. After the CDE is awarded a tax credit allocation, the CDE is authorized to offer the tax credits to private equity investors in the CDE.

The tax credit value is 39% of the cost of the qualified equity investment and is claimed over a seven-year credit allowance period.[4] In each of the first three years of the investment, the investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is 6% annually. Investors must retain their interest in a qualified equity investment throughout the seven-year period.

Program Components

The process by which the NMTC affects eligible low-income communities involves multiple agents and steps. **Figure 1** illustrates the key agents in the NMTC process.

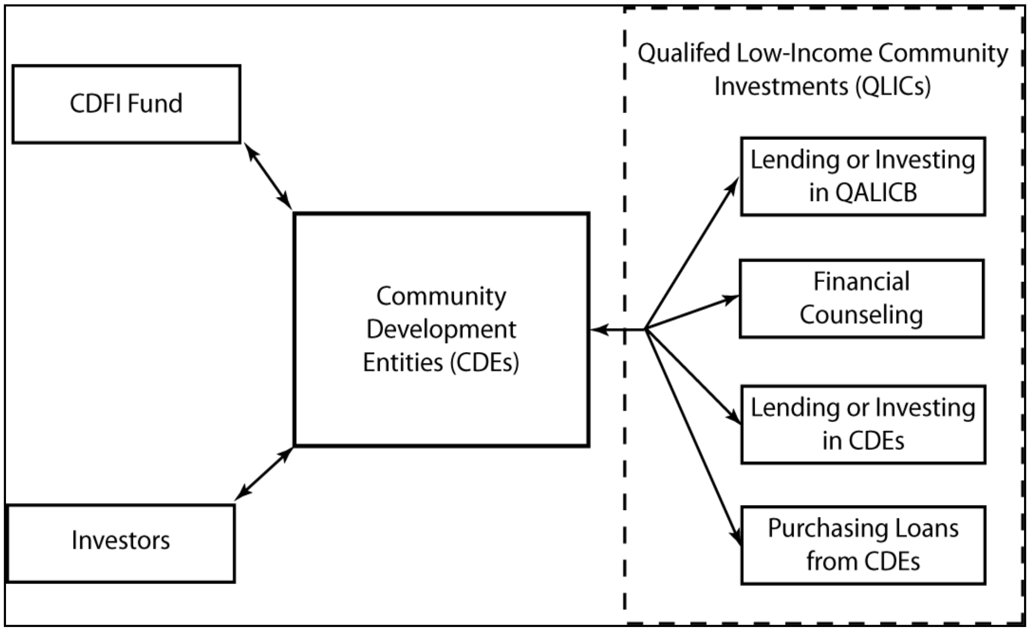
[1] Congress provided a schedule limiting the NMTC allocation authority for calendar years 2001 through 2007. The schedule allowed for $1.0 billion in allocation authority in 2001, $1.5 billion in 2002 and 2003, $2.0 billion in 2004 and 2005, and $3.5 billion in 2006 and 2007.

[2] The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) authorized an additional $1 billion of NMTC equity for qualified investments in areas affected by Hurricane Katrina. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the NMTC for an additional year (through 2008) with an additional $3.5 billion of NMTC allocation authority, and the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the NMTC for an additional year (through 2009) with an additional $3.5 billion of NMTC allocation authority. In the 111th Congress, the American Recovery and Reinvestment Tax Act of 2009, P.L. 111-5, Division B, increased the NMTC allocation for 2008 and 2009, to $5 billion from $3.5 billion, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the NMTC authorization through 2011 at $3.5 billion per year. In the 112th Congress, the American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the NMTC authorization for 2012 and 2013 at $3.5 billion per year. In the 113th Congress, the Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the NMTC authorization for 2014 at $3.5 billion. In the 114th Congress, the Protecting Americans from Tax Hikes (PATH) Act (Division Q of P.L. 114-113) extended the NMTC authorization through 2019 at $3.5 billion per year. In the 116th Congress, the Further Consolidated Appropriations Act, 2020 (P.L. 116-94) extended the NMTC authorization through 2020 for $5 billion. The Consolidated Appropriations Act, 2021 (P.L. 116-260) extended the NMTC authorization through 2025 at $5 billion per year.

[3] See CRS Report R47169, *Community Development Financial Institutions (CDFI) Fund: Overview and Programs*, by Donald J. Marples and Darryl E. Getter, for additional information on the CDFI Fund.

[4] In present value terms, the credit is equal to approximately 30% of the eligible investment at a 6.7% discount rate.

Figure 1. Key Components of the NMTC Process



Source: CRS analysis of NMTC program components.

The multiple steps and agents are designed to ensure that the tax credit achieves its primary goal: encouraging investment in low-income communities. For example, the Department of the Treasury's CDFI reviews NMTC applications submitted by CDEs, issues tax credit authority to those CDEs deemed most qualified, and plays a significant role in program compliance.

Community Development Entities (CDE)

A CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investment funding, or financial counseling in low-income communities (LICs). To become certified as a CDE, an organization must submit an application to the CDFI that demonstrates that it meets three criteria: (1) it is a domestic corporation or partnership duly organized under the laws of the jurisdiction in which it is incorporated, (2) it has a primary mission of serving low-income communities, and (3) it maintains accountability to residents of these low-income communities. A CDE may demonstrate meeting the third criterion by filling at least 20% of either its advisory or its governing board positions with representatives of low-income communities.[5]

Only CDEs may apply for the NMTC. Upon receipt of NMTC allocation, CDEs attract investors using the credits. While both for-profit and nonprofit CDEs may apply for the NMTC, only for-profit CDEs may pass the NMTC on to investors. To ensure that projects are selected on economic merit, nonprofit CDEs awarded NMTCs must transfer their allocations to for-profit subsidiaries prior to offering NMTCs to investors.

As **Figure 1** illustrates, CDEs play a critical role in a properly functioning NMTC process. CDEs are the intermediaries between the potential low-income community investments and the CDFI

[5] In addition, all Community Development Financial Institutions or Specialized Small Business Investment Companies automatically qualify as CDEs. To be recognized as CDEs, these entities are required to register through the CDFI Fund website.

during the application process. CDEs also present investors with investment opportunities and provide the CDFI the majority of its compliance data.

Qualifying Low-Income Communities

Under the tax code's NMTC provisions, only eligible investments in qualifying low-income communities are eligible for the NMTC. Qualifying low-income communities include census tracts that have at least one of the following criteria: (1) has a poverty rate of at least 20%; (2) is located in a metropolitan area and has a median family income below 80% of the greater of the statewide or metropolitan area median family income; or (3) is located outside a metropolitan area and has a median family income below 80% of the median statewide family income. As defined by the criterion above, about 39% of the nation's census tracts covering nearly 36% of the U.S. population are eligible for the NMTC. Additionally, designated targeted populations may be treated as low-income communities.[6] Further, the definition of a low-income community includes census tracts with low populations and census tracts within high migration rural counties. As a result of the definition of qualified low-income communities, virtually all of the country's census tracts are potentially eligible for the NMTC.

Qualified Investors and Investments

All taxable investors are eligible to receive the NMTC. As noted above, investors receiving the credit can claim the NMTC over a seven-year period, starting on the date of the investment and on each anniversary, at a rate of 5% for each of the first three years and a rate of 6% for each of the next four years, for a total of 39%. Once the investor begins claiming the NMTC, the credit can be recaptured if the CDE (1) ceases to be a CDE, (2) fails to use substantially all of the proceeds for eligible purposes, or (3) redeems the investment principal.[7]

Almost all qualified equity investments (QEI) in low-income communities or serving low-income populations could be eligible to receive the NMTC. These eligible investments are referred to as qualified low-income community investments (QLICIs). QLICIs are categorized in four ways: (1) loans or investments to qualified active low-income community businesses (QALICBs), (2) the provision of financial counseling, (3) loans or investments in other CDEs, and (4) the purchase of loans from other CDEs; see **Figure 1**.[8] All QLICIs, including QALICBs, are explicitly prohibited from investing in residential rental property and certain types of businesses, such as golf courses and casinos.

NMTC Allocation Process and Compliance

To receive an allocation, a CDE must submit an application to the CDFI, which asks a series of standardized questions about the track record of the CDE, the amount of NMTC allocation authority being requested, and the CDE's plans for any allocation authority granted.

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[6] See Internal Revenue Bulletin 2006-29, Notice 2006-60, issued July 17, 2006, for a more complete description of the definition of designated targeted populations.

[7] According to IRS regulations, the "substantially all" requirement is met if at least 85% of investor proceeds are used to make eligible investments in the first six years of the NMTC period and at least 75% in year seven of the investment.

[8] For a business to be a QALICB, it must be located in a qualifying census tract, derive at least 50% of gross income from activity conducted in a LIC, have at least 40% of both the use of tangible property and services provided located or performed in the LIC, and have less than 5% of the aggregate unadjusted bases of the property attributable to collectibles or nonqualified financial property.

The application covers four areas: (1) the CDE's business strategy to invest in low-income communities, (2) capitalization strategy to raise equity from investors, (3) management capacity, and (4) expected impact on jobs and economic growth in low-income communities where investments are to be made. In addition, priority points are available for addressing the statutory priorities of investing in unrelated entities and having demonstrated a track record of serving disadvantaged businesses or communities. The application is reviewed and scored to identify those applicants most likely to have the greatest community development impact and ranked in descending order of aggregate score.[9]

Tax credit allocations are then awarded based upon the aggregate ranking, until all of the allocation authority is exhausted. In each of the completed NMTC rounds, significantly more CDEs applied for allocations than were able to receive allocations. For example, in the most recent completed allocation round (2020), 48% of applicants received allocations. Additionally, allocation authority of $15.1 billion was requested, compared with the $5 billion in allocation authority available.[10]

Prior to receiving the authority to offer tax credits to investors, every CDE allocatee must sign an allocation agreement. The allocation agreement clarifies the terms and conditions of the allocation authority, such as the total tax credit authority, service areas, authorized uses of the allocation, and CDE reporting requirements. Failing to meet the terms of the allocation agreement subjects the CDE to the potential revocation of allocation authority.

Additionally, the Internal Revenue Service (IRS) monitors compliance with the tax consequences of NMTC allocations, focusing on the "substantially all" requirement.

As specified in the IRS regulations, CDE allocatees must issue tax credits to investors within five years of signing their allocation agreements and invest the QEIs in QLICIs within 12 months of signing their allocation agreements. If these requirements are not satisfied, the CDE loses the authority to allocate the unused NMTC. In addition, CDEs that receive principal payments from their QLICIs have 12 months to reinvest those funds in QLICIs to avoid recapture.

NMTC Investment Activity

Once an allocatee signs its allocation agreement and receives its NMTC allocation authority, it may begin soliciting capital from investors. Investors receive the right to claim NMTCs on a portion of their investment, by acquiring stock or a capital interest in a CDE with an allocation. The CDE, in turn, must invest the proceeds in qualified low-income community investments. Investors have, to date, invested roughly $63.4 billion in CDEs. Virtually all of the NMTC allocations made prior to 2017 have been invested in NMTC investments. For the most recent NMTC round (2020), nearly 60% of the allocation was invested within one year.[11]

[9] For past examples of what the CDFI has considered as "highly ranked applications" for the NMTC, see Community Development Financial Institutions Fund, Combined CY2020 New Markets Tax Credit Program, *Allocation Application Review Process and General Characteristics of a Highly Ranked Application*, 2021, https://www.cdfifund.gov/sites/cdfi/files/2021-09/CY2020_NMTC_Application_Review_Process_26AUG2021.pdf.

[10] CDFI Fund, *NMTC Award Book CY2020*, September 2021, https://www.cdfifund.gov/sites/cdfi/files/2021-08/CY2020_NMTC_Program_Award_Book_FINAL.pdf.

[11] CDFI Fund, *NMTC Qualified Equity Investment Report*, September 2, 2022, https://www.cdfifund.gov/sites/cdfi/files/2022-09/NMTC_QEI_Issuance_Report_September_2022.pdf.

Legislative Developments

Modifications to the NMTC program have been made in each Congress since the NMTC was created.

In the 108th Congress, the American Jobs Creation Act of 2004 (P.L. 108-357, 118 Stat. 1418) included provisions expanding the authority of the Secretary of the Treasury to treat certain other tracts and targeted populations as low-income communities.[12]

During the 109th Congress, the Gulf Opportunity Zone Act of 2005 (P.L. 109-135, 119 Stat. 2577) was enacted to provide tax relief to businesses and individuals affected by Hurricanes Katrina, Wilma, and Rita. The bill, which created the Gulf Opportunity Zone (or GO Zone), provided an additional $1 billion in allocation authority to CDEs with a significant mission in the recovery and redevelopment of low-income communities in the Katrina GO Zone.[13]

Also during the 109th Congress, the Tax Relief and Health Care Act of 2006 (P.L. 109-432, 120 Stat. 2922) extended the NMTC for one year, through 2008, with an additional allocation of $3.5 billion and mandated Treasury to promulgate regulations to ensure that nonmetropolitan counties receive a proportional allocation of investments under the NMTC.

In the 110th Congress, legislative attention focused primarily on extending the NMTC program authorization. This attention came to fruition with the enactment of P.L. 110-343, which extended the NMTC program authorization one year, through the end of 2009.

In the 111th Congress, the American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5, Division B) increased the NMTC allocation for 2008 and 2009, to $5 billion from $3.5 billion. For the additional 2008 allocation, the CDFI distributed the additional $1.5 billion in NMTCs to applicants of the original 2008 allocation round. Also in the 111th Congress, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the NMTC authorization through 2011 at $3.5 billion per year.

In the 112th Congress, the American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the NMTC authorization for 2012 and 2013 at $3.5 billion per year.

In the 113th Congress, the Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the NMTC authorization for 2014 at $3.5 billion.

In the 114th Congress, the Protecting Americans from Tax Hikes (PATH) Act (Division Q of P.L. 114-113) extended the NMTC authorization through 2019 at $3.5 billion per year.[14]

In the 115th Congress, P.L. 115-97 did not directly affect the NMTC,[15] but did reduce its value to selected investors through a base erosion provision in the law.[16]

[12] The term *targeted population*, as defined in 12 U.S.C. §4702(20), means individuals, or an identifiable group of individuals, including an Indian tribe, who (1) are low-income persons (low-income targeted population) or (2) otherwise lack adequate access to loans or equity investments.

[13] The Gulf Opportunity Zone (GO ZONE) is defined as those areas in Alabama, Mississippi, and Louisiana that were designated by the federal government as warranting assistance due to Hurricane Katrina. Disaster areas associated with hurricanes Rita and Wilma were not eligible for the additional allocation.

[14] For more discussion of other community development tax incentives that were temporarily extended in the PATH Act, see CRS Report R43541, *Recently Expired Community Assistance-Related Tax Provisions ("Tax Extenders"): In Brief*, by Sean Lowry.

[15] The original House-passed version of H.R. 1 would have repealed the NMTC beginning in 2018.

[16] To protect the tax base of foreign-owned corporations or U.S. corporations with significant foreign operations, the

In the 116th Congress, the Further Consolidated Appropriations Act, 2020 (P.L. 116-94) extended the NMTC authorization through 2020 for $5 billion, and the Consolidated Appropriations Act, 2021 (P.L. 116-260) further extended the NMTC authorization through 2025 at $5 billion per year.

In the 117th Congress, the New Markets Tax Credit Extension Act of 2021 (H.R. 1321) would make the NMTC permanent, index the NMTC authorization for inflation beginning in 2021, and allow the NMTC against the alternative minimum tax. The Rural Jobs Act (H.R. 3357) would allocate $500 million in additional NMTC allocations for investments in Rural Jobs Zones for 2021 and 2022.

Policy Considerations

The New Markets Tax Credit Program is set to expire at the end of 2025. As Congress debates reauthorization of the NMTC, the following policy considerations could be pertinent to any consideration of these bills.

The NMTC is primarily intended to encourage private capital investment in eligible low-income communities. However, the source of the investment funds has implications for the effectiveness of the program in achieving its objective. From an economic perspective, the impact of the NMTC would be greatest in the case where the investment represents new investment in the U.S. economy that would not have occurred in the absence of the program. Conversely, the impact of the NMTC is diminished to the extent the tax credit is applied to investment that would have otherwise occurred or been funded by a shift in investment from more productive alternatives.[17]

To date, only one study has empirically assessed the question of whether NMTC investment is funded through shifted investment or whether it represents new investment.[18] The findings of the study suggest that corporate investment represented a shift in investment location. In contrast, the authors concluded that a portion of individual NMTC investment, roughly $641 million, represented new investment.

Although important, understanding the source of NMTC investments alone is not sufficient to determine the effectiveness of the NMTC. A comprehensive review of the program would require an accounting of both the social and economic costs and benefits of the NMTC, an undertaking that may pose considerable challenges. For example, this would include examining the efficiency and opportunity costs of the NMTC investments, while a comprehensive accounting of the NMTC benefits would need to identify and value "spillovers" such as its effect on neighboring businesses and communities.

The most comprehensive evaluation of the NMTC, to date, was conducted by the Urban Institute under contract from the CDFI.[19] While the evaluation's final report found project level activity consistent with the NMTC achieving program goals, it was unable to generalize its findings to the

2017 law imposes a Base Erosion and Anti-abuse Tax (BEAT). The NMTC is not allowed to offset the BEAT, potentially reducing its value to affected investors.

[17] However, from a policy perspective, the desire to minimize the distortion of investment choice caused by the NMTC is usually balanced against other objectives, such as equity.

[18] Tami Gurley-Calvez et al., "Do Tax Incentives Affect Investment? An Analysis of the New Markets Tax Credit," *Public Finance Review,* vol. 34, no. 4, pp. 371-398.

[19] Martin D. Abravanel et al., *New Markets Tax Credit (NMTC) Program Evaluation: Final Report*, prepared for U.S. Department of the Treasury Community Development Financial Institutions (CDFI) Fund, Urban Institute, April 2013, https://www.cdfifund.gov/Documents/NMTC%20Program%20Evaluation%20Final%20Report.pdf.

broader universe of NMTC activity or census tract level outcomes due to evaluation design limitations. The report noted it was an initial effort to a more robust research plan that has not yet been implemented.

Others, notably GAO, have recommended that the NMTC be simplified by converting the NMTC into a grant program.[20] This option may be able to deliver the same level of incentive with lower cost to the government, as investors do not generally "buy" tax credits at face value—allowing a smaller grant to provide a similar level of incentive. Specifically, tax credit markets historically set a price of 70 to 80 cents per dollar of tax credit.

A grant option, however, likely provides a lesser incentive for investors to invest in NMTC projects, as they may not be the beneficiary of the incentive.[21] If this occurs, improving the access to capital in low-income communities (an NMTC program goal) would be more difficult. Further, a grant program may complicate existing mechanisms designed to ensure the NMTC is used for intended purposes, as the primary provision to ensure compliance, the IRS authority to recapture tax benefits, would likely not apply (as the NMTC would no longer be a tax program).

An additional issue is the geographic distribution of NMTC activity. Initial concerns focused on distinctions between urban and rural NMTC activity and were addressed in the Tax Relief and Health Care Act of 2006 (P.L. 109-432). The act required that the NMTC program direct a proportional amount of investment to nonmetropolitan counties. Beginning with the CY 2008 allocation round, the NMTC program used 20% as the appropriate benchmark for ensuring a proportional allocation of QLICIs in nonmetropolitan areas, which approximated the percentage of the U.S. population that CDFI data indicated resided in nonmetropolitan counties. According to the most recent NMTC public data release, 19.2% of NMTC investments have occurred in nonmetropolitan counties during the life of the program.[22]

NMTC activity has occurred in all 50 states, the District of Columbia, and the territories. However, the distribution of NMTC activity appears concentrated in a few states—with the 10 states with the highest activity accounting for nearly 49% of all NMTC projects and activity. In contrast, the 25 states with the least NMTC activity account for less than 13% of all NMTC activity. The current distribution of activity is not likely to reflect the distribution of low-income populations and may raise questions concerning the equity of the NMTC.

Finally, the NMTC is one of several programs designed to improve conditions in low-income communities. In a 2004 assessment of the NMTC, the Office of Management and Budget noted that the goal of the NMTC overlaps that of several other tax credits and numerous programs administered by the Departments of Housing and Urban Development and Commerce.[23] Given this overlap and the desire to target federal funds to their most productive uses, it follows that information on the performance of the NMTC relative to other programs with a similar goal

[20] U.S. Government Accountability Office, *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects on Low-Income Communities, but Could be Simplified*, GAO-10-334, January 29, 2011, http://www.gao.gov/products/GAO-10-334.

[21] Allowing CDEs to assign the grants to specific investors is an option to mitigate this problem.

[22] CRS analysis of Community Development Financial Institutions Fund, *FY2021 New Markets Tax Credit Public Data Release: 2003-2019 Data File*, https://www.cdfifund.gov/sites/cdfi/files/2021-05/FY_2020_NMTC_Public_Data_Release.xlsx.

[23] See U.S. Office of Management and Budget, *Detailed Information on the New Markets Tax Credit Assessment*, updated January 29, 2008, http://www.whitehouse.gov/omb/expectmore/detail/10002230.2004.html.

would be of use.[24] To date, however, no comparative, empirical study of this nature has been undertaken.

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Disclaimer

[24] In an NMTC program compliance report, Summit Consulting recommended further study to determine how the use of non-NMTC public funding influences the depth and distribution of benefits in NMTC transactions. See Summit, *Compliance Review of New Markets Tax Credit Program*, August 2017, https://www.cdfifund.gov/Documents/Summit%20-%20Compliance%20Review%20of%20New%20Markets%20Tax%20Credit%20Program%20-%20August%20Date%20-%20508%20Compliant.pdf.