PUBLICATION

Alternative Financing Sources – New Markets Tax Credits

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The New Markets Tax Credit (NMTC) is a federal program intended to stimulate economic and community development in America's low-income communities. The program provides investors with seven years of federal tax credits for making investments in a wide range of businesses located in such communities. Developers of qualifying projects are able to market the credits to investors so as to bridge project financing gaps or reduce the overall cost of financing to a level that permits the project to proceed.

Qualified NMTC Entities and Businesses. Under the NMTC program, Community Development Entities (CDE) receive allocations of credits from the Treasury Department and serve as an intermediary vehicle to provide loans or investments in qualifying businesses. Qualified businesses must earn income, own property, or provide services in low income communities, which are areas in census tracts that meet certain income thresholds. Certain "sin" businesses are excluded, such as golf courses, race tracks, gambling facilities and liquor stores, as are residential rental properties. On the other hand, improvements to commercial rental real estate do qualify.

Credit Amount. The NMTC program provides a federal income tax credit equal to 39% of the investor's invested capital and is earned over seven years. Because the credit is only 39% of the investment, in its purest form a NMTC financed project requires an additional return to the credit investor. However, alternative structures are commonly used to leverage the credits in a manner to allow the investor's capital to be returned entirely through tax credit allocations.

Investor Returns and Deal Requirements. Although any investor with a federal income tax liability can purchase the credits, typically banks are the purchasers. Depending on the pricing of the credits, investors typically realize after-tax returns on the credit investment of 6% to 13%, and in the case of banks the investment typically generates Community Reinvestment Act credit. From the developer's standpoint, in a leveraged structure where the investor is paid back entirely through tax credits, the NMTC program typically generates equity in the project equal to about 20% of the total credit amount. Because NMTC financing complicates the deal structure, a minimum deal value of about $10 million is usually required for the benefit to exceed additional transaction costs. Lower value deals may be feasible, though, depending on credit pricing and fees charged by CDEs.

Supplemental Financing. A project cannot be financed entirely with NMTCs. Normally, the credits are combined with traditional commercial financing to reduce overall financing costs or provide financing that would not otherwise be available. Because a qualified business must be in low income communities, other incentives are often available and paired with the NMTCs to create the best financing mix, such as historic rehabilitative tax credits, payment in lieu of tax programs, state NMTC programs, tax exempt bond financing, and various Small Business Act programs.

Additional Information. NMTC financing has many technical requirements and limitations, and requires careful analysis before a decision is made to implement the structure. Should you have any questions or otherwise wish to discuss NMTCs in general or with respect to a specific project, please contact any of the attorneys within the Firm's Tax Department.