New Markets Tax Credits – An Investment Consulting Opportunity for CPAs

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The New Markets Tax Credit (NMTC) federal program encourages investments in under-developed and economically depressed areas of the country by providing substantial tax credits that may turn marginal projects into profitable investments. While the NMTC program is scheduled to expire when current unallocated investment authority is depleted (or by FY 2015), Congress is expected to extend the program. Given their familiarity with local business economies, CPA firms may be able to use the program to benefit existing clients or attract new clients. CPA firms and their clients may also benefit from enhanced goodwill via associations with socially desirable projects.

INTRODUCTION

The thrust of this paper involves identification and discussion of the federal New Markets Tax Credit program (NMTC) with emphasis on how CPA firms might use the program to benefit clients. Given the specific focus and relative complexity of NMTC provisions, CPA firms would seem to be well situated with respect to identifying and evaluating eligible investment opportunities, soliciting existing or new clients to invest in what the program calls community development entities (CDEs) created to operate the qualifying enterprises, and finally to assist those enterprises in compliance activities regarding both setup and continuing activities of the qualifying enterprises. Qualifying investments themselves encompass a wide range of profit-oriented activities with the principal limiting proviso that they be directed a lower income communities. Given that constriction, such investments often are not financially viable on their own merits but might well be so factoring in the substantial scale of tax credits to investors provided for under the NMTC provisions (details of which will be discussed subsequently). The principal point out the outset pertains to the authors' view that the NMTC program provides potentially highly beneficial investment and tax planning opportunities that CPA firms can use to enhance investment advising services provided to clients.

Organization of the paper includes an initial general discussion of the NMTC program including its principle requirements and restrictions with focus on technical areas of organization and compliance. Following that, examples of previously qualifying projects will be provided. As the paper proceeds, it is important for readers to keep in mind that this article provides only an overview of the NMTC program.

CPA firms opting to pursue NMTC advising should certainly familiarize themselves with detailed program requirements which are available at http://cdfifund.gov.

HISTORY AND PROVISIONS OF THE NMTC PROGRAM

The NMTC program was created as part of the Community Renewal Tax Relief Act of 2000 (CRTRA). Through the initial legislation and additional later appropriations, funds authorized under the program are to date approximately $33 billion dollars. While the program funding ceased in 2011, substantial unallocated amounts remain available to be awarded to CDE's through 2016 and, while no assurance exists, reasonable expectations exist that Congress may provide additional funding in future years. Research conducted on the program from 2002 to 2007 by the U.S. Treasury Department indicates that the program has been successful at significantly generating both investment and economic activity in distressed communities. For example, communities that have received investments under the program have proven to be significantly more distressed than the program's minimum requirements. Furthermore, every dollar of federal tax credit allowed under the program generated more than $14 of investment (US Department of Treasury, Financial Strategies & Research Office of Program and Policy, CDFI Fund, October 2008).

Within the CRTRA framework, a Community Development Financial Institutions Fund (CDFIF) was established for the purpose of administering the NMTC program. Specifically, the CDFIF initially assesses and determines the eligibility of applicants to the program based upon formal project applications. The CDFIF then allocates each fiscal year's authorized tax credits to qualifying projects (referred to under the program as Community Development Entities or CDEs) based on the aforementioned evaluation of submitted projects. Annual tax credits awarded since the start of the program have averaged about $3.5 billion. Through 2011 a total of $33 billion had been allocated to the program.

CDEs in turn, as the primary investment vehicle for program projects, are limited to either U.S. domestic partnerships or corporations. A key point to emphasize regarding CDEs is that they must substantially serve a "qualifying community" ("qualifying" based on low income characteristics). Thus, in the application process, it is virtually a necessity to demonstrate that a project has support from the intended community. Examples of community endorsement of the CDE include but are not limited to: council or local government approval or endorsement, or community ownership or governance.

Once CDE certification is obtained, the CDE then applies to the CDFI Fund for an NMTC allocation. This involves a competitive application process that begins in April of each year with tax credit allocations taking place roughly two months later. The CDFI Fund verifies that applicant projects meet the minimum program requirements and evaluates the overall impact (defined as the # of new or preserved jobs) of each in light of the program's objective of spurring economic development in distressed communities. Thus, the competitive application process clearly favors proposals which are located in severely economically stressed communities and projects deemed likely to provide the most economic impact per dollar of tax credit.

Once tax credit allocations are made, a CDE finalizes collection of investments, which have likely been solicited well in advance, and initiates the proposed enterprise activity. In so doing, care must be taken to fulfill requirements concerning (1) types of investments, (2) locations of enterprise activities, and (3) intended time periods between the award of tax credits and completion of activities. With respect to these criteria, no specific limits exist regarding types of investments. But, again, the competitive nature of the evaluation process compels applicants to clearly demonstrate anticipated benefits to lower income elements of the local populations. Consistent with the aim of promoting economic development in low-income communities, CDE funds must be invested primarily in tangible assets physically located in a qualifying community. The program uses census tracts to define communities as well as to quantify the level of economic activity-unemployment and income levels. Generally, qualifying low-income communities are defined as areas for which rates of poverty among the population equal or exceed 20% or for which the median income is less than 80% of the state-wide or metropolitan median income, whichever is greater. In addition, certain communities containing “targeted populations,” rural areas with high migration rates and special “Go Zone” regions (Gulf communities disrupted by hurricane Katrina) are also qualifying communities. Finally, CDEs obtaining NMTC allocations have five years from the date of the tax credit allocations to finalize investments and ensure that the proposed enterprises are up and running.

The tax credits are a key feature of the financing structure for the proposed enterprises. And, unlike most tax credits, the NMTCs flows through directly to investors based on their overall investments, not based upon subsequent expenditures of the resulting enterprises. Allocation of the 39% in total tax credits, furthermore, are 5% for the first three years subsequent to the credit allocations and increasing to 6% for years four through seven producing a total tax credit of 39% of investments. It should be obvious, then, that qualifying for such significant tax credits is worth considerable effort. Finally, it is important to note that the NMTC program requires CDEs to commit 95% of overall investments within the first year in the asset capitalization of the qualifying enterprise. Furthermore a CDE may not return any of the qualifying investments to investors or reward investors with dividends over the first seven years of the existence of the enterprise. Thus all earnings of the enterprise over the 7-year start up period must be reinvested in the entity. There are also limits on the amount of working capital that can be maintained over the initial 6 years.

At the end of the 7-year start-up period, CDEs can begin repayment of both the initial investment and accumulated profits to investors. Private investments in the CDE can be structured as either debt or equity, or a mixture of these, and are treated equivalently under the NMTC program. The CDE can begin making distributions to private investors after the initial 7-year startup period has been satisfied. It is important to note that once the 7-year startup term has been completed the CDE is free to operate, reorganize or liquidate.

Operation of the CDE project is subject to program requirements concerning the location and usage of tangible asset investments and business activities. These requirements are designed to support the Act’s primary goal of spurring economic development in targeted communities. Basically, compliance with the program necessitates that at least 50% of the gross income from the sponsored business activity is derived from within the qualifying low-income community, at least 40% of the sponsored business’ tangible assets are located within the low-income community and at least 40% of the sponsored business’ total employment occurs within the low-income community. Failure to meet any of these requirements can result in disqualification of the CDE and resulting loss of tax credits to investors. If the venture undertaken fails and the CDE files for bankruptcy during the 7-year startup period investors will receive tax credits. Conversely, if the enterprise is more successful than initially anticipated the CDE can opt out of the NMTC program by recapturing the tax credits.

CPAs may serve an important facilitator role in both organizing and ensuring compliance with the technical details of §45D. CPA’s have strong comparative advantages for organizing the CDE startup and identifying potential investors. Many CPAs have the technical expertise to evaluate qualifying enterprise projects and can provide assistance with preparing business and operational plans to support the application for an NMTC allocation and the solicitation of investors. CPAs also have ready access to potential investors by virtue of their client base. These are two key factors for making application for NMTC allocations. Once an application for NMTC has been awarded tax credits, the CPAs can assist with the administration and oversight of the enterprise activities to ensure compliance with the program’s stringent requirements-making timely, qualifying investments in designated low-income communities, and reporting on these activities. CPAs can also provide technical and management assistance to the CDE as it transitions from startup to a mature business operation.

EXAMPLES OF QUALIFYING NMTC PROJECTS

In this section, brief descriptions of recently qualified NMTC projects are provided. While the number of cases is limited, the projects were selected in part to illustrate the diversity of economic activity and location for which the tax credits can be obtained. While a majority of NMTC qualifying projects have involved improvements of urban and inner-city housing in economically depressed cities, a significant proportion of the tax credits have been used to benefit non-urban settings. For informational purposes, the selected cases were all awarded NMTCs during the prior two years and all were undertaken in communities characterized by a loss or migration of industry from the area leaving communities with significantly higher unemployment rates, high rates of poverty and median incomes well below the national income level.

Solarsink is an alternative energy enterprise that qualified for NMTCs in conjunction with development of a solar power related manufacturing plant in Tallahassee, Florida. Specifically, the company produces a heatsink that is touted as particularly efficient at converting solar energy into electricity. The company received a $12.5 million NMTC allocation in 2011 to build the $16.6 million manufacturing facility and solar plant on a 5 acre site. Several points related to this and the following projects are noteworthy. First, while fostering clean energy technology is peripheral to the goals of the NMTC program, it is possible that projects viewed as beneficial to society will receive relatively favorable consideration in the NMTC competitive review process. And, second, the NMTC geographic focus is not an urban setting as a whole but rather on specific areas within a city which may qualify as low-income for the purpose of the program. In the Solarsink case, a community within Tallahassee was identified as having a 49% poverty rate.

Farwest Steel is a more than half-century old carbon steel product manufacturer located in the Northwest. In applying for NMTCs, the company's intent was to facilitate consolidation of its operations into a single integrated facility to enhance production efficiencies, lower transportation costs and improve customer service through more timely production and delivery of its products. Vancouver, Washington was selected as the focus of the NMTC project because of that city's qualification as an economically distressed community along with its proximity to major transportation modes including marine, railway systems and interstate highways. Partnering with both the City and the Port of Vancouver provided the community with support for the project and necessary supplemental financing from public sources. The project is expected to be completed during the summer of 2012 and involves $48 million of new investment with 128 new full-time jobs paying an average salary exceeding $40,000/year.

Borden & Remington Fall River, a Massachusetts-based highly diversified chemical manufacturing company, qualified for NMTCs in conjunction with a redevelopment project that transformed a one hundred and fifty year old former textile mill into a manufacturing business park with wind turbine manufacturing as its anchor company. Borden and Remington is a large chemical distributor located in Fall River, Massachusetts, a mid-sized city burdened by a 23% poverty rate and unemployment rate approximately 1.6 times the national average. Company leadership envisioned the project as far back as 2005 when it purchased the 29 acre mill site. After removing obsolete buildings and updating physical infrastructure, the project was successful in large part due to the NMTCs in attracting a wind turbine manufacturer and industry leader in sustainable energy solutions to participate in the project.

Zurn Industries is a manufacturer of industrial and commercial water management products including branded plumbing, janitorial and sanitation products. To remain competitive in the global marketplace, the company realized that it needed to upgrade the equipment and infrastructure at its foundry in Erie, Pennsylvania. By reaching out to local community leadership and Erie County economic development Corporation for support the company was able to secure a $7.3 million NMTC allocation which largely funded the $8 million modernization project at the foundry. For the community of Erie the investment resulted in the preservation of 133 high-skill jobs in a community with nearly a 26% poverty rate, median income just 48.6% of the national average income, and a 14.2% unemployment rate.

Stinger Welding is a bridge fabricator headquartered in Coolidge, Arizona. The company was looking for a site to expand its operations and selected Libby, Montana as a potential site. Despite a somewhat remote setting, Libby nonetheless offered a strategic advantage due to its proximity to public building projects and a large pool of skilled workers formerly employed in the mining and timber industry (Libby was declared a superfund disaster by the EPA in 2002 causing multiple mine closures which pushed the unemployment rate in the area up to nearly 16%). Using a $3.2 million of NMTC allocation the company was able to attract $14 million of investment for the plant expansion. When the expansion is completed it is anticipated that 150 new full time jobs will be created with an annual payroll exceeding $5.5 million in a community of just 2,600 residents.

CONCLUSION

This paper identified an attractive practice development area for CPA firms that leverage their existing skill sets and client relationships with opportunities offered by the New Markets Tax Credit program. We identified the program's key features and requirements and provided an illustration of their applications by way of a proposed green energy project that would create both economic development and advance a community's goals for sustainability. It is important to note that wide and diverse set of enterprise activities would meet the program's requirements and objectives. Further, this program can significantly expand the range of effective tax planning strategies offered by CPAs to their clients.

REFERENCES

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ADDITIONAL MATERIAL

Green Energy Incorporated

To illustrate the program's key features we use our CDE to develop an alternative energy project. This type of project was selected because it illustrates the goals of the Community Renewal Tax Relief Act of 2000 while creating a sustainable green energy business enterprise that is attractive to community members. It would be ideally suited for the NMTC program since debt service and investor returns are severely restricted during the initial 7-year period, a time during which working capital is often critically needed during the startup period. Further, total returns over the life of the enterprise, from both expansion and increased margins, are potentially high.

Recall that the NMTC program's principal requirements require: (1) making qualifying investments in tangible assets, (2) locating the investment in low-income, or distressed targeted communities, and (3) making timely startup investments. Sufficient planning is necessary to satisfy these requirements and maintain compliance. At the time of application to the CDFI Fund the target project should have undergone a due diligence review relating to its feasibility and investment requirements. The CPA firm can add considerable value to this effort by assisting with the feasibility analysis, economic impact analysis, and preparation of related business and operations plans.

Once NMTCs are awarded the CDE has 5 years to receive private funds and make qualifying investments. The CDE is allowed to retain just 5% of the initial private investments for working capital purposes, but the remaining 95% of funding must be expended within 12 months. Designated business activities must often obtain special permits in advance of starting operations. Thus these initial steps must be completed before investor funds are received to ensure all expenditures are made within the required 12-month investment period.

Our CDE will create and operate a waste recycling facility that receives residential and commercial waste which is sorted and either sold for recycling or consumed through electric power generation. It also will process electronics waste or “E-waste” that is becoming an increasing proportion of both commercial and residential waste. Currently E-waste represents 5% of the total waste stream, and is expected to increase each year. While E-waste contains toxic materials (e.g. lead, mercury, cadmium), it also contains valuable recoverable materials like gold and copper. In addition, the value of the recovered materials recycling fees can be charged to process this waste material.

Our Green Energy project is a good fit for NMTC because its start-up costs are high, it creates a number of direct and indirect jobs in the community area, and it meets sustainability initiatives that many communities have adopted, thus giving the added benefit of garnering community support. Green Energy Inc. is also cost-effective to locate this business in an economically depressed area because real property is readily available at lower cost, and the value added or created through production/conversion is largely captured in the immediate community. Recycling and power generation provide at least two revenue streams for the company.

Creation of a CDE is the conduit for investment from private investors to enterprise activities (see figure 1). The CDE applies for certification from the CDFI Fund. Once certification is received an application for a NMTC allocation from the CDFI Fund is prepared by the CPA firm and submitted through the annual proposal process. The proposal should specifically address the NMTC programs goals and requirements as they relate to the proposed enterprise activity. An assessment of the proposed enterprise’s economic impacts to the target low-income community should be included in the proposal to assist in the evaluation of a proposal’s merits relative to others. After receiving a NMTC allocation to fund, the CDE is in a position to solicit funding from private investors.

Like any start up business a solid business plan allows private investors to evaluate the project’s potential commercial success as well as management’s experience and qualifications. The plan should address not only the standard components but also the compliance and reporting provisions associated with the NMTC program. Delineation of the additional reporting requirements is critical to prevent a subsequent disqualification of the CDE which would require repayment of prior tax credits. Recall that private investments can be either equity or debt securities or a mixture of the two, but neither type is allowed to receive income or capital distributions until after year 6. Furthermore additional, funding (both new investment and debt financing) is also allowed if needed to fully fund startup and operational needs.

Once private investments are made and the CDE has investment funds, it is critical to acquire assets within the required 12 month horizon, and start operations as soon as possible. A key requirement of the enterprise is that private investment associated with the MNTC allocation must be 95% invested in the project’s tangible assets within a 12-month window. The program provides support for investment in service type business activities but these are quite specialized activities. For NMTC program purposes the definition of “community” is determined by the U.S. Census Bureau. It can depend on a number of factors but the NMTC strictly defines qualifying communities according to the Census Bureau’s classification and the related income statistics determine eligibility for the program.

A majority of the CDE’s business activities must also occur in the low-income community. The program defines three components of this requirement: (1) at least 50% of gross income is from the conduct of business in the low-income community, (2) at least 40% of the CDE’s tangible property or assets are located in the community, and (3) at least 40% of the services performed by CDE employees are within the community.

For our Green Energy enterprise the project begins startup operations in the 10th month and plans to be fully operational by the 14th month. The enterprise activities meet the three business activity requirements mentioned above because all recycling and power generation occurs on site within the low-income community. Green Energy continues to build capacity and production over time resulting in increased sales and finally profits. During the first three years investors receive no payments from the CDE. Tax credits that have been awarded to the CDE are allocated to investors based on their initial investment amounts. During the final 4 years of the program's 7-year period investors receive 6% tax credit allocations based on their initial investments. After the 7 years are completed the CDE is free to begin paying investors a return on their investments and share profits through dividend distributions.

For many investment opportunities it is the startup period that is greatly enhanced by the NMTC program. Normally investors want to see profits and returns within 3 or 4 years. The NMTC program provides investors with very attractive returns in the form of tax credits, especially given the current investment environment, while allowing the business to mature and build capacity. It is important to note however, that the program won't support uneconomical projects because all activities will eventually have to pay their way through profitable operations.

FIGURE 1
OVERVIEW OF NEW MARKETS TAX CREDITS