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April 19, 2010

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment 1 to Senate Bill 461 and Assembly Substitute Amendment 1 to Assembly Bill 642 -- State New Markets Tax Credit

Senate Bill 461 and Assembly Bill 642 are companion bills that would create a state supplement to the federal new markets tax credit. SB 461 was introduced on January 14, 2010, and referred to the Senate Committee on Economic Development. On February 17, that committee adopted Senate Substitute Amendment 1, and recommended the bill for passage as amended by a vote of 7 to 0. The bill was then referred to the Joint Committee on Finance.

Assembly Bill 642, was introduced on January 4, 2010, and referred to the Assembly Committee on Jobs, the Economy and Small Business. On February 23, Assembly Substitute Amendment 1 to AB 642 was offered and recommended for passage by a vote of 11 to 1. The substitute amendment was adopted by the Assembly on February 25, by a vote of 93 to 1. ASA 1 to AB 642 was then messaged to the Senate and referred to the Senate Committee on Economic Development on March 1, 2010.

SSA 1 to SB 461 and ASA 1 to AB 642 are identical. The following sections provide background information regarding the federal new markets tax credit, describe the provisions of the substitute amendments, and present information about their fiscal effects.

BACKGROUND

(A primary source of information for this section is a recent report published by the U. S. Government Accountability Office, (GAO); *GAO, New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified, GAO-10-334* [Washington D.C.: Jan. 29, 2010].)

The federal new markets tax credit (NMTC) was created by the federal Community Renewal Tax Relief Act of 2000, to encourage investors to make investments in low-income communities that traditionally lack access to capital. The federal NMTC provides investors, including individuals, financial institutions, and other corporations and businesses, with a tax credit for investing in communities that are economically distressed, or consist of low-income populations.

The federal NMTC program is administered by the Community Development Financial Institutions (CDFI) Fund in the U.S. Department of the Treasury. The CDFI Fund allocates tax credit authority--the amount of investment which investors use as the base for determining the amount of tax credits they are eligible to claim--to Community Development Entities (CDEs) that apply for, and obtain, allocations. As of January, 2010, the CDFI Fund had allocated $26 billion in total available NMTC allocation authority. The NMTC expired following the 2009 allocation round. However, federal legislation that would extend the program beyond 2009 has been proposed.

Applicants for NMTCs must submit standardized application packages to the CDFI Fund in which the applicant responds to series of questions about the CDE's track record, the dollar amount of allocated tax credits requested, and the organization's plans for using the credits to support activities in low-income communities. NMTC applications are first reviewed by a group of external reviewers with demonstrated experience in business, real estate, or community development finance. The applications are scored based on a range of criteria including: (a) business strategy; (b) community impact: (c) management capacity; and (d) capitalization strategy. Priority points may be given for demonstrating a record of successful investment in disadvantaged communities or businesses.

CDEs that meet or exceed certain thresholds advance to the second phase of the application process in which CDFI Fund officials determine, based on final ranking score, which CDEs will receive NMTC allocations, and the amount of the allocations. CDFI Fund staff review the amount of NMTC allocation authority requested, and based on the information in the application materials, award allocation amounts in order of the CDEs' final ranking scores, with consideration given to the expected amount of equity investment, amount of investment deployed to low-income communities, the quality of financial products offered, and the projected impact on low-income communities or low-income individuals. Not all CDEs that meet the minimum application score thresholds receive NMTC allocations. Allocation authority is generally awarded in order of final ranking scores until the allocation authority is exhausted.

After the CDFI Fund makes NMTC allocations to CDEs, investors make qualified equity investments (QEIs) by acquiring stock or a capital interest in the CDEs, and, in exchange, can claim tax credits on a portion of their investment. In turn, the CDEs are required to invest "substantially all" of the proceeds they receive into qualified low-income community investments (QLICIs). QLICIs include, but are not limited to, investments in businesses, referred to as qualified active low-income community businesses (QALICBs), to be used for residential, commercial, and industrial projects, and other types of investments, such as purchasing loans from other CDEs.

("Substantially all" means that CDEs must use, within 12 months, at least 85% of investor proceeds in years one through six, and 75% in year seven of the investment. CDEs can meet the requirement by two methods: (a) direct tracing of investments to specific qualified low-income community investments; or (b) showing that at least 85% of their aggregate gross assets [75% in year seven] are invested in QLICIs.)

Both nonprofit and for-profit CDEs can apply for and receive NMTC allocations. However, only for-profit CDEs can offer NMTCs to investors because, by definition, nonprofit organizations generally do not have access to equity investment. When a nonprofit CDE receives a NMTC allocation it must transfer the allocation to one or more for-profit subsidiaries.

Once a CDE has obtained qualified equity investments from NMTC investors, and the CDE has invested the funds in an eligible low-income community, an investor can claim NMTCs over a period of seven years, for a total of 39% of the investor's original QEI. Beginning in the year in which the investment is made, investors can claim a NMTC equal to 5% of the investment in each of the first three years, and a NMTC equal to 6% of the investment in each of the last four years. The NMTC is a nonrefundable credit. However, under federal law, unused NMTC amounts can be carried back one year, or carried forward up to 20 years to offset tax liabilities. Also, under federal law, after the initial NMTC investment, taxpayers that are eligible to claim the NMTC may sell their investment, along with the right to claim any remaining tax credits, to another investor. Investors can cease to qualify for the NMTC, and trigger a recapture event if the CDE: (a) ceases to be a certified CDE; (b) does not meet the "substantially all" requirement; or (c) redeems the investment. A recapture event means that an investor can no longer claim the credit, and that the investor that originally purchased the equity investment, and subsequent holders of the investment, are required to increase their income taxes by previously claimed tax credits, plus interest for each resulting underpayment of tax.

NMTC investors generally use leveraged or direct investment structures when making QEIs in CDEs. Under the leveraged NMTC investment structure, an equity investor usually forms a limited liability pass-through entity that obtains a loan from a bank. The equity investor combines its own tax credit equity funds with the loan from the bank (the leveraged lender) to make a QEI in a CDE. Because NMTC program rules require CDEs to obtain qualified equity investments from NMTC investors, the equity investor must obtain the loan from the bank, and combine the loan and tax credit equity investment funds in the limited liability entity. The limited liability entity then makes an equity investment in the CDE using those combined funds. The financial benefits from the transaction are separated from the tax benefits, with the leveraged lender receiving interest payments on the loan to the limited liability pass-through entity, and the tax credit investor receiving a return on investment by purchasing the right to claim tax credits on the total amount of the QEI.

This investment structure is attractive to the leveraged investor because the loan-to-value ratio is more favorable than it would be if the debt was not combined with the investor's equity. (Loan-to-value ratio is the relationship, expressed as a percentage, between the amount of a loan and the value of the asset that the loan is being used to finance.) The more favorable ratio may compensate the leveraged lender for making a loan with a greater degree of risk. From the tax credit investor's perspective, the base for calculating the tax credit is much larger with the addition of the loan. The tax credit investor obtains its return on investment by making an equity investment in the CDE (purchasing the credits) that is less than the full value of the credits it can claim. In addition, if a business defaults on its loan, the investor is still generally allowed to claim the full amount of the tax credit.

Once the CDE receives the QEI from the limited liability entity it then makes QLICIs in qualified low-income communities. According to the CDFI Fund, most CDEs commit to invest more than 95% of their QEIs as qualified low-income community investments, and retain the remaining 5% as an administrative fee. Typically, QLICIs are loans to businesses, because CDEs must meet related-party tests that require the CDE have no more than a 50% ownership interest in a QALICB. Direct equity investments by the CDE could result in the CDE exceeding the 50% threshold. As a result, CDEs generally offer two loans to a QALICB in a leveraged transaction, rather than one loan and one equity investment. One loan represents the funds loaned to the limited liability entity by the leveraged lender (usually an interest-only loan for seven years), and a second loan that represents some portion of the tax credit equity generated from the sale of the NMTCs by the CDE to the tax credit investor (typically converted to equity at the end of seven years).

The QALICB is responsible for repaying the interest, sometimes limited principal, on both loans during the seven-year tax credit period. At the end of the seven-year period, the QALICB generally must refinance the loan financed by the leveraged lender. The QALICB usually has the option of converting a loan from the sale of tax credits to equity by purchasing the tax credit equity from the CDE through a "put" option (contract to sell at a predetermined price). The QALICB uses the remaining equity to help refinance its remaining debt into more of a conventional, market rate loan.

The primary benefit of the leveraged NMTC investment structure to the low-income community business is the ability to purchase tax credit equity from the investor after seven years, because it assists the QALICB in obtaining more conventional financing after the NMTC claiming period is over. GAO found that the projected equity in low-income community businesses after the seven-year period in which tax credits can be claimed is about 50% to 65% of the amount of tax credits an investor can claim over seven years. The leveraged investment structure also allows the CDE to raise more funds to invest in low-income community businesses than would otherwise be available.

In addition to the leveraged investment structure, another common method for structuring NMTC transactions uses NMTCs to subsidize interest rates to businesses in low-income communities. In this structure, a single or multiple investors make an equity investment in a CDE. The CDE then loans funds from the investment to a QALICB. Because the investors can claim NMTCs, the CDE can offer the loan at a below-market interest rate. The CDE generally passes interest paid on the loan back to the NMTC investor. Combining the tax credits with a below-market interest rate generally allows the investor to obtain a sufficient rate of return on investment to offset the risk associated with investing in a low-income community business. GAO indicates that, depending on prevailing market interest rates for loans, NMTC loans under this NMTC investment structure could be 50% or more below market interest rates. The interest savings over seven years from below-market interest rates could put the QALICB in position to obtain more conventional financing.

Based on an analysis, through fiscal year 2008, of NMTC investments made in the U.S. (including the District of Columbia and Puerto Rico), GAO found that Wisconsin ranked eighth in the amount of NMTC investments. Nationally, NMTC financing was frequently used to fill the gap between funds that had already been raised for a project, and the total amount of funding needed to complete the project. On average, NMTC financing was used to support about 36% of total project costs. CDE officials indicated that, for most individual projects, NMTC financing provided 20% to 30% of total project costs. GAO found that national NMTC investments were used primarily for commercial real estate projects. CDEs used about 65% of total NMTC loans and equity investments for real estate projects. A 2008 paper prepared for the Federal Reserve Bank of San Francisco indicates that CDEs have likely made real estate investment the predominant form of NMTC investment because investors view real estate as more profitable than other types of investment, and less likely to fall out of compliance with NMTC restrictions (Lambie-Hanson, Fall 2008).

SUMMARY OF SUBSTITUTE AMENDMENTS

SSA 1 to SB 461 and ASA 1 to AB 642 would create a new markets tax credit under the state individual income tax, corporate income and franchise tax, and insurance premiums tax, for investments made after December 31, 2010. The credit would equal the amount of a claimant's qualified equity investment, as certified by the Department of Commerce, multiplied by the following percentages:

a. 0% for the tax year that corresponds to the first credit allowance date--the date on which such investment is initially made.

b. 3% for the tax years that correspond to the six credit allowance dates following the first credit allowance date--each of the following six anniversary dates of the initial credit allowance date

The new markets tax credit could be used to offset state income and franchise, and premiums tax liabilities, and unused credit amounts and could be carried forward up to 15 years to offset future tax liabilities. The Wisconsin adjusted basis of any investment for which a credit was claimed would have to be reduced by the amount of the credit that was offset against state income and franchise taxes. In order to claim a new markets tax credit, a claimant would be required to include, with the claimant's income, franchise, or premiums tax return, copy of the Department of Commerce certification of eligibility to claim tax benefits. A person could claim the state new markets tax credit regardless of whether the person claimed a federal new markets tax credit.

Federal Internal Revenue Code (IRC) passive activity loss limits, as they apply to individuals, estates, trusts, closely held C corporations, and personal service corporations would not apply to the state new markets tax credit. The maximum amount of tax credits that could be certified for making investments in certified qualified equity investments would be $10 million for each fiscal year, including the amount for all credit allowance dates.

A partnership, limited liability company (LLC), or tax-option corporation (S corporation) could not claim the credit, but eligibility for, and the amount of the credit would be based on eligible costs incurred by the entity. A partnership, LLC, or tax-option corporation would be required to compute the amount of the credit that each of its partners, members, or shareholders could claim and provide that information to them. Shareholders of a tax-option corporation could claim the credit in proportion to their ownership interest. Credits could be claimed by partners and members of LLCs in proportion to their ownership interest, or allocated to them as provided in a written agreement among the partners or members that was entered into by the last day of the tax year of the partnership or LLC for which the credit was claimed. A partner or member who claimed a credit under a written agreement would be required to attach a copy of the agreement, if applicable, to the tax return on which the credit was claimed. A person claiming a credit under a written agreement would be solely responsible for any tax liability that would arise from a dispute with the Department of Revenue (DOR) related to claiming the credit.

A claimant who transferred an interest in a partnership, LLC, or tax-option corporation after the first credit allowance date, but before the final credit allowance date, would be entitled to claim a credit for the remaining credit allowance dates by filing, with the claimant's income, franchise, or premiums tax return, a written agreement between the claimant and the transferee of the interest that would specify that the claimant, and not the transferee, was the person entitled to claim the tax credit.

DOR would administer the tax credit, and current law provisions related to change of ownership or timely claims would apply to the new markets tax credit. DOR would be authorized to promulgate administrative rules regarding the recapture of new markets tax credits consistent with federal IRC provisions. If a claimant's federal new markets tax credit was subject to recapture under federal law, then the state tax credit would be subject to recapture at the same time and in the same manner as the claimant's federal NMTC.

As noted, the federal NMTC is subject to recapture, if at any time during the seven-year period beginning on the date of original issue of a QEI in a qualified CDE: (a) the CDE ceases to be a qualified community development entity; (b) the proceeds of the QEI cease to be used for qualified low-income community investments; or (c) the low-income community investment is redeemed by the CDE. Federal law requires that the investor's income tax liability be increased by the recapture amount in the tax year that the recapture event occurs. The recapture amount equals the sum of: (a) the aggregate decrease in new market credits allowed to the taxpayer for all prior tax years that would have resulted if no credit had been provided for the related QEI; and (b) interest for underpayment of taxes on the amount of decreased credits for each prior tax year for the period beginning on the due date for filing the income tax return for first the tax year to which the recapture applies.

The Department of Commerce would be required certify a qualified equity investment as eligible for state new markets tax credits and administer the certification process. Specifically, Commerce would be authorized to certify a qualified equity investment if all of the following applied:

a. The proposed QEI would be funded by a community development entity whose service area included the state.

b. The qualified CDE applied to Commerce, on a form provided by the Department, and included evidence with the application that the Department was satisfied that all of the following applied: (1) proceeds from the QEI would be invested in, or loaned to, a qualified active low-income business in Wisconsin; and (2) the proposed QEI would promote the creation or retention of jobs in the state, or would promote other economic development goals established by Commerce by rule.

A QEI that was certified by Commerce would have to be funded by the qualified CDE by the last day of the 13th month beginning after the date of certification. If a QEI was not funded by that date, its certification would expire by the first day of the 14th month beginning after the date of certification. QALICBs could not receive more than $5.0 million in investments, loans, or proceeds from qualified CDEs.

Commerce would be authorized to certify a person to claim state new markets tax credits, if the person applied to the Department and submitted evidence that the person made an investment in a QEI that was satisfactory to the Department. A person certified to claim tax credits would be eligible to claim state new markets tax credits in each tax year in which there was a credit allowance date. As noted, the maximum amount of new markets tax credits that could be certified for investments in QEIs, including the amount for all credit allowance dates, would be $10 million in each state fiscal year.

Commerce would be required to notify DOR of every QEI and tax credit certification, including the date on which the certification was granted. Commerce would also be required to provide each applicant for certification of QEIs or tax credits with a dated written notice indicating the Department's decision to grant or deny certification. Commerce would promulgate administrative rules to administer the certification program including: (a) deadlines for the submission of an application for certification; (b) the period for review of applications, not to exceed 45 days; and (c) criteria for reviewing certification applications and for prioritizing applications for certifications of QEIs. The criteria would be required to: [1] include economic development goals that are consistent with federal new markets tax credit provisions; and [2] prioritize applications for QEI certification from CDEs proposing qualified equity investments in QALICBs that are owner-occupied, and not primarily engaged in real estate development, insurance, banking, lending, lobbying, political consulting, professional services provided by attorneys, accountants, business consultants, physicians, or health care consultants, wholesale or retail trade, leisure, hospitality, transportation, or construction, except for power production plants that derive energy from a renewable resource.

The definitions of QEI, qualified CDE, and QALICB are all referenced to the federal NMTC Internal Revenue Code definitions. "Qualified equity investment" means any equity investment in a CDE if: (a) the investment is acquired by the taxpayer at its original issue [directly or through an underwriter] solely in exchange for cash; (b) substantially all of such cash is used by the CDE to make qualified low-income community investments [at least 85% of the aggregate gross assets of the CDE are invested in QLICIs]; and (c) the investment is designated for the purposes of the NMTC program by the CDE. "Equity investment" is: (a) any stock [other than nonqualified preferred stock as defined under federal law] in an entity which is a corporation, and (b) any capital interest in an entity which is a partnership.

"Qualified community development entity" means any domestic corporation or partnership if (a) the primary mission of the entity is serving, or providing investment capital for low-income communities or low-income persons; (b) the entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity, or on any advisory board to the entity; and (c) the entity is certified by the Secretary of the U.S. Department of the Treasury. Specialized small business investment companies and community development financial institutions as defined under the IRC are considered CDEs.

"Qualified low-income community investment" means: (a) any capital or equity investment in, or loan to, any qualified active low-income community business; (b) the purchase, from another CDE, of any loan made by such entity which is a QLICI; (c) financial counseling and other services, specified in federal regulations by the Secretary of the Treasury, to businesses located in, and residents of, low-income communities; and (d) any equity investment in, or loan to, any CDE.

"Qualified active low-income community business" is defined as any corporation, including a nonprofit corporation, or partnership if for the tax year: (a) at least 50% of the total business income of the entity is derived from the active conduct of a qualified business within a low-income community; (b) a substantial portion of the use of the tangible property of the entity (whether owned or leased) is within a low-income community; (c) a substantial portion of the services performed for the entity by its employees are performed in a low-income community; (d) less than 5% of the average of the aggregate unadjusted bases of the property of the entity is attributable to collectibles as defined under the IRC (metal, gems, coins, stamps, works of art, rugs, antiques, alcoholic beverages), other than collectibles that are held primarily for sale to customers in the ordinary course of business, and (e) less than 5% of the average of the aggregate unadjusted bases of the property of the entity is attributable to nonqualified financial property as defined under the IRC (debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, annuities, notional principal contracts, other similar property). Sole proprietorships are considered QALICBs if the business would meet these requirements if incorporated. A "qualified business" is generally any trade or business, except for certain businesses engaged in: the rental of real property; holding of intangibles; leisure or recreational activities such as golf courses, massage and suntan parlors, hot tub facilities, gambling facilities; liquor stores; and farming.

In general, "low-income community" means any population census tract where: (a) the poverty rate for the tract is at least 20%; or (b) the median family income for the tract does not exceed 80% of the statewide median family income, if the tract is not located in a metropolitan area, or does not exceed 80% of the greater of the statewide or metropolitan median family income, if the tract is located in a metropolitan area. The Secretary of the Treasury is authorized to issue regulations designating populations that may be treated as low-income communities, and procedures for determining which entities are QALICBs with respect to such populations. In addition, the definition of low-income community includes certain areas not within census tracts, tracts with low population, and census tracts with high-migration rural counties.

The substitute amendments would require Commerce to submit the required administrative rules for administering investment and tax credit certifications to the Legislative Council staff by the first day of the fourth month beginning after the effective date of the substitute amendments. Commerce would be authorized to promulgate emergency rules for the period before the permanent rules were effective, without a finding of emergency.

The provisions of the substitute amendments would take effect on the day after publication and first apply to tax years beginning on or after January 1, 2011.

FISCAL EFFECT

Department of Commerce. Commerce would be required to certify qualified equity investments and taxpayers as eligible to claim state new markets tax credits, and perform related administrative activities. The Department would also be required to promulgate rules for administering the certification process. The substitute amendments do not provide Commerce with additional positions or funding for theses new administrative responsibilities. However, Commerce indicates that it would require 1.0 GPR position and $73,400 GPR annually to perform the necessary administrative functions related to the state new markets tax credit.

New Markets Tax Credit. The substitute amendments would create a state new markets tax credit that that could be clamed over seven years. The credit would equal 0% of the claimant's QEI for the first tax year in which the investment was made, and 3% of the claimant's QEI for the following six years. Credits could only be made for investments made after December 31, 2010, and the maximum amount of credits that could be claimed in a fiscal year would be $10 million. Because the credit could first be claimed for investments made beginning on January 1, 2011, and the first year credit rate is 0%, there would be no fiscal effect in the 2009-11 biennium.

The fiscal effect of the state new markets tax credit for fiscal years after 2010-11 will depend upon the amount of QEIs and tax credits certified by Commerce in a given fiscal year. Based on the

CDFI Fund, Qualified Equity Investment Report of February 1, 2010, a total of approximately $962.8 million in NMTC authority in investment allocations were available to CDEs that could invest in Wisconsin low-income communities. Since $333.3 million in QEIs would generate $10 million in annual tax credit claims, there are sufficient unused investment allocations to generate the maximum $10 million in annual tax credit claims.

The maximum fiscal effect would be a revenue loss of $10 million annually beginning in tax year 2012. This assumes that Commerce would certify investments worth $333 million in tax year 2011, with a 3% credit ($10 million total per year) claimed beginning in tax year 2012 and each of the next five years. With this approach, no additional investments could be certified until 2017.

However, another potential investment pattern would be for Commerce to certify approximately $55.55 million in new investments each year from 2011 through 2016. This would result in total investments of $333.3 million by 2016, along with increasing amounts of credits being claimed each year (beginning in tax year 2012). The following table shows the estimated cost of the credit in 2011-12 and later years under this assumed investment pattern. The actual costs of the credit could vary from these amounts if the amount of proposed qualified investments received and certified by Commerce differs from the assumptions outlined above.

Fiscal Year	Estimated Fiscal Effect (Millions)
2011-12	-$0.4
2012-13	-2.1
2013-14	-3.8
2014-15	-5.4
2015-16	-7.1
2016-17	-8.8
2017-18	-10.0
2018-19	-10.0

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