NMTC Report

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Improving the New Markets Tax Credit Program for Venture Capital

By Philip Bylund, Community Development Venture Capital Association
Part two of two

As we reviewed in the last issue of the *NMTC Report*, the New Markets Tax Credit (NMTC) program was hailed as the answer to seeing much needed long-term capital finding its way into under-served communities. Certainly, witnessing the 345 NMTC applications filed in 2002, valuing investments of $25.8 billion, underscores the market's enthusiasm for this stimulus package. In part, based on this overwhelming market reaction to the NMTC program, the NMTC Coalition submitted a proposal to President George W. Bush on December 10 urging the administration to include an additional $2.5 billion in NMTC allocations in the federal economic stimulus package.

While the industry awaits the results of the 2002 NMTC application decisions, the Community Development Venture Capital Alliance (CDVCA) continues to address the challenges of applying the NTMC to venture capital. There is a risk that the financial markets will interpret the magnitude of the NMTC allocation applications as a clean measure of the program's success. While it is too early to have definitive results and draw conclusions, CDVCA anticipates that the large majority of the 2002 NMTC allocations will be toward debt financing rather than equity financing. To ensure that the NMTC program sponsors true equity capital investing in underserved communities, further refinements to the NMTC program are necessary. Some of these modifications are regulatory and some are legislative.

Regulatory Changes

The control test as an exception to the reasonable expectations safe harbor

The NMTC program provides for harsh recapture provisions should a particular investment fall out of compliance. For example, if a business in which tax credit funds are invested moves out of a low-income area, all prior tax credits on such funds are subject to recapture. Unlike with lenders to real estate projects, venture capital provides equity capital to growing businesses. Successful businesses may find advantages in expanding and therefore moving. Such a move would result in non-compliance and recapture. However, the temporary regulations promulgated by the Treasury Department provide for a safe harbor from recapture if the investor in a business had a reasonable expectation that a business would remain compliant throughout the seven-year investment period and the investor does not control the business. Thus, if such a reasonable expectation exists at the time of the investment, then the investing fund and its NMTC investor would be

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NMTC Watch

The General Accounting Office (GAO) stated in a December 6 letter to Congress that it does not plan to evaluate the effectiveness of the New Markets Tax Credit (NMTC) program in its 2004 report but instead report on the progress of the program implementation. The NMTC statute requires the GAO to audit and report on the new markets program in January of 2004, 2007 and 2010. The GAO says it is continuing to explore which tools and methodologies it will use to evaluate program impact and effectiveness. However, the agency's letter to Congress suggests that "an evaluation of the program's effectiveness presents some significant difficulties. "For more information, the GAO letter can be found on the Resources page at www.newmarketscredits.com.

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protected from recapture.

The challenge of this safe harbor for venture capital is the imposition of a criterion for control and more so, that the control hurdle has been defined at 33 percent. What this means for venture capital is that even if, at the time of the investment, the reasonable expectation was that the business would remain compliant throughout the seven-year investment period but during that period, the investor's ownership interest in the business exceeded 33 percent, which can easily occur in successful venture capital, the investor loses the reasonable expectations recapture safe harbor.

Venture capital aims to provide equity capital and extensive technical assistance to start-up and/or rapidly growing businesses. Unlike with fixed-income investing, the equity investment through venture capital has a direct impact on the control over the investee company. Ensuring compliance with the terms of the NMTC program through provisions of control limitations severely disadvantages equity investing and encourages such investments to be in the form of debt. Through this orientation, a capital structure dependent upon leverage is the indirect result.

As a point of comparison, traditional venture capital often starts out with 100 percent ownership of the business with the entrepreneur then rewarded for a successful enterprise through the ability to "buy into" the business — gradual transfers of ownership shares held by the venture capitalist to the entrepreneur. More often with community development venture capital, the venture capitalist makes smaller initial investments but successful business ventures are subsequently rewarded with subsequent rounds of investment capital for further growth and development. However, unlike incremental debt infusions, these important ownership increases, resulting from these follow-on investments, directly impact ownership and therefore control.

Another application of investment variations sometimes used in the venture capital model is referred to as "ratchet provisions." In this method, the portfolio company works toward identified business performance measures and should there be a shortfall in achieving these performance hurdles, the venture capitalist has the right to increase its ownership stake in order to increase its control in the business operations, all toward turning around the business.

Whether in the form of second round financing or utilizing ratchet provisions, the venture capital model provides for equity capital as a means of enhancing the business' operation while ensuring that the venture capitalist has appropriate strategic influence over the business' activities. Unlike large-scale traditional venture capital, with community development venture capital and its orientation toward smaller investments in entrepreneurs, the venture capitalist is not just providing the capital but is the mentor to the entrepreneur. Retaining the ability to apply capital in this dynamic manner and altering control over the busi-

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ness itself facilitates a robust financing model with profoundly positive long-term results.

CDVCA Recommendations:

- Removal of "control" provision, or
- If retaining a "control" standard, increase the control threshold to a level substantially above 51 percent.

Legislative Changes

Other aspects of the NMTC program that warrant modifications in order to expand the application of venture capital into these communities of economic need are changes that would require amendments to the original legislation enacting the NMTC program. While these reflect more complicated remedies, CDVCA hopes that these changes could be considered in tandem with any future technical corrections tabled in the subsequent federal tax bills.

A core element of the NMTC program is the use of a tax credit recapture mechanism, should there occur breaches to critical aspects of the program. The recapture provision receiving some of the widest attention and comment in the venture capital community is the requirement that investments by CDEs be outstanding for a minimum of seven years. For fixed-income securities with the known investment period, which can be defined as longer then seven years, community development venture capital provides for the ability to recognize rapidly growing businesses that achieve a level of performance warranting exiting the investment. This may occur before or after the seven-year time restriction in the NMTC program and retaining that flexibility is critical to the inherent operation of the venture capital model. Forcing the venture capitalist to adopt an artificial imposition of a seven-year investment timeframe, without regard to the dynamics of the business in which the investment has been made, prevents responsive investment practices, potentially undermining the venture capital financial model and performance. Accordingly, for venture capital, imposing recapture based on a defined seven-year investment period should be removed.

Qualifying active low-income capital funds

The NMTC program provides for the concept of qualifying active low-income investments (QALICIs). Reinvestment from the proceeds of one QALICI must be placed into a new QALICI to avoid recapture of the tax credits. As such, the NMTC program focuses on individual investments into low-income communities rather than providing the tax incentive to support capital commitments to a fund of qualifying investments. Expanding the application of capital to a fund focusing on identical low-income investing, rather than on a specific investment, would achieve the same developmental objectives of the current NMTC program while decreasing the significant risk of recapture.

As an extension of the concept of qualifying investments in defined funds rather than in specific assets, the NMTC program should qualify and therefore

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reward through the tax credits, investments in designated new markets venture capital funds, many of which are attempting to utilize the NMTC program in their business model. Through this, these two new markets programs could become complimentary, as was indeed the original intent in the pursuit of increasing equity investments in low-income communities.

The substantially all test and venture fund expenses

The NMTC requires that substantially all of the cash proceeds of a tax credit investment be invested in qualifying investments. The NMTC regulations define substantially all as 85 percent, leaving 15 percent of the proceeds for non-qualifying investments, operating expenses and other uses. This substantially all requirement can make it difficult for traditionally structured venture capital funds to operate appropriately and pay management fees and other operating expenses.

A venture capital fund ordinarily pays its operating expenses out of contributed capital. That is, the fund pays a management fee (typically 3 percent per year of funds under management for a community development venture capital fund) to a management company whose employees manage the fund. In addition, other operating expenses not included in the management fee, such as legal and accounting fees, may be paid from the corpus of the fund, on top of the management fee.

The fund ordinarily does not have much current income to pay for these costs, because equity investments typically do not produce much current income. Equity investments produce income at the end of the life of the investment in the form of capital appreciation. This contrasts with loans, which produce current income in the form of interest payments throughout the life of the loans.

Without current income, a venture fund must pay for operating expenses, such as the management fee and other expenses, out of contributed capital. This may run afoul of the substantially all test. For example, a fund that pays a 3 percent per year management fee over a typical 10-year fund life would pay out 30 percent in fees, plus additional amounts for other expenses. Obviously, this would be impossible to do if only 15 percent of contributed capital may be used for purposes other than making qualifying investments.

This problem is ameliorated somewhat by a provision in the tax credit legislation that makes technical assistance to investee businesses a qualifying use of tax credit funds, which counts toward the 85 percent substantially all test. It can be argued that a significant portion of the management costs of a community development venture capital fund go toward technical assistance to portfolio companies and prospective portfolio companies. However, this still may not be enough to make the tax credit work for the traditional structure of a venture fund. Making the management fee of a traditionally structured community development venture capital fund count toward the substantially all test would remove this issue from the list of problems that make it difficult to use the tax credit for equity investment.

Philip Bylund is the director of international strategy and special initiatives at the Community Development Venture Capital Alliance. He leads CDVCA's efforts in the international arena and is active in the group's consulting services, particularly with respect to the New Markets programs. He can be reached at 212.594.6747 or pbylund@cdvca.org. *CDVCA recognizes the valuable input provided to the investment community through the NMTC program, and will continue to work to promote enhancements to the program to facilitate equity investing in the communities to which the NMTC program is intended to serve. It welcomes your input to this process and feedback to these structural recommendations.*

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