Why QALICBs, CDEs Should Consider Qualifying for Targeted Populations

The vast majority of business and nonprofits that receive new markets tax credit (NMTC) financing serve low-income communities that are physically located in a low-income census tract. However, there's another underutilized method for businesses and nonprofits to qualify for NMTC financing that is not geography based. It's called the targeted populations approach. Michael Novogradac, CPA, and Novogradac partner Bryan Hung, CPA, discuss the potential benefits of the targeted populations method, how to meet the targeted populations criteria, compliance considerations and more.

Summaries of each topic:

1. Background of Targeted Populations (04:10-8:52)
2. Meeting the Targeted Populations Criteria (8:53-14:59)
3. Meeting the Higher Distress Criteria (15:00-18:52)
4. Considerations for Closing a Targeted Populations Transaction (18:53-20:47)
5. Compliance Considerations (20:48-24:42)
6. Exit/Off-Mike (24:43-28:23)

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Transcript

[00:00:00] **Michael Novogradac, CPA:** Hello, I'm Michael Novogradac. And this is Tax Credit Tuesday. This is the June 7th, 2022, podcast. Today's podcast is a must-listen for any community development entity that is currently rolling out a new markets tax credit award, or is planning to apply for allocation in a future new markets tax credit application round. Today's topic is probably even more important to any business and nonprofit seeking new markets tax credit subsidized financing.

Now the new markets tax credit is a federal incentive that drives private debt and equity capital to businesses and nonprofits serving low-income communities. Generally speaking, the term “low-income community” is a census-tract-based definition under the new markets tax credit. This would mean a census tract is considered a low-income community if it has a poverty rate of at least 20% or a median family income that is 80% or less of the metropolitan area median income. So that's the geographic definition of a low-income community.

Now the overwhelming majority of businesses and nonprofits that receive new markets tax credit financing have met the statutory requirements of the code by physically locating in a low-income census tract.

Now I say “overwhelming majority,” I don't say “all” are located in a low-income community because there is another underutilized method that allows the nonprofit or business to qualify for new markets tax credit financing method that is not geography based. That method is referred to as the targeted populations approach. Under this targeted populations approach, a population is treated as a low-income community and the business or nonprofit needs to serve this group in order to be eligible for new markets tax credit financing. The targeted populations approach can enable a business or nonprofit to qualify for the new markets tax credits subsidized financing, even if the business or nonprofit is not qualified under the census tract-based criteria of the general approach.

Today's episode will focus on this vastly underutilized option. If you're listening to this podcast and you have a business or nonprofit that is already located in a low-income census tract, you might think there's no reason to look at the targeted populations approach, but don't make that judgment too hastily. Your business or nonprofit may benefit from using the targeted populations method, even if it's already in a low-income census tract. That's because community entities or CDEs generally commit to financing

businesses or nonprofits that are at a higher level of distress or serving communities at a higher level of distress than the statutorily defined minimums for the definition of low-income community.

So in order to access the new markets tax credit allocation of these CDEs, your business needs to satisfy higher distress criteria. We at Novogradac find that the targeted population is sometimes a more viable way to help CDEs satisfy their higher distress criteria than location-based criteria alone.

So in short, if you think your business is not eligible for new markets tax credit-subsidized financing because it's not in a qualified census tract, you should consider the targeted populations method. And even if your business is already located in a low-income census tract, but you're having difficulty attracting new markets tax credit financing because your census tract isn't considered highly distressed, you also should consider the targeted populations methods.

Now joining me in this week's discussion is my partner Bryan Hung from Novogradac's Long Beach, California, office. Bryan has extensive expertise with historic tax credits and the new markets tax credit. Bryan helps many clients each year learn about the untapped potential of the targeted populations method.

So we're very fortunate to have him on the podcast to share those insights today. If you're ready, let's get started.

[00:04:04] **Michael Novogradac, CPA:** So Bryan, welcome to Tax Credit Tuesday.

[00:04:07] **Bryan Hung, CPA:** Thanks for having me, Mike. Happy to be here.

Background of Targeted Populations

[00:04:10] **Michael Novogradac, CPA:** So before we get into the details as to what makes a business or nonprofit eligible for the targeted populations method, let's take a step back and discuss why this option exists.

Now I know that the targeted population method was not originally part of the new markets tax credit when it was enacted in December of 2000. So, Bryan, if you could share with our listeners why the targeted populations approach or option was created.

[00:04:36] **Bryan Hung, CPA:** Sure. As you mentioned, the new markets tax credit program was created to drive investments to help local communities.

I think for the first few years in New Markets Tax Credit program, the definition of a low-income community was geographically based and qualifying businesses had to be located within a low-income census tract. And I think, few years went by and I think it was realized that not all low-income communities are being served.

And I think that's the reason why targeted population was created and it was created so that a low-income community did not have to be geographically based. It could be outside of low-income census tract, but serving the low-income community. And the low-income community could be considered the employees or the customers of the business. And the targeted population option was enacted through the American Jobs Creation Act of 2004 and using targeted populations, CDEs can now invest in projects. For example, health clinics that serve the low-income population or manufacturing facilities that employ low-income workers, regardless of if it's located in low-income community census tract or not.

[00:05:56] **Michael Novogradac, CPA:** Great. Thank you for that background. Let's start off in terms of a landscape of new markets tax credit transactions at what percentage of the financings that you work on would you estimate use targeted populations as their definition of local community, as opposed to a low-income census tract-based definition of low-income community?

[00:06:17] **Bryan Hung, CPA:** Sure. I think for the first few years when targeted population was enacted there was very little actually involving targeted population, but in the last seven, eight years, I see an uptick picking up on transactions using targeted population, but it's still right now in the last seven years, I would say about 5% of the transactions I work on involve targeted populations.

[00:06:38] **Michael Novogradac, CPA:** And what portion of those do you think are using targeted populations because they're not located in low-income community as opposed to using targeted populations in order to be serving a higher distressed population?

[00:07:6:52] **Bryan Hung, CPA:** Eighty percent of the transactions I work on are targeted population projects that are not located in a low-income community, low-income

census tract versus about 20% that are located in a low-income census tract, but do not meet the definition of higher distress.

[00:07:07] **Michael Novogradac, CPA:** Got it. Yeah. So in terms of the, the lack of use, if you will, you said it's been rising, but it's still only sort of that 5%-ish range of financings are through the targeted populations approach. Maybe you could explain to our listeners why you think the ratio is so skewed towards location-based, as opposed to targeted populations based.

[00:07:34] **Bryan Hung, CPA:** Sure. So I think new markets itself is complex in terms of qualifying for their financing and understanding how to close a new markets tax credit transaction. And I think that in itself requires a high learning curve for people to understand and work on to close those deals and then to add in targeted population was another layer of complexity to these highly structured new markets tax credit transactions.

And sometimes, they’re not as familiar with these requirements, so they tend to avoid them, or they might not understand, or not even know about this tax credit for this targeted population approach. So the new markets tax credit is already complex and then adding an additional layer makes it harder to close these transactions.

And I think maybe sometimes businesses are scared or not as excited adding more complexity for a complex transaction. And also there are ongoing compliance requirements that is more than a normal new markets tax credit transaction that’s located in a low-income community. So because of all this additional work, I think people tend to avoid these as much as possible.

Meeting the Targeted Populations Criteria

[00:08:53] **Michael Novogradac, CPA:** So maybe to summarize it, they're not that familiar. Number one, they've been maybe unfamiliar with the options, so it’s not something they consider. Two, it does add a level of additional complexity and no matter how complex the transaction is, you always want to do less complex than you never, ever encourage complexity. Then three, it does have a little bit more in terms of annual compliance requirements.

So maybe let's switch to what it actually means in terms of how a business meets the targeted populations criteria. When we look at location-based, there's various metrics to

identify whether or not the business or nonprofit is operating in a low-income community.

But when you're serving a targeted population, you didn't have to have other metrics to identify whether or not a business or nonprofit is serving this low-income community, which is people. So maybe you could discuss the three ways for listeners as to how a business or nonprofit meets the targeted population criteria, the ways in which they can meet it.

[00:09:54] **Bryan Hung, CPA:** Sure. There are three ways that a business can meet the targeted population requirements. The first approach is your employees of a business. Enough employees of a business have to be qualified as a low-income person. The second approach is revenue based and basically it's the people that you serve through your business. They have to qualify as a low-income person. And the third and last approach is having an owner that qualifies as a low-income person. And when I say low-income person, it's really a family-based test. So the person, and then all their family members within that person's family.

[00:10:42] **Michael Novogradac, CPA:** So which of these three, what percentage of new markets tax credit clients, use the employment approach or the client service approach versus the owner approach?

[00:10:53] **Bryan Hung, CPA:** So, I think the overwhelming majority of my targeted population deals have been through the employee approach. I would say about 90% of the transactions I close use employee approach. The rest of the 10% is through the customer approach. And I have not experienced closing a deal where the owner approach was used. And I would imagine that's pretty difficult.

[00:11:22] **Michael Novogradac, CPA:** What I would suspect is the owner approach also doesn't fit in well with the business strategies that most CDEs applying for allocations, apply for that they're generally focused on employing low-income persons or serving low-income persons as opposed to financing businesses that are owned by low-income persons.

Would you agree with that as a general rule?

[00:11:44] **Bryan Hung, CPA:** Yep. I agree. I agree. The community benefits that CDEs are looking for are usually targeted, serving low-income persons.

[00:11:52] **Michael Novogradac, CPA:** And also just from a compliance risk perspective, it strikes me that if you're focusing on employing low-income persons, that's pretty manageable from an ongoing compliance perspective.

It strikes me that when you're serving low-income persons, it can be a little bit more challenging to meet the various threshold requirements, which we'll talk about in a moment. Obviously, the low-income owner would be fairly straightforward to document as well, similar to the employment, but for other reasons, that one isn't used as often.

And I did mention in the intro, if a business owner looks at new markets tax credits, should consider targeted populations if they're not in a low-income community or if the low-income community that they're in isn't highly enough distressed in order to attract an allocation from a CDE. Are there any other reasons or anything you wanted to amplify on that?

[00:12:45] **Bryan Hung, CPA:** Yes, Mike. So there is one thing I do want to point out to our listeners. And one is that geography still needs to be considered because targeted populations has a threshold limit in terms of area median income. So a business cannot be located in a census tract that's above 120% of area median income.

[00:13:07] **Michael Novogradac, CPA:** Right. Thank you for that. So that's so we have to be mindful of that while the targeted population you're serving isn't an area-based concept, where the business is located still has this 120% area median income limit in terms of their eligibility for financing. So it seems like we've talked about businesses and they obviously should be focused on this method because it can help them attract financing, new markets tax credit subsidized financing thing that CDEs need to be aware of.

And then it seems like CDEs in turn should be focused on targeted population method because it increases the pool of eligible businesses. Are there other reasons why you think community development entities should be focused on targeted populations?

[00:13:56] **Bryan Hung, CPA:** Well, I think that's one of the biggest reasons is that it increases the pool of eligible businesses and it allows CDEs to maybe choose really great projects versus very good projects.

And by having these businesses meet the high distress criteria they're allowed to invest in projects that are say the best of the projects that they're looking at. Another item I think

could be, it allows flexibility. So, when COVID first hit, there was all of a sudden shift to food banks. And food banks they might not qualify for new markets, but I worked on a transaction where we were able to qualify a food bank using targeted population to try to get dollars to that nonprofit so they can purchase more food to serve the community during when COVID first hit where there's a great need.

Meeting the Higher Distress Criteria

[00:15:00] **Michael Novogradac, CPA:** No, that's a great example. That's a great example. So maybe we can talk a bit about what the higher distress criteria are for targeted populations.

[00:15:12] **Bryan Hung, CPA:** Sure, Mike. So, to qualify for high distress, a low-income community business has to have at least 60% of their employees qualify as low-income persons or 60% of their gross revenue generated from a low-income person or 60% of the business is owned by a low-income person. If I could elaborate on the 60% gross revenue: The gross revenue is actually looking at the total revenue numbers. So maybe if you're charging a low-income person less than say a not low-income person and then you have to have maybe even more than 60% of your customer from the local community to make up the difference.

[00:16:03] **Michael Novogradac, CPA:** Okay. So what, I don't know that we've discussed this year. So what makes up a targeted population under the general rule? You just described the higher distress criteria, but as a general rule, what does it mean to be a targeted population? What is eligible to be a member of a targeted population?

[00:16:24] **Bryan Hung, CPA:** That's a great question, Mike. So the statutory requirement is 50% of gross revenue generated from low-income persons. Forty percent of employees have to be a low-income person or 50% of the business is owned by a low-income person. And this is the minimum threshold to meet the statutory requirement for targeted population.

[00:16:44] **Michael Novogradac, CPA:** So basically those are 50% or 40% standards and the higher distress raises those to a 60% standard.

[00:16:52] **Bryan Hung, CPA:** That is correct.

[00:16:54] **Michael Novogradac, CPA:** So maybe you could share an example of a client that came to you, who wasn't thinking about targeted populations. And then after you discussed it with them, they ended up, not that you were suggesting this, or you should go down targeted populations, as you're working with them, you realized that targeted populations was probably a better approach.

[00:17:15] **Bryan Hung, CPA:** Sure Mike. Yeah. So, a couple of years ago I was working with an organization and they say they serve the low-income community as just part of their organizational mission. They're a nonprofit and deliver great community benefits, but they wanted to avoid the additional complexity of compliance requirements that they have to meet.

The business needed about $45 million of allocation. And, because of the community benefit they provided, they thought that they were a great contender to get CDEs involved and provide those allocations. However, after a few months of discussing their project with various CDEs, they had a commitment from a CDE, but they didn't have enough commitment from the CDE to provide the entire $45 million allocation.

So after that few months we were strategizing and targeted populations came up with. How they could increase their appeal to the various CDEs out there and by meeting the higher distress criteria. And then after that was considered an option, we were looking at the business and what approach might be best for the organization to meet those criteria.

And eventually it was settled on the employee method to meet the high distress criteria. And after the organization committed to meeting those criteria, they were able to quickly get other CDEs involved to get all the allocation that they needed for their project.

Considerations for Closing a Targeted Populations Transaction

[00:18:53] **Michael Novogradac, CPA:** That's great. That's a great example. So if I'm a listener, I'm thinking, okay, this sounds great. What do you want to tell me about closing the new markets tax credit transaction that's using targeted populations as the low-income community they're serving?

[00:19:10] **Bryan Hung, CPA:** So I think first, first thing you want to look at is to see is your business or organization the type of business that would qualify on the targeted

population because there's only three ways of qualifying is either through the gross revenue test, the employee test or the ownership test.

And if you're a nonprofit, there's really no owner. So, if you're looking at gross revenue or employee tests, you have to consider what will be the path of least resistance. And employees, they could cause problems if all you have is higher income-earning employees. And the pool that you're hiring from is all high-income earners or versus gross revenue tests where it's hard to track your customers if they're low-income persons or not.

So the type of business that you have will determine what approach you want to take. And I think I recommend first, if you are going through the employee test first, get a survey of all your existing employees and to see what income level they're at.

And second, really get an experience targeted population accountant or an attorney involved to help you put procedures in place to help you or to also help you tailor your message to employees, well future employees, to get this program implemented into your organization so that CDEs can see that you have a plan for this targeted population requirement and that they have confidence in you meeting the compliance requirements going forward.

Compliance Considerations

[00:20:48] **Michael Novogradac, CPA:** So you mentioned compliance, that seems like that's certainly a key with targeted populations because you have these various percentage tests that you need to be monitoring, pretty continuously. So what are some of the ongoing compliance requirements related to targeted populations?

[00:21:06] **Bryan Hung, CPA:** So, it depends on the approach you're taking.

So the targeted population requirements are a commitment. There is going to be compliance reporting that you have to submit to the community development entities that you work with and you’re also going to have policies and procedures in place, so if you are using the employee test approach, the compliance is basically you test each employee at the time they're hired and only at the time that they're hired. So the employee can be hired in at a very low level and raise through the ranks all the way to your highest level in your organization and with the pay increases as well. But that wouldn't matter, as long as, at the time they're hired, they meet the low-income person test.

And versus, the other approach is a revenue approach and that approach requires the organization or business to track where they're generating the revenue from. It requires the business to look at if the customers are a low-income person or not. And some businesses that could be very hard to track. And also for certain other types of businesses, for example, health clinics, they might already be tracking those in terms of the low-income population they're serving. But even in those instances, you do have to make sure that your record keeping is able to separate out the low-income person revenue generation versus non-low-income person revenue generation.

And this has to be verified every single year and a low-income person that might meet that test for revenue generation might not meet it the following year. So they might qualify one year, the next year, they might not versus the employee test where the employee is just qualified at one time when they're hiring.

[00:23:07] **Michael Novogradac, CPA:** Great. Thank you for that. That's also one of the other reasons why the employee test is a little bit more popular than that services or sales test. So thank you for sharing your insights with us today here on targeted populations. I'm sure there are some listeners out there that are going to reach out to you for more information, and their own specific, financing opportunities.

So if you could please share your email address and I will include it in today's show notes.

[00:23:30] **Bryan Hung, CPA:** Sure, Mike. It’s Bryan.Hung@novoco.com.

[00:23:44] **Michael Novogradac, CPA:** Great, Bryan, please do stick around for our Off Mike segment of the podcast, where I get to ask you some fun questions not directly related to tax incentives to our listeners.

Please be sure to tune into next week's episode of Tax Credit Tuesday. My partner Frank Buss will be on the podcast to discuss the Financial Accounting Standard Board's new lease standards that were implemented Jan. 1 of this year. These new lease standards can have a major effect on any business with an operating lease.

We're going to break down the consequences for different tax incentive areas such as renewable energy, the new markets tax credit, the historic tax credit and low-income housing tax credit. You can make sure that you're notified of that episode in each week's episode, by following or subscribing to the Tax Credit Tuesday podcast.

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Off-Mike

[00:24:43] **Michael Novogradac, CPA:** So, now I'm pleased to reach our Off-Mike section where listeners can get some off-topic advice and words of wisdom from our podcast guests.

So, Bryan, let me start with one of my fun questions I always like to ask and that is, what's a productivity tool you find indispensable. And why is it so useful?

[00:25:02] **Bryan Hung, CPA:** Sure. All right. So I think my favorite is probably Excel. I seem to do everything on it. I use it. It's a really flexible tool, and I use it to track everything and also helps me keep organized in terms of basically everything I do. But at the same time, it's also complex enough where I can create complex financial models with it. And I think just the flexibility that it offers it's probably the most valuable tool I have in terms of keeping organized and producing work.

[00:25:36] **Michael Novogradac, CPA:** Is that generally one workbook, one sheet, multiple workbooks?

[00:25:37] **Bryan Hung, CPA:** I create multiple workbooks depending on the different categories of things. Certain things might have different sheets. And, so even my personal finances, I keep track on Excel and I just have different tabs with different things.

[00:25:50] **Michael Novogradac, CPA:** No, that's a very interesting, so let me go to my next favorite of the three and that's your favorite work-life balance tip.

[00:26:02] **Bryan Hung, CPA:** I think the thing I realized that provides me the best work life balance is putting my phone down when I'm not working when I'm spending time with my family. I think technology these days makes it so convenient for us to, I guess, be connected, that sometimes that I feel like I'm always on my phone. So I've learned to put it down and make a conscious effort to be in the moment. And enjoy life when I'm not working.

[00:26:33] **Michael Novogradac, CPA:** And then the last one here is what book is on your summer reading list and why?

[00:26:41] **Bryan Hung, CPA:** So I've been wanting to read "Deception Point" by Dan Brown. I'm a huge fan of "The Da Vinci Code" and "Angels and Demons" books that he wrote years back and the way that he uses landmarks, secrets related to landmarks.

I just find them really fun. And, and it's, I love learning what the mystery was about at the end.

[00:27:05] **Michael Novogradac, CPA:** No, it sounds really interesting. Are you a Kindle or the hard book or paperback?

[00:27:10] **Bryan Hung, CPA:** iPad.

[00:27:12] **Michael Novogradac, CPA:** So iPad Kindle or iPad Apple Book?

[00:27:16] **Bryan Hung, CPA:** Apple Book.

[00:27:17] **Michael Novogradac, CPA:** Okay. I'm an iPad person, but I end up using Kindle on iPad. It's probably not as bad as having an aol.com email address.

[00:27:30] **Bryan Hung, CPA:** Are they still around?

[00:27:33] **Michael Novogradac, CPA:** Yeah, Amazon is still around. Thank you very much. Thank you, Bryan. Thank you for joining me on the podcast. I look forward to having you back as a guest in the future. And to our listeners, I'm Mike Novogradac. Thanks for listening.

Additional Resources

Email

Email Bryan Hung