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New Markets Tax Credit Coalition

DRAFT
TO: Representative Pat Tiberi
FROM: Robert Rapoza, New Markets Tax Credit Coalition
Michael Novogradac, Novogradac & Company LLP
DATE: August 19, 2013
RE: New Markets Tax Credit Program

Thank you for inviting us to the round table briefing on Low-Income Housing Tax Credits (LIHTC) and New Markets Tax Credits (NMTC) for Members of the House Ways and Means Select Revenue Subcommittee on Thursday, July 18th.

At the end of the roundtable, you asked us to follow up with a response to questions on the following topics: (1) waste, fraud, and abuse; (2) whether the credit is too generous; (3) the credit's efficiency and whether it can be improved.

We also provide further information on how the NMTC fits into federal community development policy.

Is there any evidence of waste, fraud, or abuse?

The law and guidance governing the New Markets Tax Credit (NMTC) define the characteristics of the communities eligible for the Credit, the businesses that may receive financing under the Credit and the terms and conditions under which taxpayer investments may be made in return for the Credit.

The CDFI Fund, the administering agency in the Treasury Department, requires all Community Development Entities (CDEs) that have been awarded NMTC allocations to submit an annual report detailing how they invested proceeds in low-income communities. These reports must be submitted to the CDFI Fund by the CDEs, along with their audited financial statements, within six months after the end of their fiscal years.

Thus far, through nine allocation rounds, with over $27 billion in NMTC investments and over 6,000 NMTC transactions, there is not any evidence of non-compliance with the law or regulations. The penalty for non-compliance is recapture of the all credits taken with interest to the beginning of the credit period. Thus far, we are not aware of a single recapture event. Those investments resulted in the creation of some 350,000 jobs in some of most economically distressed urban and rural communities in America.

Indeed, as the program has unfolded and the industry surrounding the Credit has matured, the outcomes of NMTC have improved. While all investments must be in low income communities, the Credit increasingly goes to communities with higher rates of poverty and unemployment. Over 70% of the investments are in businesses located in communities with poverty rates above 30%, area median incomes below 60% and/or unemployment rates at least 1.5 times the national average.

Because of the large number of transactions and businesses that have received financing, it is possible that a particular investment may not meet a particular person's view of the appropriate use of NMTC. It is important to note that NMTC transactions are not approved in Washington, DC. Decision-making lies with Community Development Entities with ties to the communities and representative advisory boards. The Community Renewal Tax Relief Act, which originally authorized NMTCs, required three separate Government Accountability Office (GAO) reports on the NMTC[1], and the GAO has released three other subsequent reports[2]. None have uncovered program abuse.

As evidence of their interest in assuring a successful NMTC, the CDFI Fund issued a request for public comment and recommendations to improve the Credit in November, 2011[3] and, as a follow-up, conducted a series of listening sessions with stakeholders during the first quarter of 2013.

All evidence indicates that NMTC has met its purpose: harnessing private sector capital to revitalize rural and urban communities. In fact, the New Markets Tax Credit has been named by Ash Center of Harvard University as one of the Top 25 Innovations in Government.

Is the Credit Too Rich?

There are three key parties in a typical NMTC transaction that directly or indirectly receive a portion of the subsidy associated with the NMTC, the qualified business, the investor and, to a small extent, the Community Development Entity (CDE) that receives the NMTC allocation award. The qualified business gets beneficial financing, the investor gets a risk adjusted yield on its investment, and the CDE is reimbursed for its costs related to distributing and managing the NMTC award over the seven plus year compliance period.

First, and most importantly, the business located in a highly distressed low-income community receives substantially all of the economic benefit of the NMTC subsidy. CDEs have “but for” and other tests to ensure they are only financing businesses that are in need of below-market capital. CDEs size the amount of allocation they make available to a qualified business based on the size of the financing gap that the qualified business has. In reviewing NMTC allocation applications by CDEs, the CDFI Fund evaluates how the allocatees will determine which businesses will be financed, in order to ensure below market rate financing is provided to businesses in highly distressed low-income communities. These representations in allocation applications become commitments documented in allocation agreements. Furthermore, the CDFI Fund requires that CDEs be accountable to low-income communities through advisory or governing boards and has a compliance management division to monitor compliance with allocation agreements during the seven year compliance period.

Second, the investor that invests in the CDE directly or indirectly in order to receive the NMTCs, receive a portion of the NMTC subsidy. Investors make equity contributions and in turn receive tax benefits over seven years. These tax benefits are subject to recapture. At least two factors ensure that appropriate value is given by investors for the NMTCs. First, the NMTCs are generally marketed among

[1] GAO-03-223R, Dec 6, 2002; GAO-04-326, Jan 30, 2004; and GAO-07-296, Jan 31, 2007.
[2] GAO-09-795T, Jun 18, 2009; GAO-10-334, Jan 29, 2010; and GAO-12-547R, Apr 26, 2012.
[3] Federal Register, Vol. 76, No. 215

numerous investors to generate market competition to get the highest value. Second, the CDFI Fund considers a CDE's plans to raise capital from the NMTCs as part of the NMTC allocation award process.

Third, the community development entity that receives the allocation receives a small portion of the subsidy. The CDE discloses its compensation levels as part of the allocation application competition and the CDFI Fund considers fee levels as part of the award process. Investors generally, as part of investing in a CDE, compare the level of associated fees with the CDE's allocation application in order to ensure consistency.

Efficiency

NMTC represents a cost-efficient approach to community development financing. As advertised, the NMTC provides a 39% credit against federal income taxes. However – in terms of cost to the taxpayer – the effective cost in foregone federal revenue is 26% as there is an exit tax for NMTC investors, which lowers the net cost of the credit. The NMTC reduces federal income tax basis and is, in essence, a "taxable" credit. If a change is made to eliminate the basis adjustment, the price of the credits will rise, ultimately increasing the price investors are willing to pay, and directly increasing the portion of subsidy provided to QALICBs.

The most recent Joint Committee on Taxation ten-year cost estimate for NMTC was $1.8 billion based on a two-year extension (2012-13) of $3.5 billion per year for 2012 and 2013 (25.6% of $7 billion). A 2012 report issued by the NMTC Coalition found that the income taxes paid by NMTC financed businesses and generated by the direct and indirect jobs created offset the cost of NMTC to the federal government[4].

This low cost translates into clear efficiencies. A federal investment of *one dollar* in a grant program yields *one dollar* and puts the federal government on the hook for cost overruns and other subsequent costs. An investment of *one dollar* in NMTC yields *four dollars* in private sector investment. The risk burden is not placed on the government, but on the investor who puts capital at risk and the Community Development Entity that makes the investment.

Between 2003 and 2011 NMTCs leveraged $55 billion in total project investment. Of this amount, $27 billion was NMTC loans and equity investments, with the balance coming from other sources of investment, lured by the patient, flexible, risk absorbing capital provided by the Credit. Based on total project costs, every dollar in NMTC yields eight dollars in total investments in rural and urban communities across the country.

Congress can take steps to further increase the NMTC's efficiency. The real obstacles to greater efficiency are the lack of a longer time horizon for the program and an exemption from the Alternative Minimum Tax (AMT) for NMTC investments. A long-term or permanent authorization will provide investors and CDEs more time to plan and invest in the infrastructure necessary to support the program.

[4] *NMTC Economic Impact Report (2003-2010).* December, 2012, New Markets Tax Credit Coalition.

Exemption from the AMT would diversify the pool of investors who could invest in the NMTC. Unlike other investment tax credits –including the Low Income Housing Tax Credit and the Historic Tax Credit– NMTCs cannot offset the AMT. Providing an AMT exemption for NMTC investments would bring the NMTC in line with those other credits and open up the NMTC investor market to new investors, including community banks and corporate investors who are currently restrained from investing by the inability to claim the NMTC against AMT. Broadening the NMTC investor base would increase competition and efficiency, leading to better pricing, and driving even more subsidy to businesses operating in NMTC qualified highly distressed communities.

The Importance of NMTC as a tool for revitalization

There is substantial evidence that low and moderate income areas are underserved by private sector capital. This lack of capital stifles entrepreneurs and impedes growth leading to urban decay and economic stagnation in small towns and farming communities, despite opportunities for investment. The principal policy objective of NMTC is to address this challenge by increasing the flow of private sector capital to communities long overlooked by market forces.

There is substantial evidence that without the NMTC, investments would not reach businesses and revitalization efforts in underserved markets. A 2007 report published by the U.S. Government Accountability Office (GAO) indicated that 88% of investors surveyed would not have made the investment in the low income community without the Credit.

Further, an analysis of Community Reinvestment Act (CRA) data compiled by the Institute for a Competitive Inner City indicates that the lowest income census tracts in inner cities receive only about 79% of the loans they would expect to receive based on the number of firms operating in those census tracts.[5] CRA alone cannot attract sufficient capital to meet the demand in underserved markets. Banks have a number of options regarding CRA investing. Fundamentally, NMTC provides the subsidy, or the margin, that makes it possible for banks to work in hard-to-serve communities with businesses with less than perfect credit that need financing on terms and conditions that banks simply cannot provide.

NMTC and Federal Community Development Policy

Spending on programs at HUD, USDA, Commerce, and Interior's Indian programs have declined over the last 30 years. According to U.S. Office of Management and Budget, federal community development spending measured as a share of GDP has fallen by 75% since 1980[6]. The requirements of the Budget Control Act of 2011 – with a 10-year freeze on discretionary spending and close to $1 trillion more in potential reductions, due to the sequester required under the Act – have accelerated the downward trend on this spending.

[5] Source: Federal Financial Institutions Examination Council (EFIEC), "Findings from Analysis of Nationwide Summary Statistics for Community Reinvestment Act Data", various years; Initiative for a Competitive Inner City analysis.
[6] Source: U.S. Office of Management and Budget Historical Budget Tables.

These reductions have narrowed the options for communities seeking financing for an industrial facility such as the Verso Paper Plant in Michigan, a community facility like the Tom Green Library in Texas or a small business such as the blueberry processing plant in rural Georgia.

In many small towns and farming communities and urban neighborhoods, NMTC is one of the few remaining financing sources available for community revitalization. The New Markets Tax Credit expires at the end of this year. We hope the Committee will recommend to the 113th Congress a long term or permanent extension of NMTC that includes an increase in annual credit authority.

Thank you again for hosting us at the roundtable. Please let us know if we can answer any additional questions.

Sincerely,

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