Tax Credits **Work**

The Truth Behind One of the Federal Government's Most Productive Financing Programs

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As the development finance industry has demonstrated over the past three decades, unique financing solutions can provide incentives for individuals and companies to invest in a wide variety of catalytic economic development projects. These resources–tax credits, most notably–are crucial elements of the development finance toolbox. While each program is different, they have a shared purpose: catalyzing investment.

The federal government has created tax credit programs to encourage specific investments. Current programs exist to help catalyze historic rehabilitation, environmental remediation, affordable housing, underserved markets, and renewable energy. To take advantage of the full development finance toolbox, economic development professionals must be able to understand and use these investment tools, which can make a measurable difference in fostering economic development.

The complexity of some tax credit programs can be a contributor to their limited use and inaccurate portrayals. In March, Bloomberg News published a scathing article undermining the success and productivity of the U.S. Department of Treasury CDFI Fund's New Markets Tax Credit (NMTC) program. The largely circumstantial piece of writing failed to accurately describe the massive public benefit that this program has provided to communities throughout the country. The inaccuracies of the article have been articulated by other organizations, but CDFA felt compelled to not only provide a clear story about the importance and impact of the NMTC program, but also about tax credit programs in general.

Understanding Tax Credit Finance

In order to catalyze local investment with tax credits, it is critical to understand the history and impact of these programs. Tax credits, which are often complex, remain widely under-utilized. According to CDFA research, less than five percent of finance agencies regularly employ state or federal tax credit programs. Nonetheless, these programs have become increasingly important, particularly as federal resources for other programs have diminished over the past 20 years.

Tax credits are performance-based financing tools, and once implemented, their worth must be proven. The verification of relevant investment goals requires a great deal of due diligence. The tax credit application process brings with it a considerable amount of scrutiny. For most programs, the investors must prove that "but for" the provision of these tax credits, the targeted project would not attract the necessary private investment.

Tax credit programs are flexible. They can be used in urban, rural, and suburban communities. They can target low-income, historic, or underserved sectors, or they can be applied broadly. Tax credits can be used within development projects to: provide an increased internal rate of return for investors, reduce the interest rates on a particular financing package, or provide a repayment method for investors in place of cash.

Tax credit programs involve many different stakeholders, which is one of the greatest benefits these financing tools have over direct loans or grants. Tax credits may bring investors, businesses, non-profits, community development organizations, industrial development authorities, financial institutions, pension funds, state governments, the federal government, and others all together for the same deal. The opportunity to attract non-traditional stakeholders into an investment is one of the key factors that make tax credits so beneficial.

Perhaps the most important feature of tax credits is that they do not disappear during economic downturns, unlike many other financing programs. In short, economic development tax credit programs are catalytic, dependable, and politically popular.

How Tax Credits Work

In news media and public perception, tax credit deals are often lumped together with tax incentives and tax abatements. However, unlike tax incentives and abatements, the tax credit user must demonstrate the outlay of resources in order to receive the benefits. The distributor of the tax credit is authorized to issue credits based on the actual outlay of resources, as evidenced by the investor.

Tax credit programs help to encourage private sector leveraging of resources and act as a catalyst for public/private partnerships. Tax credit programs allow businesses and investors to claim a tax credit for committing resources to a deal. A resource commitment could be an investment in a real estate project, seeding a revolving loan fund or a cash investment in a business. Without these structures, private financing for nearly all of the projects identified by Bloomberg would not have materialized.

NMTCs permit taxpayers to receive a credit against federal income taxes for making qualified equity investments in designated Community Development Entities (CDEs). Substantially all of the qualified equity investment must in turn be used by the CDE to provide investments in low-income communities. The credit provided to the investor totals 39 percent of the cost of the investment and is claimed over a seven-year credit allowance period. The investor receives a credit equal to five percent of the total amount paid for the stock or capital interest at the time of purchase for the first three years and six percent annually for the final four years. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period. This has resulted in a committed investor base working hand-in-hand with CDEs nationwide, helping to encourage project success and even expansion.

The Case for NMTC

The NMTC program, created under President Clinton, has funded and helped to leverage financing for thousands of development projects over the past decade. Bloomberg's article outlined a handful of projects that, while meeting or exceeding every criteria of the program, did not live up to the perceived standards of their writer and editor. Inaccurately described as abusive and serving unintended markets, the NMTC program has actually worked remarkably well over the past decade and is widely considered one of the federal government's most successful programs.

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Critics often point out that tax credit projects benefit large investors. Of course they do. Investor groups like Prudential Financial Inc., JPMorgan Chase & Co., Goldman Sachs Group Inc., and U.S. Bancorp are some of the most active participants in the NMTC program, and for good reason. The NMTC program provides an alternative and attractive investment opportunity for these firms while helping them meet Community Reinvestment Act (CRA) and socially responsible investment goals. The financial institutions earn a solid return, which is the purpose of private firms, but they also invest in local economic development projects that serve the community. Particularly during an economic downturn, these projects would not move forward but for the financial inducement provided to investors.

Bloomberg's article pointed out projects for luxury hotels, high end commercial projects, and a renovation of a historic armory. The article ignored the fact that each project passed the CDFI Fund's qualification tests and were further approved by the local CDE. Each project also created a significant number of jobs and catalyzed investment throughout their neighborhoods.

The more important omission by Bloomberg and many other critics are references to the hundreds of other projects that have unquestionably positively affected communities nationwide. The CDFI Fund has reported that NMTC investments through 2007 supported 210,000 construction jobs and 45,000 full time-equivalent jobs through the development of over 68 million square feet of real estate in low-income communities. According to the New Markets Tax Credit Coalition, NMTCs have raised more than $14 billion in qualified equity investments for low-income communities, and nearly 300 CDEs are using NMTCs to support economic development initiatives.

The bottom line is that NMTCs have simply worked. Over the life of the program, the CDFI Fund has awarded 594 allocations totaling $29.5 billion in allocation authority. The program is so oversubscribed that 250 applications were received for the latest $5 billion round of funding.

Representative cases of the NMTC program range from an investment in a new childcare facility on the west side of Chicago, to the creation of the first new supermarket and shopping center in Southeast Washington, DC in many years, to the establishment of a new aerospace facility in rural Oklahoma, and to the financing of a solar manufacturing facility that will create 1,500 new jobs in a low income community outside of Albuquerque.

With the NMTC program, the potential is endless and the opportunity is abundant. This program was designed a decade ago to infuse capital into underserved markets and is meeting that goal unequivocally. No amount of scrutiny, focused solely on outliers and ill informed assumptions, will ever diminish or reduce the positive impact that this program has had in the development finance community.