

January 2010

NEW MARKETS TAX CREDIT

The Credit Helps Fund
a Variety of Projects
in Low-Income
Communities, but
Could Be Simplified



GAO

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Highlights of [GAO-10-334](#), a report to congressional committees

Why GAO Did This Study

The Treasury Department's Community Development Financial Institutions (CDFI) Fund awarded \$26 billion in New Markets Tax Credits (NMTC) through 2009 for investment in low-income communities. The NMTC allows investors to claim a tax credit totaling 39 percent of their investment in Community Development Entities (CDE) over 7 years which CDEs reinvest in qualified communities.

This mandated report (1) describes where and how CDEs are using NMTCs, (2) assesses how CDEs use NMTCs to offer favorable financing terms to low-income community businesses and describes options for simplifying the NMTC, (3) describes how, if at all, NMTC investments support low-income community development, and (4) determines how effective IRS and the CDFI Fund have been in monitoring NMTC compliance. GAO analyzed CDFI Fund and CDE data, did case studies of CDEs, and interviewed relevant experts.

What GAO Recommends

Congress should consider options to simplify the NMTC's structure, and GAO recommends that the Secretary of the Treasury direct the CDFI Fund Director to collect additional data on program performance and improve project-level data. The CDFI Fund agreed with GAO's recommendations and disagreed with GAO's matter for Congress. GAO maintained its matter for Congress; evaluating the simplification's effects can include the Fund's concerns.

View [GAO-10-334](#) or [key components](#). For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

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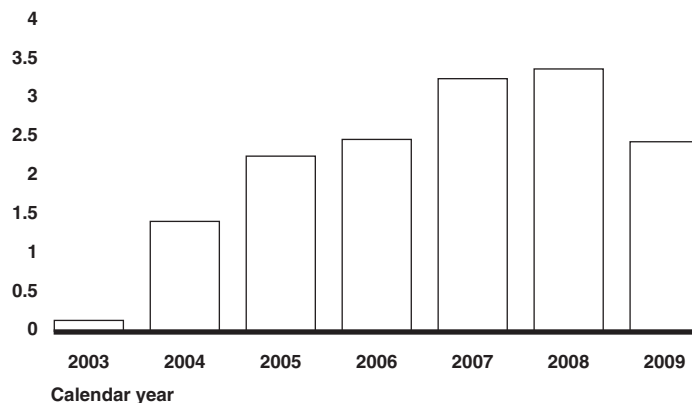
What GAO Found

Since 2003, CDEs have made NMTC investments in all 50 states, the District of Columbia, and Puerto Rico, with about 65 percent for real estate. NMTCs are often used as "gap financing," accounting for a portion of total project costs.

NMTC investments in low-income community businesses generally use leveraged structures, where equity is left in the businesses, or subsidized interest rate structures, where below-market interest rate loans are offered. Recently, investors appear to be paying less for tax credits than in previous years and they made fewer NMTC investments in 2009 than in previous years. The CDFI Fund does not collect data that could identify the portion of the subsidy channeled to businesses, such as data on credit pricing, transaction fees, and the amount of equity left in businesses. Two potential options (i.e., changing related parties tests or converting the NMTC to a grant program) could simplify the program and make additional funds available to businesses.

NMTC Investment by CDEs for Calendar Years 2003 through 2009

Dollars (in billions)



Source: GAO analysis of CDFI Fund data.

CDEs have used the NMTC program to support a variety of investments, but project impacts are difficult to measure and likely vary depending on the project. GAO identified NMTC-supported projects for mixed-use facilities, housing developments, and community facilities, among other qualified business activities. The CDFI Fund does not collect data on incomplete or failed projects, which might be used, for instance, to improve credit allocation selections. Projects with NMTC financing likely contribute employment and other outcomes to low-income communities. Limitations with available data make it difficult to isolate project impacts and GAO's analysis does not allow it to determine whether the projects supported by NMTCs would have taken place absent the credit. Continued improvements could be made in collecting project-level data (e.g., removing double-counting of some outcomes).

IRS monitors CDE and investor compliance with applicable laws, while the CDFI Fund monitors CDEs' compliance with their allocation agreements. IRS and CDFI Fund officials weighed the costs and benefits of options to monitor compliance and selected controls on that basis.

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Abbreviations

AMT	Alternative Minimum Tax
CDE	Community Development Entity
CDFI	Community Development Financial Institutions
CIIS	Community Investment Impact System
FTE	Full-Time Equivalent
GO Zone	Gulf Opportunity Zone
HFA	Housing finance agency
IRS	Internal Revenue Service
LIHTC	Low-Income Housing Tax Credit
NCMS	New Markets Compliance Monitoring System
NMTC	New Markets Tax Credit
OMB	Office of Management and Budget
QALICB	Qualified active low-income community business
QEI	Qualified Equity Investment
QLICI	Qualified low-income community investment

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United States Government Accountability Office
Washington, DC 20548

January 29, 2010

Congressional Committees

Congress established the New Markets Tax Credit (NMTC) program as part of the Community Renewal Tax Relief Act of 2000¹ to encourage investors to make investments in impoverished, low-income communities that traditionally lack access to capital. Conventional access to credit and investment capital for developing small businesses, creating and retaining jobs, and revitalizing neighborhoods is often limited in economically distressed communities or in communities with large low-income populations. The NMTC provides investors (individuals, financial institutions, other corporations, etc.) with a tax credit for investing in communities that are economically distressed or consist of low-income populations.

The NMTC program is administered by the Community Development Financial Institutions (CDFI) Fund in the Department of The Treasury which 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 (CDE) that apply for and obtain allocations. As of January 2010, the CDFI Fund had allocated all \$26 billion in total available NMTC allocation authority. The NMTC expired following the 2009 allocation round. However, legislative proposals have been put forth that would extend the program beyond 2009.

The Community Renewal Tax Relief Act of 2000 mandated that we report to Congress on the NMTC program by January 31, 2004, 2007, and 2010. In our report issued January 31, 2004, we described the status of the NMTC program, profiled CDEs that received first-round allocations, and evaluated whether systems were in place or planned to ensure NMTC compliance.² We concluded that progress was being made in implementing the program and recommended that the Internal Revenue Service (IRS) and the CDFI Fund work together to take additional steps toward monitoring compliance. In response, IRS and the CDFI Fund took steps to

¹ Pub. L. No. 106-554 (2000).

² GAO, *New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance*, [GAO-04-326](#) (Washington, D.C.: Jan. 30, 2004).

design and implement compliance monitoring processes. In our 2007 report, we reviewed whether the NMTC appeared to be generating new investment in low-income communities and revisited CDFI Fund and IRS efforts to monitor compliance.³ We concluded that the NMTC appeared to be generating new investment from individual investors and that corporate investors appeared to be shifting investments from higher income areas to low-income communities. We also made recommendations to IRS to develop a representative sample of CDEs to select for a compliance study and to explore options for cost-effectively monitoring investor compliance. In response, IRS used CDFI Fund data to revise criteria for selecting a more representative sample of CDEs to review as part of its compliance study and IRS studied the feasibility of developing a comprehensive investor compliance program. IRS concluded that such a program would not be cost-effective and that currently available data should allow them to detect investor noncompliance. In addition to our two mandated reports, in the spring of 2009, we addressed congressional interest in minority CDEs' NMTC participation rates and found that minority CDEs have not been as successful in obtaining allocations as nonminority CDEs.⁴ The CDFI Fund generally agreed with the findings of our requested report on minority CDEs' participation in the NMTC program.

Based on consultations with your offices, this final mandated report: (1) describes where and how CDEs are using NMTCs to invest in low-income communities and targeted populations; (2) assesses how CDEs use NMTC financing to offer favorable financing terms to low-income community businesses and describes options for simplifying NMTC investment structures; (3) describes how, if at all, NMTC investments appear to support low-income community development; and (4) determines how effective measures taken by the CDFI Fund and the IRS have been in monitoring CDEs' and investors' compliance with the NMTC program.

To accomplish these objectives, we used multiple methods of analysis. We analyzed data from the CDFI Fund's Community Investment Impact

³ GAO, *Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, [GAO-07-296](#) (Washington, D.C.: Jan. 31, 2007).

⁴ GAO, *New Markets Tax Credit: Minority Entities Are Less Successful in Obtaining Awards Than Non-Minority Entities*, [GAO-09-536](#) (Washington, D.C.: Apr. 30, 2009).

System (CIIS) database that contains data on the status of NMTC projects through fiscal year 2008. We analyzed information obtained through a non-generalizable, purposeful sample of nine case study CDEs. To capture the range of projects supported by NMTC investment, we selected case study CDEs based on the geographic distribution of their operations, their communities of service (i.e., urban or rural), their status as a for-profit or nonprofit organization, and the asset size of a CDE or its parent corporation. We limited our CDE selection to organizations that received NMTC awards in the 2005 and 2006 allocation rounds, to examine NMTC investments that better reflect the types of investments that have taken place as the program has matured. In addition, we interviewed and analyzed information obtained from local lenders and other subject-matter experts who are familiar with the low-income communities, targeted populations, and businesses that the case study CDEs serve. We also met with officials from the CDFI Fund and IRS, and reviewed documents on their efforts to monitor NMTC compliance.

We interviewed CDFI Fund officials with knowledge of the CIIS about the steps they take to ensure its accuracy and reviewed the computer programs the CDFI Fund uses to generate its NMTC databases. We determined that the data in this report were sufficiently reliable for our purposes. We conducted this performance audit from September 2008 through January 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The CDFI Fund in the Department of The Treasury is authorized to allocate \$26 billion⁵ in tax credit authority to CDEs that manage NMTC

⁵ The original legislation that authorized the program allowed for \$15 billion in tax credit authority for the NMTC program through 2007. However, the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135 (Dec. 21, 2005) authorized an additional \$1 billion of NMTC equity for qualified areas affected by Hurricane Katrina over a period of 3 years: \$300 million in 2005, \$300 million in 2006 and \$400 million in 2007. The Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 (Dec. 20, 2006) and the Tax Extenders and Alternative Minimum Tax Act of 2008, Pub. L. No. 110-343 (Oct. 3, 2008) extended the amount of NMTC authority available by \$3.5 billion for both 2008 and 2009. The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (Feb. 17, 2009) added an additional \$3 billion of NMTC allocation authority to be split equally between the 2008 (retroactively) and 2009 allocation rounds.

investments in low-income community development projects.⁶ Eligible organizations may apply for and receive NMTC allocations once they have been certified as a CDE by the CDFI Fund (a CDE that receives an allocation is often referred to as an allocatee).⁷ Since the first round of NMTC allocations in 2003, demand for the NMTC has exceeded available allocation authority by at least 4.5 times in each allocation round. As of January 2010, the CDFI Fund had awarded all \$26 billion in NMTC authority through 2009. The program expired at the end of 2009, but legislation has been proposed that would extend the program for future years.⁸

The NMTC Investment Process

As figure 1 illustrates, after the CDFI Fund makes allocations to CDEs, investors make qualified equity investments (QEI) by acquiring stock or a capital interest in the CDEs, and, in exchange, can claim tax credits on a portion of their investment. The CDEs, in turn, are required to invest “substantially all” of the proceeds they receive into qualified low-income community investments (QLICI).⁹ QLICI investments include (but are not limited to) investments in businesses, referred to as qualified active low-income community businesses (QALICB), to be used for residential,

⁶ A low-income community is defined as a census tract (1) in which the poverty rate is at least 20 percent or (2) outside a metropolitan area in which the median family income does not exceed 80 percent of median statewide family income or within a metropolitan area in which the median family income does not exceed 80 percent of the greater statewide or metropolitan area median family income. After October 22, 2004, the Secretary of the Treasury was authorized to issue regulations designating targeted populations that may be treated as low-income communities and procedures for determining which entities are qualified active low-income community businesses with respect to such populations. In addition, the definition of a low-income community included certain areas not within census tracts, tracts with low population, and census tracts with high-migration rural counties.

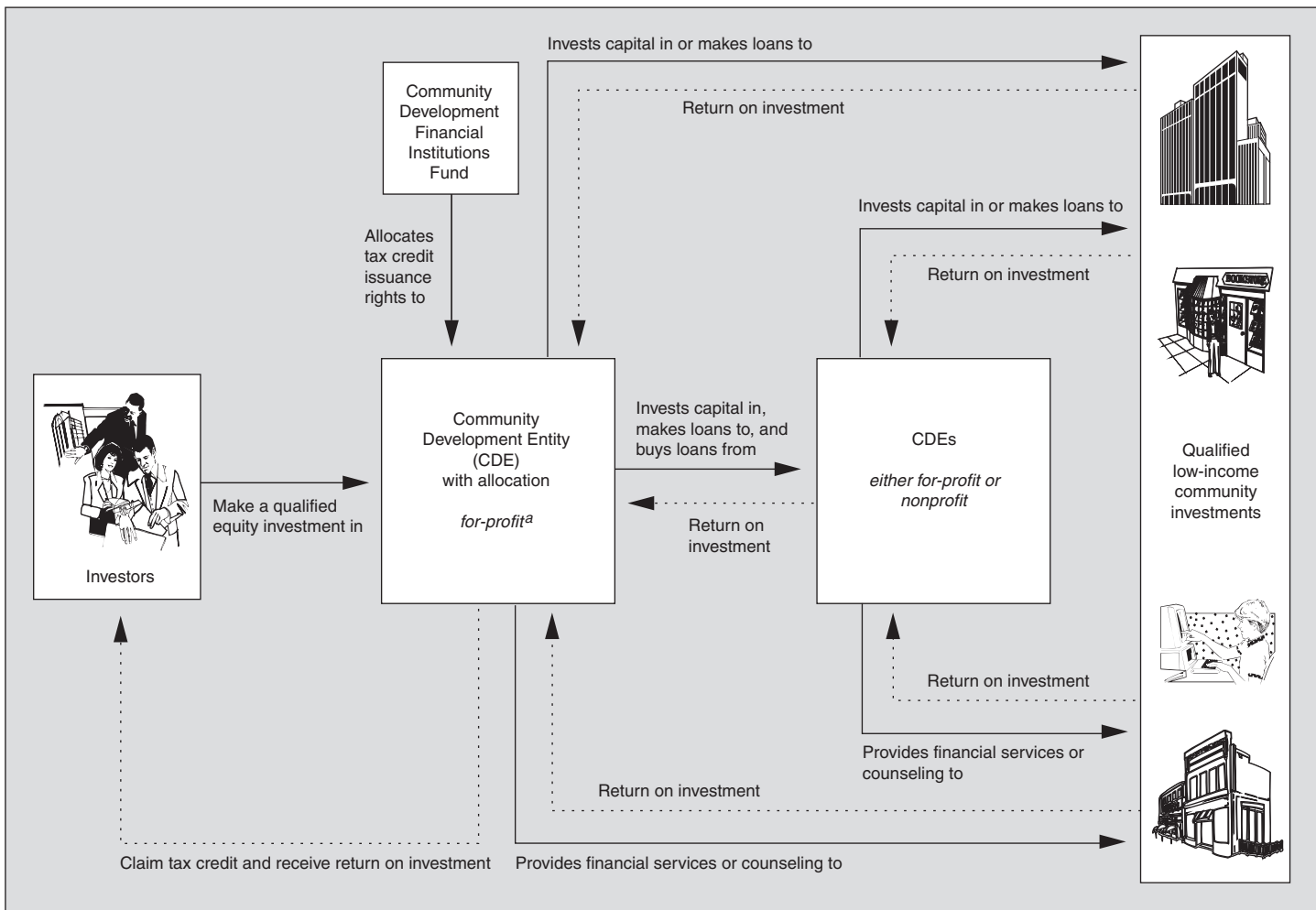
⁷ Community Development Financial Institutions and Specialized Small Business Investment Companies automatically qualify as CDEs and only need to register as CDEs rather than apply for certification.

⁸ The Tax Extenders Act of 2009 (H.R. 4213) proposes to extend the NMTC for one year. As of the time of this report’s publication, the legislation has passed the House of Representatives.

⁹ “Substantially all” means that CDEs must use (within 12 months) at least 85 percent of investor proceeds in years 1 through 6 and 75 percent in year 7 of the investment. CDEs can satisfy this requirement by two methods: (1) direct tracing of investments to specific qualified low-income community investments or (2) showing that at least 85 percent of their aggregate gross assets (75 percent in year 7) are invested in qualified low-income community investments.

commercial and industrial projects, and other types of investments such as purchasing loans from other CDEs.

Figure 1: NMTC Process for Using Allocated Tax Credits to Make QLICs



Source: GAO.

^aOnly a for-profit CDE can receive qualified equity investment from NMTC investors. These CDEs can then make investments in other CDEs that could be for-profit CDEs or nonprofit CDEs or they can directly invest the NMTC funds in low-income communities. However, both for-profit and nonprofit CDEs can receive allocations from the CDFI Fund. If a nonprofit CDE receives a NMTC allocation from the CDFI Fund, it must transfer the allocation authority to a for-profit CDE before NMTC investments can be made.

Although for-profit and nonprofit CDEs can apply for and receive NMTC allocations, 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 of its for-profit subsidiaries. The for-profit subsidiaries do not have to be formed when the nonprofit CDE applies for an allocation. However, the subsidiary must submit a CDE certification application to the CDFI Fund within 30 days of receiving a Notification of Allocation from the CDFI Fund and must be a certified CDE before entering into an allocation agreement.

Once a CDE with an allocation has obtained qualified equity investment 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 7 years totaling 39 percent of their original QEI.¹⁰ The NMTC is a nonrefundable tax credit, meaning taxpayers do not receive payments for tax credits that exceed their total tax liability. Investors can cease to qualify for the NMTC, and trigger a recapture event if the CDE (1) ceases to be a certified CDE, (2) does not satisfy the “substantially all” requirement, or (3) redeems the investment. A recapture event means that an investor will no longer be able to 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 tax liability by the credits previously claimed plus interest for each resulting underpayment of tax.¹¹

The NMTC Application Process

The CDFI Fund’s process for making NMTC awards takes place in two phases. Under the first phase, NMTC applicants submit standardized application packages in which they respond to a 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 and scored by a group of external reviewers selected by the CDFI Fund who have demonstrated experience in business, real estate, or community development finance.¹² Reviewers receive an applicant’s entire

¹⁰ Beginning in the year in which the investment is made, investors are entitled to claim the credit for a 7-year period with 5 percent of the investment claimed in each of the first 3 years and 6 percent in each of the last 4 years. Investors are allowed to carry the credit back 1 year and carry the credits forward for a 20-year period.

¹¹ For a more detailed explanation of the NMTC investment process, see [GAO-07-296](#).

¹² The CDFI Fund requires reviewers to disclose any conflicts of interest related to applicants with whom they have or had a relationship.

NMTC application, including applicant information that identifies the applicant CDE's type and the amount of total assets held by the CDE. If the applicant has a controlling entity, similar information is provided to the reviewers about the controlling entity.

Each application is reviewed by three external reviewers and, if the CDFI Fund identifies a scoring anomaly by one of the reviewers, a fourth reviewer also reviews and scores the application. Applications are scored based on a range of criteria, and applicants can receive scores of up to 25 points by each reviewer in each of the following four sections: (1) business strategy, (2) community impact, (3) management capacity, and (4) capitalization strategy. Applicants can also receive up to 10 “priority” points by demonstrating a record of successful investment in disadvantaged communities or businesses (up to 5 points) and by investing in businesses unrelated to the applicant (5 points). By agreeing to invest in unrelated entities, CDEs cannot own more than 50 percent of the QALICBs in which they invest. However, priority points are not included in calculating an applicant's score until the second phase of the application review process.

CDEs that meet or exceed an overall scoring threshold and a threshold in each of the four application sections advance to a second phase of the application process in which CDFI Fund officials determine—based on a final ranking score—which CDEs will receive allocations and how much they will receive.¹³ The final ranking score is the sum of the aggregate business strategy score, the community impact score, and half of the priority points that a CDE received for demonstrating a track record of successful investment in low-income communities and investing in unrelated entities.

To determine how much allocation authority a CDE will receive, CDFI Fund staff review the amount of allocation authority that the CDE requested and, based on the information in the application materials, award allocation amounts in the order of CDEs' final ranking scores. When

¹³ Applicants that meet or exceed minimum scoring thresholds (48 out of 75 aggregate points—each of the three reviewers assign a score out of 25 for each application section—in each of the four application sections and an overall aggregate base score of 216 out of 300 points) are assigned Final Rank Scores, which determine the order by which the CDFI Fund reviews CDEs for awards. This means that CDEs receiving average scores of 16 out of 25 or higher in each application section and average scores of at least 72 out of 100 points overall advance to the second phase of the application process.

recommending allocation amounts, CDFI Fund staff members are instructed to consider the amount of equity investment the CDE can expect to raise in 2 years, the amount of NMTC investment in low-income communities that can be deployed within 3 years, the quality of the financial products being offered, and the projected impact on low-income communities or low-income persons. Not all of the CDEs that satisfy the minimum application score thresholds receive allocations. Allocation authority is generally awarded in order of final ranking scores until the allocation authority is exhausted.

Evaluating NMTC Effectiveness and the “but-for” Test

In evaluating the effectiveness of the NMTC program, a key question is whether the investment is likely not to have taken place in the absence of the NMTC. That is, would investors have invested in the specific project in the same location “but-for” the NMTC subsidy included in the project? Addressing this question is difficult because it requires estimating what decisions investors and developers would have made in the absence of the tax credit. Several methods have been developed that address some of the difficulties present in effectiveness evaluations. For example, statistical methods use control or comparison groups in an effort to determine what program participants and other potential investors would have done if the program did not exist. In a 2007 report, we used methods like these to analyze the effect of the NMTC on investor behavior.¹⁴

Making definitive assessments about the extent to which benefits flow to targeted communities as a direct result of NMTC investments presents challenges. For example, the small size of the projects relative to the total economic activity within an area or areas eligible for the credit makes it difficult to detect the separate effect of the project.¹⁵ (For the NMTC program, 39 percent of the census tracts qualify and 36 percent of the U.S. population lives in these census tracts.) Many of the eligible communities may already have significant business activities that could mask NMTC impacts. Limitations associated with available data and the application of statistical techniques also make it difficult to determine whether benefits generated in a low-income community outside the scope of a particular project are the direct result of the NMTC program.

¹⁴ GAO-07-296.

¹⁵ GAO, *New Markets Tax Credit: Implementation Status and Issues Related to Mandated Reports*, GAO-03-223R (Washington, D.C.: Dec. 6, 2002).

As a result, the analysis included in this report is limited to providing some examples of how CDEs participating in the NMTC program themselves apply a “but-for” test when selecting projects for NMTC investment. By applying these tests, CDEs attempt to identify and direct investment to projects in low-income communities that might not be feasible without NMTC assistance.

CDEs Made NMTC Investments, Which Generally Fill Gaps in Project Financing, in All 50 States, Primarily Investing in Real Estate

Through fiscal year 2008, CDEs reported making about \$12 billion in NMTC investments (on which investors can claim tax credits totaling 39 percent) to about 2,111 projects located in all 50 states, the District of Columbia, and Puerto Rico.

California received just over \$1.2 billion in NMTC investment, the most of any state, which was nearly 10 percent of total NMTC investment. New York and Louisiana received the second and third largest NMTC investment amounts at just under \$1.2 billion and \$863 million, respectively. Table 1 shows the 10 states that received the most NMTC investment measured in dollars from 2003 through 2008.

Table 1: Top 10 States by NMTC Dollars through Fiscal Year 2008 (Constant 2008 dollars)

Rank	State	Total dollar amount of investment	Percentage of total dollar amounts	Number of projects	Percentage of total projects
1	CA	\$1,208,528,336	9.6%	257	12.2%
2	NY	1,184,947,158	9.5	100	4.7
3	LA	862,539,451	6.9	96	4.5
4	MA	697,153,422	5.6	121	5.7
5	OH	575,835,516	4.6	172	8.1
6	WA	484,742,478	3.9	57	2.7
7	MO	464,481,135	3.7	57	2.7
8	WI	445,072,159	3.6	117	5.5
9	MD	408,771,661	3.3	39	1.8
10	NJ	388,761,424	3.1	44	2.1
	Total	6,720,832,740	53.6	1,060	50.2

Source: GAO analysis of CDFI Fund data.

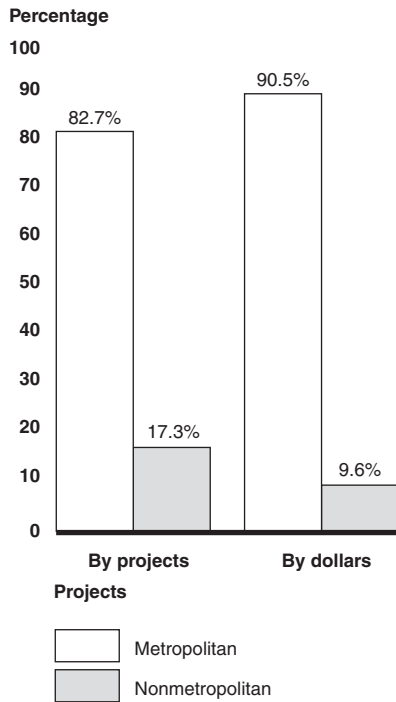
CDEs also funded more projects in California than any other state, with 257 projects. CDEs made the 2nd and 3rd largest number of NMTC investments in Ohio and Massachusetts, 172 and 121, respectively.

Louisiana, as the third state receiving the most NMTC investment measured by dollars, also received significantly higher NMTC investment since 2005, likely owing largely to Gulf Opportunity (GO) Zone NMTC allocations to assist in recovery and rebuilding from Hurricane Katrina in 2005. On a per capita basis (using 2008 state populations) the District of Columbia received the most NMTC investment, followed by Rhode Island, Louisiana, Maine, and Massachusetts. Appendix II contains a full list of the number of projects and amount of dollars received by each state, the District of Columbia, and Puerto Rico from 2003 through 2008, including the amount of NMTC investment in each state on a per capita basis.

NMTC allocations are distributed widely across states and projects tend to be predominantly located in metropolitan areas. Measured in dollars, about 90 percent (\$10.6 billion) of total NMTC allocations deployed to QALICBs were used for projects in designated metropolitan areas. Measured by the number of projects, 1,730 (83 percent) of total projects were located in metropolitan areas. In recent NMTC allocation rounds, the CDFI Fund has taken steps to ensure that additional NMTC allocation dollars are targeted to nonmetropolitan communities.¹⁶ For example, the CDFI Fund now tries to ensure that at least 20 percent of its NMTC allocation awards are targeted to nonmetropolitan areas. Figure 2 shows the relative proportions measured by amount of dollars and number of projects for NMTC projects.

¹⁶ The CDFI Fund has defined nonmetropolitan counties as those counties that are not contained within a Metropolitan Statistical Area, as defined in Office of Management and Budget (OMB) Bulletin No. 99-04 with respect to 2000 census data. Section 223 of the American Jobs Creation Act of 2004 (P.L. 108-357) further specifies that low-income communities include census tracts in High Migration Rural Counties with a median family income at or below 85 percent of the applicable area median family income. Section 102(b) of the Tax Relief and Health Care Act of 2006 requires that the CDFI Fund ensure nonmetropolitan counties receive a proportional allocation of Qualified Equity Investments (QEI) under the NMTC Program.

Figure 2: NMTC Loans and Investments in Metropolitan and Nonmetropolitan Areas

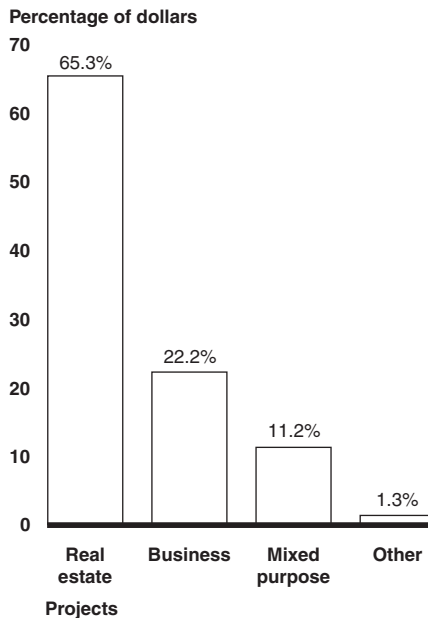


Source: GAO analysis of CDFI Fund data.

Most of NMTC Investment Has Been in Real Estate Projects by For-Profit Allocatees

Although the range of activities financed by CDEs varies, NMTC investments have been used primarily for commercial real estate projects. As figure 3 shows, CDEs used about 65 percent of total NMTC loans and equity investments for real estate projects, although designating fewer NMTC loans and investments, about 22 percent, to finance business-related activities of QALICBs. According to our analysis of CDFI Fund data, commercial real estate construction and rehabilitation accounted for nearly all (about 98 percent) of the investment in real estate. Commercial real estate facilities may also include mixed-use facilities that have a portion of the building dedicated to for-sale housing or rental housing and a portion dedicated to commercial activities. Investments strictly in housing account for the remaining portion of NMTC investments in real estate—investments strictly in rental housing are prohibited under program rules.

Figure 3: NMTC Loans and Investment by Project Type



Source: GAO analysis of CDFI Fund data.

Note: Business includes the following categories of business-related projects: business, working capital, fixed assets, and microenterprises. Real estate includes the following categories of real estate projects: commercial construction and rehabilitation, and residential construction and rehabilitation of single and multifamily housing. The mixed purpose category includes projects with multiple CDEs contributing for different purposes—the real estate category includes mixed-use facilities with a single CDE contributing or with multiple CDEs all reporting real estate as the purpose.

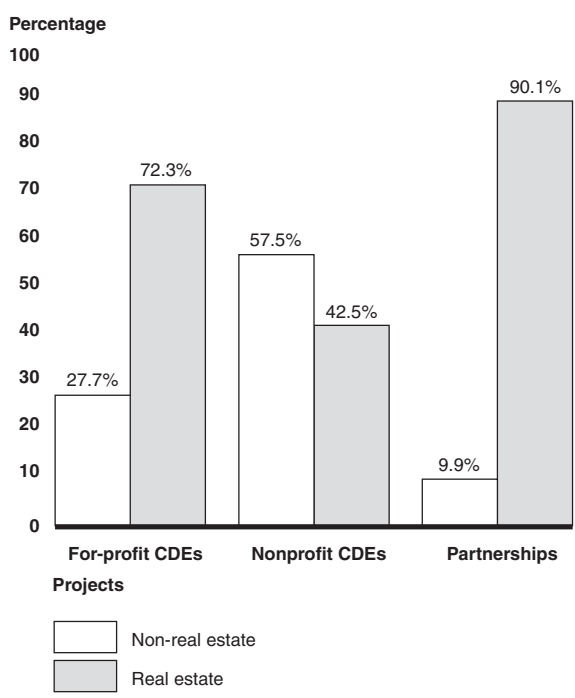
According to a recent paper developed for the Federal Reserve Bank of San Francisco, the CDEs have likely made real estate investment the predominant form of NMTC investment because investors see real estate as more profitable than other types of investment and less likely to fall out of compliance with NMTC restrictions. For example, real estate deals can often be more easily paired with other federal, state, and local tax incentives.¹⁷ Representatives from CDEs we interviewed also noted that real estate projects are fixed in location, making it less likely that the project will fall out of compliance with NMTC program rules by moving the investment to a nonqualifying census tract within the 7-year NMTC compliance period. Furthermore, the investments are usually large and

¹⁷ Lauren Lambie-Hanson, *Addressing the Prevalence of Real Estate Investment in the New Markets Tax Credit Program*, Federal Reserve Bank of San Francisco, Working Paper 2008-04, Fall 2008.

long term, making it unlikely that the investors will be repaid any principal on their investments within the 7-year compliance period, which would, by a requirement of the NMTC program, necessitate a reinvestment of the funds in another qualified low-income community business.

Although the range of projects adopted by for-profit and nonprofit CDEs varied across different purpose categories, CDEs established or controlled by for-profit entities (and partnerships between for-profit and nonprofit CDEs) made a majority of their QEIs in real estate projects. On the other hand, CDEs established or controlled by nonprofit entities made a majority of their QEIs in business projects.

Figure 4: NMTC Loans and Investments by CDE Type and Project Purpose



Source: GAO analysis of CDFI Fund data.

Representatives from
CDEs We Interviewed Said
Most Projects Receive
NMTC Funding to
Supplement Funds from
Other Sources

Through fiscal year 2008, our analysis indicates for projects with available data NMTC financing has been used, on average, to support about 36 percent of total project costs for projects that receive NMTC financing.

Due to limitations with project-level CDFI Fund data,¹⁸ we were unable to identify what portion of each individual project NMTC investments supported. However, according to CDE officials we interviewed, although NMTC investments are unique to individual projects and the portion of the project being financed with NMTC funds varies depending on the amount of other funding available, NMTC investments generally support 20 percent to 30 percent of the total project costs for a particular project. For example, NMTC funds may be paired with other federal tax benefits, such as Historic Tax Credits,¹⁹ or used in conjunction with state and local development subsidies, including programs such as tax increment financing.²⁰ Other projects may have access to funds from private foundations or individual donors. CDE representatives indicated that NMTC financing is frequently used to fill the gap between funds that have already been raised for a particular project and the total amount of funding needed to complete a project.

According to data reported by CDEs to the CDFI Fund, most investment made by the CDEs in QALICBs comes in the form of term loans. Term loans comprised \$10.1 billion (85.1 percent) of total NMTC dollars distributed by CDEs through fiscal year 2008 to QALICBs. Participating CDEs also used debt with equity features, lines of credit, and other types of transactions, but these transaction types accounted for smaller portions of the overall NMTC investment from 2003 through 2008.

¹⁸ These limitations, which include instances where multiple CDEs report different project costs for the same project and lead to the potential over-, or in some cases under-, counting of project costs, are addressed in more detail beginning on page 35 of this report.

¹⁹ According to our 2007 report, the NMTC is frequently combined with at least one other government tax incentive that can provide additional tax benefits to the investor. Respondents to a GAO survey of NMTC investors noted that they most frequently combined the NMTC with state and local tax benefits, but also combined NMTCs with other federal tax benefits, including benefits for rehabilitating historic properties, environmental tax incentives, and tax benefits for Empowerment Zones and Enterprise Communities.

²⁰ Local governments often establish tax increment financing (TIF) districts to use additional property tax assessments collected from economic development projects to retire the debt that a developer had to incur to undertake the project.

According to CDE Representatives, CDEs Offer NMTC Financing Terms That Benefit Low-Income Community Businesses; Current Market Conditions Present Challenges and NMTC Financing Could Be Simplified

According to CDFI Fund data and representatives from CDEs we interviewed, CDEs generally provide beneficial financing terms by either using NMTCs to leverage additional investment dollars to place in QALICBs or by subsidizing the interest rate on a loan to a QALICB (i.e., charge lower than market rate interest on its loans). In the case of the leveraged NMTC model, at least some portion of the tax credit equity generated from the sale of tax credit authority to NMTC investors is generally left in the QALICB at the end of the 7-year period in which investors can claim the credit. Businesses are able to obtain loans from CDEs that essentially function as private equity and should help QALICBs refinance their debt into more conventional loan products after the 7-year tax credit period. In the case of the subsidized interest rate on loans to QALICBs, less equity, if any, may be left in the QALICB after the 7-year period, but QALICBs may save more on interest costs than under the leveraged model. These businesses require less cash flow to repay loans than would be needed in the absence of the credit.

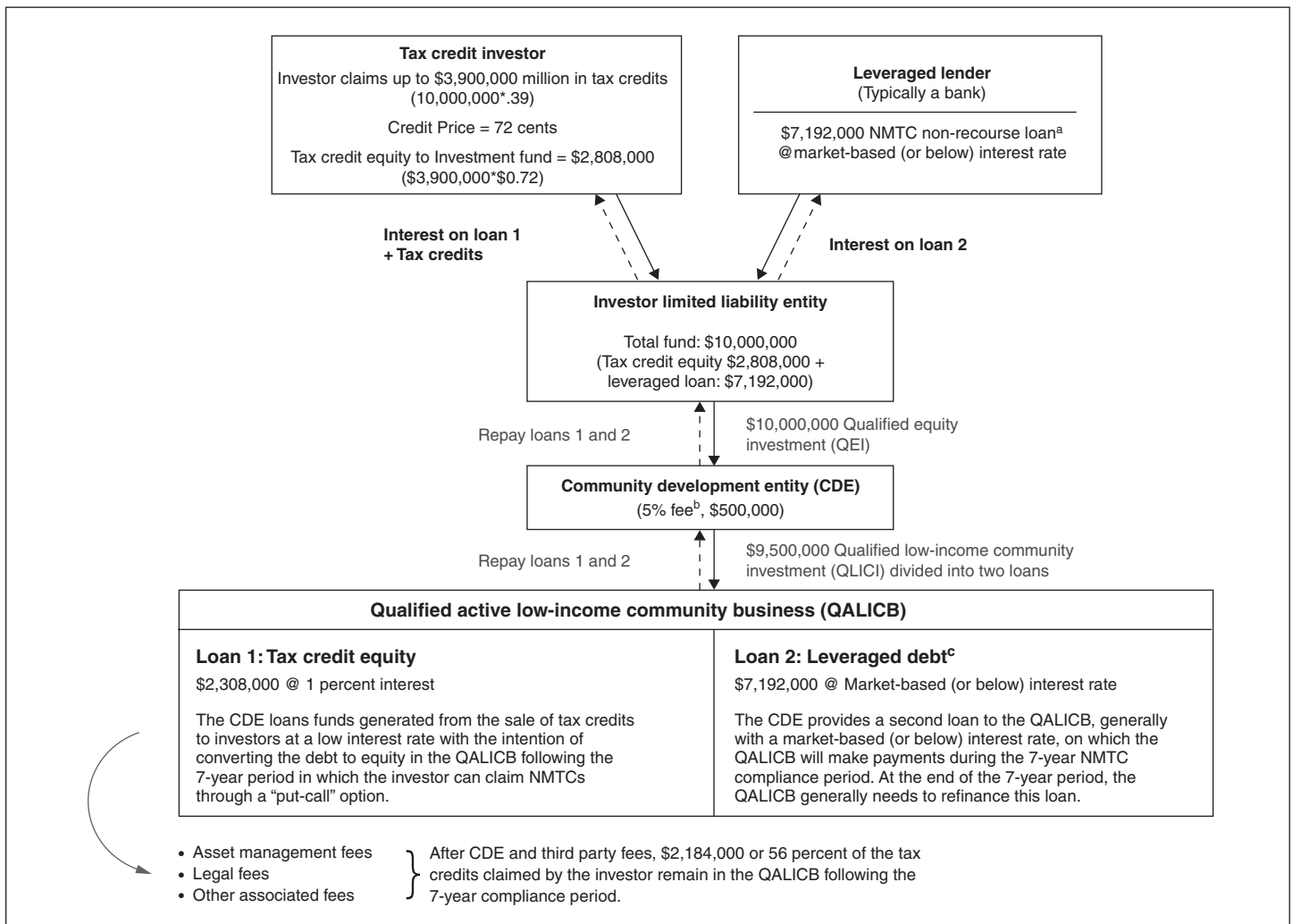
Under the leveraged NMTC model, a tax credit equity investor generally forms a limited liability pass-through entity that obtains a loan from a bank. The tax credit equity investor combines its own funds with the loan from the bank (referred to as the leveraged lender) to invest in a CDE (makes a QEI) that, in turn, invests makes a qualified low-income community investment (QLICI). Because program rules require that CDEs obtain qualified equity investment from NMTC investors, the tax credit investor must obtain a loan from the leveraged lender—when the funds are combined in the limited liability entity, that entity then makes an equity investment in a CDE. In doing so, the financial benefits from the transaction are separated from the tax benefits; the leveraged lender receives interest payments on the loan to the limited liability pass-through entity and the tax credit investor receives a return on their investment by purchasing the right to claim tax credits on the total amount of the QEI.

The leveraged investment structure may offer a more attractive combination of risk and return to investors than the direct investment approach illustrated in figure 1. From the leveraged lender’s perspective (as illustrated in fig. 5), this investment structure may be attractive

because the loan-to-value ratio²¹ is more favorable than it would have been if the debt was not being combined with the investors' equity. The more favorable ratio may compensate the leveraged lender for assuming a greater degree of risk, most notably if the business that receives the loan from the CDE defaults on its loan agreement. In that case, the leveraged lender's investment is secured by the equity in the original investment in the limited liability entity, i.e., generally the tax credit investor's contribution to the limited liability entity. From the tax credit investor's perspective, the base for calculating the credit is much larger than it would be without the participation of the leveraged lender and if the business defaults on its loan, the investor is still generally allowed to claim the full amount of the credit.

²¹ 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. NMTC financing may assist businesses in obtaining loan-to-value ratios generally associated with more conventional financing in cases where low-income community businesses obtain equity or equity-like investment from NMTC investors (the equity reduces the amount of debt that the QALICB must borrow in relation to the value of the asset the loan is being used to finance).

Figure 5: Example of a Leveraged NMTC Transaction



Source: GAO.

^aThe leveraged lender does not have recourse to the assets of the QALICB if it were to default on its loan repayments. Rather, the leveraged lender only has recourse to the assets of the limited liability entity formed to make a QEI.

^bAccording to the CDFI Fund, most CDEs commit to invest more than 95 percent of their QEIs as QLICIs. For the 2009 pool of awardees, the average amount was 97.5 percent. Each awardee is required to meet its stated commitment as part of its allocation agreement.

^cDue to the 7-year compliance period associated with the NMTC, most leveraged loans are interest-only for the 7-year period.

In this example, the tax credit investor obtains its return on investment by purchasing the tax credits for an amount less than the full value of the tax credits that it will be allowed to claim. For example, in a \$10 million QEI in

a CDE, the tax credit investor would be able to claim about \$3.9 million in tax credits over 7 years.²² If the tax credit investor invests \$2.8 million in the limited liability entity, in effect, it pays 72 cents to the CDE for each dollar of tax credits that it will be allowed to claim.²³ The leveraged lender would provide a \$7.2 million loan to the limited liability entity for the total QEI of \$10 million. Once the CDE obtains the QEI from the limited liability entity formed between the tax credit investor and the leveraged lender, it then makes QLICIs in qualified low-income communities.

In general, the QLICIs take place in the form of loans to businesses because CDEs are generally required to adhere to related-party tests which require that the CDE have no more than a 50 percent ownership stake in a QALICB. Providing equity directly to a QALICB could result in the CDE owning more of a QALICB than is allowed. Representatives from CDEs we interviewed said that, as a result of the related-party test, CDEs generally offer two loans to a QALICB in a leveraged transaction (as opposed to one loan and one equity investment)—one loan that represents the funds loaned to the partnership by the leveraged lender (usually an interest-only loan for a 7-year period) and a second loan that represents some portion of the tax credit equity generated from the sale of the tax credit by the CDE to the tax credit investor (which is typically converted to equity at the end of the 7-year period).

The QALICB is responsible for repaying the interest (and sometimes limited principal) on both loans during the 7-year tax credit period. At the end of the 7-year period, however, the QALICB generally has the option of purchasing the tax credit equity from the CDE through a “put” option for a nominal fee.²⁴ The original tax credit investor does not generally get their

²² Because inflation reduces the value of the dollar over time and because of the time value of money, the tax credits are worth somewhat less than the \$3.9 million at the time the investment is made than the \$3.9 million total over the 7-year period.

²³ $\$0.72 \text{ per dollar of tax credit authority} \times \$3.9 \text{ million in authority} = \$2.8 \text{ million in tax credit equity in the pass-through entity.}$

²⁴ A “put” option is a contract that gives the holder of the contract the right to sell all or a portion of its interest in a security to a specified entity at a predetermined price. Conversely, a “call” option gives the holder the right to purchase all or a portion of an interest in a security from a specified entity at a predetermined price. In the case of the NMTC leveraged structure, CDEs generally structure transactions so that the tax credit investor may “put” its tax credit equity to the QALICB or the QALICB may “call” the tax credit equity from the investor, in either case, for a predetermined price at the end of the 7-year period.

original investment back because they obtain a sufficient return on their investment from the initial sale of the tax credit equity to the CDE. The QALICB should then generally be able to use the remaining equity generated from the sale of the tax credit to help it refinance its remaining debt into a more conventional, market rate loan with a standard loan-to-value ratio.

Although, according to CDEs and other experts we interviewed, the ability to purchase the NMTC equity from the investor after 7 years is the primary benefit of the leveraged model to the low-income community business, the model may also generate other benefits. For example, by combining the tax credit equity and the leveraged debt in a limited liability entity, CDEs can raise more money to invest in low-income community businesses than would otherwise be available. CDE representatives also noted that using tax credits to leverage debt also allows CDEs to offer competitive or below-market interest rates on some NMTC loans issued to QALICBs. In addition, by introducing the NMTC leveraged structure, CDE representatives indicated it is often possible to obtain other incentives, whether from private investors or governments, including additional equity, for projects.

Structuring deals in such a manner requires QALICBs to obtain a legal opinion to ensure that the loans to the QALICB represent “true debt.” According to representatives from CDEs we interviewed, this is particularly true for the loan representing the tax credit equity given that it has equity-like features²⁵ and the investor is expected to sell the equity to the QALICB at the end of the 7-year period in which the investor can claim tax credits. According to CDE and many QALICB representatives we interviewed, fees associated with obtaining such legal opinions and other expenses, including asset management fees²⁶ over the 7-year compliance period, reduce the amount of tax credit equity that reverts to the QALICB after 7-years. In addition, according to representatives from CDEs,

²⁵ The loan representing the tax credit equity has “equity-like” features because a portion of it (less associated fees) is generally to be converted to equity in the QALICB after 7 years through a “put-call” mechanism.

²⁶ According to representatives from CDEs we interviewed, the fee structure of an NMTC transaction varies on a transaction-by-transaction basis. For example, in some transactions, QALICBs might pay asset management fees to the CDE to ensure that the QALICB remains compliant with NMTC requirements. However, the amount of fees charged by CDEs and other participating parties varies by transaction, as does who bears the burden of paying them.

QALICBs, and attorneys representing CDEs, QALICBs, and investors with whom we spoke, the fees generated by the complexity of NMTC transactions are not necessarily subject to the “substantially all” test because some are paid by the QALICB out of the proceeds of the QICI or other sources of funds and not by the CDE out of the QEI, which is the point at which the “substantially all” test is assessed.

The amount of capital that is left in the QALICB is reduced by such fees, as well as by any reduction in the price that the tax credit investor pays for the right to claim the tax credits. The combined effect of high fees and lower price would be a lower net present value of the tax credit equity that remains in the QALICB after the 7-year period. The equity remaining in the QALICB after 7 years is the primary benefit of the NMTC to the QALICB under the leveraged structure because it should help QALICBs to obtain more conventional project financing after the NMTC compliance period is finished. Businesses that have considerable equity are more likely to have better loan-to-value and debt service coverage ratios²⁷ and are generally more likely to obtain loans with conventional interest rates than businesses without their own equity. For this reason, the larger the amount of equity remaining in the business, the greater the likelihood that the business will continue on its own without any further government subsidies. Because the equity remaining after 7 years is the primary benefit to the low-income community business, the amount remaining as a percentage of the cost of the program to the government is an indicator of how cost-effectively the financial structure is performing.

To understand the NMTC’s cost-effectiveness, the CDFI Fund would need to collect data on the sale price of the tax credits, fees paid by QALICBs not subject to the “substantially all” test, and the amount of equity that CDEs estimate will be left in the QALICB at the end of the 7-year period in which tax credits can be claimed. However, because the CDFI Fund does not collect this data, it is not possible to identify with precision the net benefits flowing to low-income community businesses in relation to the cost of the program to the government in foregone tax revenue. According to representatives from CDEs we interviewed, such information would not likely impose significant additional burdens on CDEs in addition to

²⁷ Debt service coverage ratios provide a measure of how much revenue a business tends to generate in relation to its debt obligations. NMTC financing, in some cases, could assist in businesses demonstrating more standard debt-service coverage ratios because when businesses obtain below market interest rates on loans, they generally have lower debt service payments than in the absence of the NMTC.

current NMTC reporting requirements and would be readily available on a transaction-by-transaction basis.

Although complete data on the cost of NMTC transactions in relation to the equity left in low-income communities do not exist, our analysis of leveraged transactions, which is limited to those identified in our case studies indicates that the projected equity in low-income community businesses after the 7-year period in which tax credits can be claimed is about 50 percent to 65 percent of the amount of tax credits that the tax credit investor can claim over 7 years. All eight of the CDEs that were the focus of our case studies and participated in leveraged transactions generally agreed that it is reasonable to expect that the CDE will leave about 50 percent to 65 percent of the amount of tax credits investors can claim in QALICBs after the 7-year tax credit period and that the complexity of the leveraged structure is a factor causing less equity to end up in the low-income community businesses.

Because the NMTC investors are also required to pay taxes on a portion of their earnings from their NMTC investment and some QALICBs owe taxes on the equity remaining in the QALICB following the 7-year tax credit period, the total cost of the program to the government may be lower than the sum of the tax credits and the amount of equity left in the QALICB may actually be a larger share of total cost of the NMTC program to the government than the 50 percent to 65 percent figure cited above. However, the amount of tax credit equity left in the QALICB as a percentage of the total cost to the government also depends on fees paid and assumptions made about the time value of money.²⁸ In addition, to the extent that NMTC investors may not be allowed to claim all of the tax credits that they initially believe they will be eligible to claim, the cost of the tax credit program to the government would be lower. Other market conditions also play a role in determining the amount of residual equity that ends up in QALICBs—when NMTC prices are higher, more equity is generated from the sale of the credits to investors than when prices are lower, which increases the capital available for CDEs to reinvest in low-income community businesses.

²⁸ In periods of higher interest rates, the present value of a dollar to be received in the future is worth less than in periods of lower interest rates.

In contrast to the leveraged structure, another common method for structuring NMTC transactions involves using NMTCs to subsidize interest rates to businesses in low-income communities. In this structure, a single investor (or multiple investors) may make an investment in a CDE and the CDE then, in turn, loans the money to a QALICB. As a result of the investors being able to claim NMTCs, the CDE is able to offer the loan at a below-market interest rate. The CDE generally passes the interest paid on the loan back to the NMTC investor. By combining the tax credits with a below-market interest rate, the investor is generally able to obtain a sufficient return on investment to justify the risk associated with investing in a low-income community business. Representatives from one CDE we interviewed said that the CDE can generally offer loans with interest rates between 3.5 and 4.0 percentage points below the standard market rates at a given time and in a given location. Depending on prevailing market interest rates for loans, NMTC loans under the subsidized rate model could be as much or more than 50 percent below market interest rates. For example, if an investor were to offer a loan to a QALICB at a 7 percent interest rate, subsidizing the loan with NMTCs would likely allow the investor to offer the loan at 3.5 percent or 3.0 percent, or about 50 percent to 57 percent below market, resulting in considerable interest savings to the QALICB. Although this is a considerable interest rate savings to the QALICB over 7 years, available data make it difficult to compute a measure of interest savings to the QALICB in relation to the amount of tax credits claimed by the investor or whether the interest savings will allow the QALICB to save enough in interest over the course of the loan to be in a position to obtain more conventional financing after 7 years.

The subsidized interest rate model differs from the leveraged model in that no equity generated from the sale of the tax credits to investors is generally left in the low-income community business after the 7-year period. However, according to representatives from CDEs that we interviewed, the subsidized interest rate model is also less complex than the leveraged model and it may be possible to close NMTC transactions with fewer legal costs and other associated fees than in the leveraged model. As a result, the subsidized rate model may allow CDEs to finance smaller projects than can generally be completed using the leveraged model.

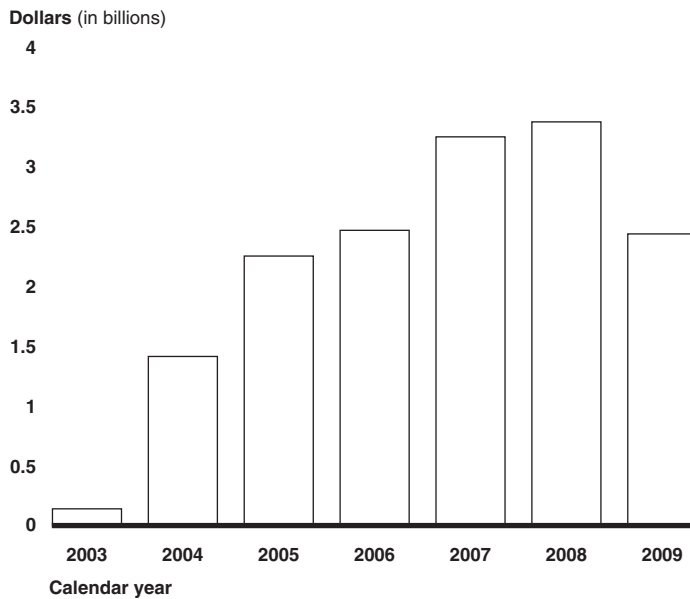
Current Economic Conditions May Also Decrease the NMTC's Cost-Effectiveness by Lowering the Price Investors Pay for Tax Credits and Reducing the Number of Investors

According to representatives from CDEs and CDFI Fund data, current economic conditions also may be reducing investors' appetite for tax credits, meaning that less tax credit equity is likely being generated from the sale of tax credits from CDEs to investors and CDEs, in general, are able to generate less QEI. For example, representatives from several CDEs indicated that before the housing market collapse and subsequent credit crisis in 2008, investors generally paid between \$0.75 and \$0.80 per dollar in tax credits. Under current economic conditions, these representatives said that investors may only be willing to pay \$0.65 to \$0.70 per dollar in tax credits. One CDE indicated that it has sold NMTCs to investors for as low as \$0.51 per dollar and another CDE indicated that it had heard of NMTCs being sold for as low as \$0.48. These lower prices to obtain NMTCs also imply that the amount of subsidy reaching the QALICBs has declined significantly.

In addition, as figure 6 shows, NMTC investment in 2009 is likely to be less than in 2007 and 2008, which may be partially due to current credit market conditions. As of the end of 2009, CDEs had raised about \$2.4 billion in QEI during calendar year 2009.²⁹ According to representatives from CDEs we interviewed, when demand for the credit is lower, CDEs are more likely to sell tax credits to investors at reduced prices.

²⁹ Although the 2009 figure is updated through the end of the year, CDEs have up to 60 days to report investment data to the CDFI Fund after the investments are made, meaning additional 2009 investments could be reported in January and February of 2010. However, even if the CDEs raise more QEI in the 4th quarter of 2009 than any other 4th quarter of the year in which NMTCs have been available, or about \$1.3 billion (which CDFI Fund officials do not expect), NMTC investment in 2009 would be about 16 percent to 19 percent lower than in 2007 and 2008, respectively.

Figure 6: NMTC Investment by Calendar Year, 2003 through 2009



Source: GAO analysis of CDFI Fund data.

To increase the number of investors, industry organizations and CDEs have offered several policy options. Some have suggested that allowing NMTC investments to offset alternative minimum tax (AMT)³⁰ liability would broaden the pool of potential investors. For example, while NMTCs cannot be used to offset AMT liability, other tax incentives for community development, including Low-Income Housing Tax Credits for rental housing and the Historic Rehabilitation Credit, can be used to offset AMT liability. If such an allowance increased the pool of investors and the price investors are willing to pay for the credit, it might have the beneficial effect of ensuring that a larger portion of the subsidy ended up in QALICBs. However, such an allowance would increase federal revenue losses to the extent that investors subject to the AMT who are not currently investing in NMTCs become NMTC investors and claim credits that would otherwise go unclaimed. Our analysis did not address whether such changes would likely increase the number of likely NMTC investors,

³⁰ AMT is a separate federal tax system that applies to both individual and corporate taxpayers. It parallels the income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.

contribute to increased NMTC investment, or assist in increasing the amount that investors are willing to pay for NMTCs.

Although It Is Unclear Whether Low-Income Community Projects Would Occur “but-for” the NMTC, According to CDE Representatives, CDEs Use a Variety of Methods to Determine if Low-Income Community Businesses Need NMTC Financing

Representatives from CDEs we interviewed indicated that the “but-for” test can be applied in a variety of different ways. For example, some CDEs require businesses to demonstrate that they have not otherwise been able to obtain financing before considering whether it would be appropriate to provide NMTC funds to a business. CDEs may also require potential beneficiaries of NMTC funds to complete a questionnaire that CDEs use to assess the likelihood that other forms of financing may be available. Representatives from other CDEs we interviewed indicated that they review their ongoing list of potential projects, often referred to as their project pipeline, to make assessments about which businesses or development projects require NMTC financing. Some CDEs may apply for an NMTC allocation with a specific project in mind for which they have tried to obtain financing in the past.

However, evidence we gathered was inconclusive in corroborating that procedures used by CDEs target funding only to projects that would not have otherwise been done. On the one hand, in most cases, representatives from CDEs and businesses we interviewed indicated that alternative sources of financing were not available to finance their respective projects. On the other hand, in two cases, businesses that had obtained NMTC financing said that alternative sources of financing would have been available for their project, but that the terms and conditions offered as a result of the NMTC financing made their respective projects less expensive and the use of NMTCs was more attractive than other sources of financing. In addition, although low-income community businesses may be benefiting from NMTC financing, it is not always clear how much better the terms and conditions being offered are than would otherwise be available. For example, representatives from CDEs we interviewed indicated that it is sometimes difficult to identify standard market-based interest rates to make comparisons across projects. CDE representatives indicated that prevailing, standard market interest rates vary by industry type, geographic location, and over time.

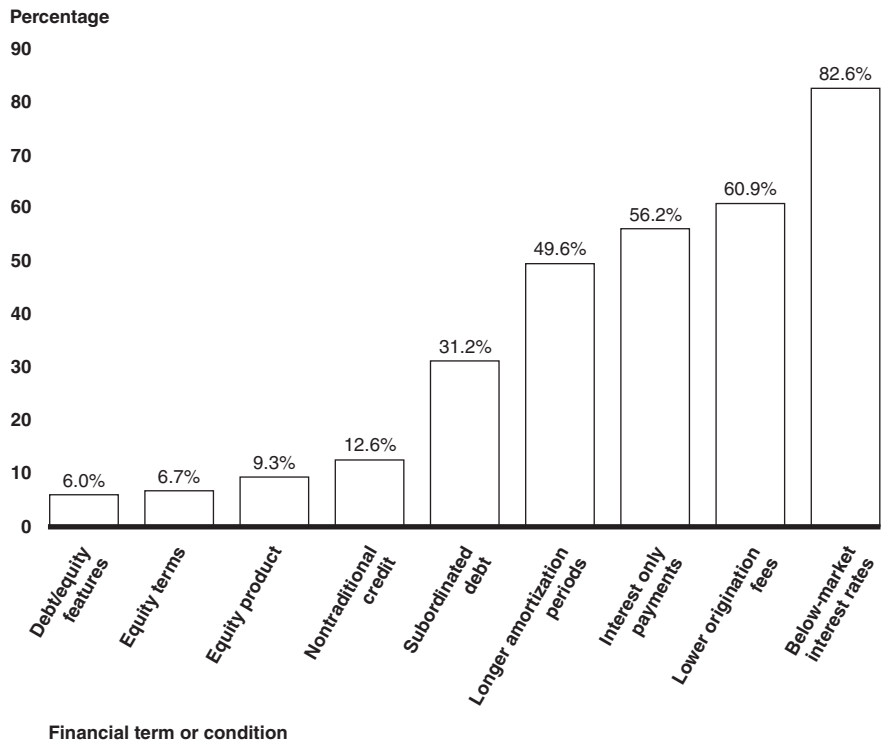
The CDFI Fund requires that CDEs commit to providing financial products to QALICBs that contain better rates and terms than the QALICBs would be able to obtain in the absence of NMTCs being part of the deal structure (CDEs make this commitment when they sign allocation agreements with the CDFI Fund after being notified that they received an NMTC allocation). The CDFI Fund prioritizes equity or equity-like investments

and below-market interest rate loans as generally providing the greatest benefits to low-income community businesses. The CDFI Fund also collects information on other measurements indicative of flexible financial products, such as lower than standard debt-service coverage ratios, higher than standard loan-to-value ratios, and other measurements.³¹

As figure 7 shows, CDEs report providing equity or equity equivalent terms and conditions (first three columns in the figure) for about 22 percent of financial products that include NMTC financing. Below-market interest rates on loans are the most common type of flexible financial product being offered. About 82 percent of financial products that CDEs report to the CDFI Fund indicate that QALICBs have received below-market interest rate loans. In the case of leveraged transactions, the loan made by the tax credit equity investor is generally far below market interest rates and the loan from the leveraged lender is at a more standard interest rate, although lower than what would have been attainable in the absence of the NMTCs. In addition, the large number of loans in comparison to other equity investments does not reflect the portion of those loans designed to essentially function as private equity under the leveraged model.

³¹ Other than equity or equity equivalent financing and below market interest rates, the CDFI Fund defines the following measures as being flexible rates and terms for NMTC financial products: subordinated debt, lower than standard origination fees, longer than standard interest only periods, longer than standard amortization periods, more flexible borrower credit standards, nontraditional forms of collateral, loan loss reserve standards that are less than standard, higher than standard loan-to-value ratios, and lower than standard debt-service coverage ratios.

Figure 7: Percentage of Flexible Rates and Terms Reported by CDEs Used in NMTC Products, Fiscal Year 2003 to Fiscal Year 2008



Source: GAO analysis of CDFI Fund data.

Options for Simplifying NMTC Transaction Structures

Although the NMTC’s authorizing legislation and legislative history provide little explicit information on the program’s intent, the NMTC program seems designed to increase the amount of investment, particularly equity investment, available to businesses in low-income communities where conventional access to credit has traditionally been limited. While our analysis does not allow us to draw conclusions about what would have happened in low-income communities absent the credit, to the extent the NMTC program subsidizes projects that would not otherwise have occurred, businesses benefiting from both leveraged and subsidized interest rate NMTC investments may be aiding in the development of low-income communities. To increase the effectiveness of how NMTC funds are dispensed to low-income businesses, changes to the application of the related entities test or replacing the tax credit with a grant are two options that could simplify NMTC transaction structures and

increase the amount of equity investment available to low-income businesses.

Option one

According to representatives from CDEs we interviewed, economic development experts, and attorneys and accountants that execute NMTC transactions and based on actual transactions we reviewed through our case studies, the leveraged investment model is the structure that most directly develops equity in low-income community businesses. Though the leveraged NMTC investment model is structured to leave equity in low-income community businesses at the end of the 7-year loan period, the transaction's complex structure and its associated costs (in the form of the return on investment to tax credit investors and associated fees), raises questions about whether this is the most effective way to subsidize the creation of equity in low-income community businesses. According to representatives from CDEs we interviewed, identifying ways to streamline the leveraged model may result in CDEs placing more investment in QALICBs at the beginning of the 7-year period while incurring fewer fees and related costs that reduce the amount of tax credit equity that ultimately reverts to the QALICB under the current structure. According to representatives from CDEs and lawyers who developed rules for implementing the leveraged structure while working at IRS, one change that would reduce the complexity of leveraged transactions would be to apply the related parties test before the QLICI is made rather than afterwards, as is currently the case. This would allow CDEs to hold equity stakes in QALICBs in excess of the current 50 percent limit provided the CDE (or its investors) did not have more than 50 percent ownership of the QALICB before making the QLICI. The CDFI Fund is considering changes to the related entities test.³² Although this would somewhat increase the equity that can be left in low-income businesses, it would not address the major factor—the sale of the tax credits—which reduces equity that ultimately is left in the businesses.

Option two

According to our analysis, replacing the tax credit with a grant likely would increase the equity that could be placed in low-income businesses and make the federal subsidy more cost-effective. When the demand for NMTCs was highest, the credits sold for \$0.75 to \$0.80 per dollar. Therefore, the federal subsidy intended to assist low-income businesses

³² While the NMTC statute defines what constitutes ownership under the related-entity test, the CDFI Fund has the authority to establish the timing with respect to when the test of relatedness shall be applied.

was reduced by 20 percent to 25 percent before any funds were made available to CDEs. With low demand for the tax credits, as has recently been the case, the credits sold for as low as \$0.50 cents, or lower, halving or more the amount of federal subsidy available to CDEs for investment in low-income businesses. In a grant program, these up-front reductions in the federal subsidy could be largely or entirely avoided.

A grant program could take various forms. A grant program could begin with the CDFI Fund making grants to CDEs, and then the CDEs making either equity investments in low-income businesses or providing them grants. Because the NMTC is structured much like a grant program—the CDFI Fund advertises for applications, peer review panels score applications, Fund staff determine amounts of NMTCs to allocate to winning applicants, and the CDFI Fund gathers information to monitor compliance and gauge program outcomes—the CDFI Fund likely could substantially use its current process for allocating the tax credits to instead allocate grant funds to CDEs. However, in switching the NMTC program to a grant program, some additional administrative costs may be incurred by the CDFI Fund and other interested parties, including CDEs and investors. For example, the Fund and CDEs would have responsibilities related to tracking costs associated with the grants to ensure only applicable costs are funded by the grant. Whether these costs would be greater or lesser than costs for the current tax credit program would depend somewhat on the design of any grant program. CDEs would continue to play a critical role in selecting and monitoring projects.

To ensure that the federal subsidy remains in the business, whether the CDE then made an equity investment (owns part of the business) or a grant (has no ownership interest) to the low-income business, those funds ultimately would be left in the business. In either case, to ensure that the business has at least as much funding up front as it receives in the NMTC structure, a private lender would need to loan funds to the business.³³ The CDEs could either broker this loan, somewhat as they do in the current structure, or the business itself could go into the market for a loan using the equity investment or grant received from the CDE as collateral. The program could be structured so that the lender may have recourse to the assets of the QALICB in the case of a bankruptcy, which is currently not

³³ The grant funds might also be used to induce additional equity investment by private investors in the low-income businesses as an alternative to loans or in combination with loans. NMTC investments in low-income businesses currently help induce equity investments in those businesses in some of the leveraged transactions.

generally the case under the leveraged model. In the latter case, the CDE might provide advice to the business. Involvement of the CDE in assisting the low-income business might be made a requirement of the equity investment or grant since that business may be inexperienced in obtaining significant credit. In our case studies, we heard that some lenders were more confident in making loans because they knew and had confidence in the CDEs, including that the CDEs would be monitoring the low-income businesses throughout the lending period. Requiring CDE involvement in obtaining financing for the low-income business and subsequently monitoring the business might therefore facilitate lending that would not otherwise occur or that would not occur on as favorable terms.

Regardless of how funds would be made available to businesses from CDEs, because more of the federal subsidy should make its way to the low-income businesses, which could be leveraged to obtain additional private financing, a grant-based program could either provide more funding to the same number of businesses at the same revenue cost, or similar funding to more businesses in total. Further, by eliminating the tax credit investor, a grant-based program likely would have less complex transaction structures with reduced fees relative to the current credit, thereby allowing an increased portion of available funds to flow to low-income community businesses. In any case, reducing the complexity and associated transaction costs for NMTC projects might have the added effect of making smaller projects more viable. According to CDE representatives, because fees associated with the various NMTC transaction structures tend to be fixed and do not generally vary based on the size of the transaction, using the leveraged model for smaller transactions has proven challenging.

Congress has turned to grant programs in other cases where tax credits had formerly been used. For example, to fill funding gaps in Low-Income Housing Tax Credit (LIHTC) projects, under the American Reinvestment and Recovery Act of 2009, Congress is offering the option of allowing state housing finance agencies (HFA) to exchange LIHTCs for federal grants to subsidize low-income rental housing. Under this option, LIHTC investors may or may not be a part of the investment structure. In cases where investors are no longer involved, HFAs are playing a more significant role in managing the assets developed from the grants awarded in lieu of tax credits. However, because the price LIHTC investors were willing to pay for tax credits dropped considerably during the severe economic downturn, if they were willing to invest at all, temporarily structuring the program as a grant program rather than a tax credit may be more cost-

effective from the government’s perspective than continuing to sell tax credits for fractions on the dollar.

If the NMTC were to be restructured as a grant program, a number of design issues would need to be considered and the choices made could affect how well the program would perform and whether, in practice, it would be more effective at providing equity to low-income businesses and facilitating private investment than the tax credit. Consequently, evaluating the performance of any grant program compared to the performance of the current credit would be useful. Table 2 illustrates two options for simplifying the program and the potential benefits and issues associated with these options.

Table 2: Options for Simplifying the NMTC Program

Option	Who makes the change	Examples of potential benefits	Examples of potential issues
1. Change the point at which the related entities test is applied from after the QLICI is made to before the QLICI is made.	Treasury	<ul style="list-style-type: none"> • Would make it easier for CDEs to make equity investments in QALICBs. • Would reduce costs associated with “true debt” analysis for leveraged loans and, as a result, would likely make more investment available to QALICBs. • By reducing fees, would make smaller projects more feasible than under the current structure. 	<ul style="list-style-type: none"> • Need to ensure that safeguards are in place to prevent investors from investing in their own businesses. • Continues to rely on the sale of the tax credits to subsidize low-income community businesses.
2. Make grants to CDEs that, in turn, make equity investments in or provide grants to QALICBs.	Congress and Treasury	<ul style="list-style-type: none"> • Should increase the portion of the subsidy that goes to low-income communities by eliminating the sale of tax credits. • Would maintain the flexibility CDEs currently have in selecting projects to fund. • Would continue to rely on the administrative structure established by the CDFI Fund to administer the NMTC. • By reducing complexity of the structure, fees would be reduced and smaller projects would be more feasible than under the current model. 	<ul style="list-style-type: none"> • Would need to change the related entities test if CDEs are allowed to make equity investment in QALICBs. • Would need to calibrate the allocation amounts available to ensure that the cost of the grant program to the federal government is similar to the cost of the tax credit program. • Would need to define the relationship between the CDE and the low-income business in obtaining private financing for the business and monitoring it over time.

Source: GAO

CDEs Use NMTCs for a Range of Purposes with Outcomes That Can Be Difficult to Measure and Vary Depending on the Project

Unlike some other federal programs, such as the LIHTC program which is used strictly to develop rental housing, CDEs with NMTC allocations have considerable flexibility in deciding how to deploy NMTC financing to low-income community businesses. In developing the program, Congress did not specify how CDEs can use the NMTC.³⁴ CDE representatives, in general, said that the flexibility associated with the NMTC is one reason why the program has been popular among community development professionals and low-income community businesses. As a result, the impact of the program varies depending on the project characteristics and it can be difficult to fully measure through data reported to the CDFI Fund. In addition to our limited number of case studies, forthcoming research by the Urban Institute may provide additional information on how NMTCs are used for a wide range of purposes.³⁵

Our case studies of CDEs illustrated a variety of NMTC projects. In these studies, we reviewed NMTC projects with a chiefly educational purpose, such as an after-school program for at-risk youth in a low-income area of a major metropolitan area and a charter school for children with special needs. Other projects were intended to promote diverse goals such as housing and jobs, including a community center that assists low-income residents in obtaining housing and employment, and enhancing the health of community residents through medical facilities (e.g., hospitals and a doctor's office) in both a metropolitan location and a nonmetropolitan location. Mixed-use projects supported by NMTC investment also include commercial real estate, for-sale housing, and rental housing and appear to provide varying degrees of benefits to low-income community businesses and low-income community residents. CDEs have also identified and implemented techniques that allow for the NMTC's use in strictly for-sale

³⁴ Regulatory requirements preclude business activities such as residential rental property, golf courses, massage parlors, liquor stores, gambling facilities, and farms from qualifying for NMTC financing.

³⁵ The Urban Institute received a contract from the CDFI Fund to evaluate the effectiveness of the NMTC program. The results of its study, which includes surveys and additional case studies, are due in 2011.

housing projects.³⁶ Although it is clear from our case studies that low-income community businesses and residents have benefited from projects supported by NMTC investment, available data and statistical techniques do not allow us to identify the extent to which these benefits would have been realized in the absence of the credit. Table 3 provides a list and description of all of the NMTC financed projects we visited.

Table 3: Location and Descriptions of NMTC Case Study Projects

Census region	Project description
South	Multifamily housing facility that provides affordable rental housing and childcare opportunities to low-income persons.
	Single and multifamily housing units that will provide affordable housing opportunities to employed persons, living in high-cost areas, with limited capacity to purchase market-rate housing.
Northeast ^a	Community facility that houses year-round academic enrichment, sports, and community service programs for youth in the surrounding community.
	Community facility that provides comprehensive housing, community, and employment services to low-income residents in the surrounding community.
	Educational facility that provides comprehensive and multidisciplinary (i.e., psychological, social services, physical and occupational therapy) services to special-needs children in the surrounding community.
	Community-owned forest that provides local resource management and eco-tourism opportunities to the surrounding community.
	Mixed-use complex that houses a hotel, restaurant, and commercial office space.
	Medical center and hospital that will provide comprehensive health care services to the surrounding nonmetropolitan community.
	Education facility that conducts research, community outreach, and youth programs on matters related to fishing and the environment.
Midwest	Single-family housing units that will provide affordable housing opportunities to employed persons, living in high-cost areas, with limited capacity to purchase market-rate housing.

³⁶ Using NMTCs to finance the development of for-sale housing presents challenges because when developers complete the construction of the housing and sell the houses to home buyers, the developer may be in a position to repay the CDE, which would be considered redemption of the original investment. Per NMTC program rules, the CDE would have to redeploy the original investment within 12 months or risk having the credits recaptured by the IRS. One developer with whom we spoke indicated that the CDE with which his organization worked facilitated a deal structure that would legally address these concerns.

Census region	Project description
	Medical center and mixed-use facility that provides healthcare and other services to the surrounding metropolitan community.
West	Mixed-use development that will provide market-rate “for sale” and affordable housing opportunities, commercial office space, and public open space for the surrounding metropolitan community.
	Mixed-use development that will provide market-rate and affordable housing opportunities and commercial space to the surrounding metropolitan community.

Source: GAO case study analysis.

^aWe visited more project sites in the Northeast than in other census regions because we visited a large financial institution in the Northeast that participates in the program in a number of ways (e.g., allocate, tax credit investor, and leveraged lender) and we visited a CDE that focuses on investing in nonmetropolitan areas that took us to multiple project sites.

The variety of projects supported by NMTC investment also makes it difficult to devise and implement a set of measures that fully captures their impact on the low-income communities. Job creation can be difficult to quantify and may have different relevance for different types of projects. For example, the after-school program we visited included a \$9 million facility financed, in part, with NMTC funds. According to the director of the after-school program, with the use of NMTC funds and other funds, it has created about 12 full-time jobs. The director and representatives from the CDE that financed the project noted that although financing a \$9 million facility to generate only 12 jobs may not, on the surface, appear to be generating significant benefits to low-income communities, the after-school program provides counseling and physical education activities to a number of at-risk children each week. They also noted that the facility fulfills a need in providing physical education opportunities to children that are generally not available in the public school system due to a lack of funding. Representatives from the CDE that financed the project indicated that it can be difficult to demonstrate the impact of the program because many projects may be providing benefits to low-income communities that extend beyond quantifiable data, such as the number of jobs that a facility is expected to generate or the square feet of real estate being constructed or rehabilitated.

Other projects we visited, which may have the potential to provide benefits to low-income communities, are currently still in the development phase or have been slowed by legal issues or market and regulatory risks. For example, one CDE we visited used its NMTC authority for predevelopment costs associated with a relatively large mixed-use facility in a depressed urban area. Although the NMTC funds have been depleted,

the developer has not yet been able to obtain all of the additional financing necessary to begin the construction phase of the project. The CDFI Fund's application process can try to limit specific risks associated with the management capacity or capitalization strategy of a CDE but cannot address such systemic risks as an unanticipated tightening of capital markets.

The CDFI Fund does not collect data on project failure rates and our limited number of case studies does not show how frequently community development projects supported by NMTC financing are never completed or end up in bankruptcy. If the projects are never completed, taxpayers bear the burden because failure to complete a project does not cause the tax credits to be recaptured. In addition, because the NMTC program is designed to support projects in areas where access to capital has been traditionally scarce and capital investment is considered riskier, it seems likely that certain projects supported by the NMTC may ultimately fail. Data on the failure rate of NMTC projects would likely give the CDFI Fund a better understanding of the types of projects best suited for NMTC financing and additional resources for making future decisions about how to allocate NMTC funding.

CDEs Report Data on Employment, Real Estate Development, and Other Outcomes in Low-Income Communities to the CDFI Fund

The authorizing legislation for the NMTC program does not require the CDFI Fund to evaluate the success of the NMTC program; however, the agency does collect data from CDEs about the outcomes associated with projects that receive NMTC financing. CDEs that receive NMTC allocations submit annual reports to the CDFI Fund through CIIS. The annual CIIS reports contain information about how projects that received NMTC financing (in whole or in part) may have contributed to economic-development-related project outcomes, such as the number of full-time equivalent (FTE) positions by job type,³⁷ affordable housing opportunities, and other new construction and rehabilitated real estate development in low-income communities. However, it is difficult to establish causal links between QEI, QLICI, and these reported project outcomes. Consequently, we are unable to determine the extent to which any economic development in the communities receiving the NMTC investment would have occurred if the NMTC program did not exist.

³⁷ For projects receiving business financing, one FTE is a 35 hour or more work week. In calculating FTEs, the CDFI Fund instructs CDEs to combine the hours worked by part-time employees.

Although the CDFI Fund collects information from CDEs on the number of FTEs associated with funded projects, the CDFI Fund had not (at the time of publication of this report) released this information with respect to the 2008 data—primarily because it had not yet fully completed the process of cleaning the data, including implementing changes to its data cleansing protocols, particularly with respect to projects that were financed by multiple CDEs. According to representatives from CDEs we interviewed, techniques to determine the number of jobs varied widely. Some CDEs use proprietary economic modeling tools or contract with third-party consultants to determine the number of jobs on projects with NMTC financing, while other CDEs relied on internally developed research methods or on input from developers and low-income community businesses. These techniques vary in their reliability. As a result, although self-reported jobs data to the CDFI Fund represents a solid step in tracking the use and accountability of federal resources, the data may not reliably identify the number of jobs associated with NMTC financing.

The CDFI Fund also collects self-reported data on the projected real estate square footage for projects with NMTC financing as well as data on rental and for sale housing units, the capacity of educational, childcare and healthcare facilities developed using NMTC financing. Although information on the square footage of real estate provides an additional measure of the outcomes of projects associated with NMTC financing, the raw numbers, in and of themselves, may not provide information about the full context of a particular project. For example, according to comments submitted to the CDFI Fund by one research institution, developing real estate in low-income communities in some areas is much more costly and difficult than in other low-income communities.

Although the CDFI Fund collects project-level data on the self-reported estimates of outcomes, the data collection method they use does not allow them to clearly identify the estimated outcomes for each individual project. Specifically, in cases where multiple CDEs contribute NMTC funds to the same project, the CDEs often all report outcome data on the project in CIIS. Our analysis indicates that this occurs for about 18 percent of the projects in the CIIS database. In such cases, CDEs can report duplicate and inconsistent data for a single project which can result in the overcounting or undercounting of estimated project outcomes.

The CDFI Fund is aware of this data limitation and has developed an approach to consolidate and aggregate multiple entries for a single project. However, the CDFI Fund's methods may not be adequate in all cases. For example, if four CDEs contribute to the same project and report the same

project-level information, simply summing the project level data in CIIS would result in overestimating the outcomes for the NMTC program as a whole. According to CDFI Fund officials, in these cases it is appropriate to average the reported outcomes from all four CDEs to estimate the outcome of the project. However, if a similar number of CDEs were contributing NMTC funds to a single project for different purposes and were reporting the projected outcome of only their portion of the investment, then attempting to correct for duplicate entries for the same project might result in underestimating the outcomes of the NMTC program.

IRS and the CDFI Fund Have Established Processes That Will Allow Them to Better Assess NMTC Compliance

IRS is responsible for ensuring that CDEs and NMTC investors adhere to NMTC laws and regulations. As we noted in our 2007 report,³⁸ to get a sense of how many resources to dedicate to the new NMTC program, IRS conducted a compliance study of CDEs receiving allocations in the first round, focusing on CDEs' compliance with the "substantially all" requirement to invest at least 85 percent of their QEIs within 1 year of receiving the investment. IRS officials said that they chose to focus on CDEs' compliance with the "substantially all" requirement because they believed that this was the area where noncompliance with NMTC provisions was most likely to occur. In response to our recommendation in that report, IRS established criteria for selecting which CDEs to audit as part of the compliance study to ensure that IRS was reviewing the full range of NMTC transactions and that the results of its sample would be as representative as possible of all CDEs with NMTC allocations. For example, IRS officials indicated that they attempted to identify a range of CDEs to audit based on characteristics such as the physical location of the CDE, allocation amount, the CDE's status as a nonprofit or for-profit entity, percentage of allocation invested in urban and rural areas, the percentage invested in real estate and non-real estate projects, and other characteristics.

Based on the results of its compliance study and the outcome of future CDE audits, IRS intends to make decisions on the amount of resources to dedicate to CDE audits. In 2008, IRS used criteria similar to those used to identify CDEs for its compliance study to identify which CDEs to select for audit.

³⁸ [GAO-07-296](#).

IRS officials have also taken steps to ensure that only taxpayers eligible to claim NMTCs actually claim them on their tax returns. For example, IRS selected a sample of NMTC investors using CDFI Fund data from the beginning of the NMTC program until the end of calendar year 2004 to assess whether investors were claiming the proper amount of tax credits on their returns and to determine whether it would be cost-effective to identify all eligible NMTC claimants, including those investing in pass-through entities.³⁹ IRS chose this time period because the information was readily available from the CDFI Fund and correlated with 2005 tax returns, the most recently available tax returns at the time of the study.

Using its sample, IRS officials compared the amount of NMTCs that they believed NMTC investors identified in CDFI Fund data should be able to claim on their tax returns to the amounts that taxpayers actually claimed on their tax returns. This comparison showed little evidence of ineligible taxpayers claiming the credit. IRS officials found that in cases where taxpayers claimed more tax credits than IRS would have expected the taxpayer to be eligible to claim, the additional tax credits claimed generally resulted from investors carrying over unused credits from previous years.⁴⁰

IRS officials also noted that it can be difficult to track the amount of tax credits claimants are eligible to claim in the leveraged structure because it is not clear from the data what portion of the NMTC investment is allocated to which investor. However, IRS concluded that it is possible to work around limitations associated with CDFI Fund data on NMTC investors to ensure that NMTC claimants do not fraudulently claim tax credits. For example, IRS noted that it can use the CDFI Fund data as supplementary information when conducting audits and CDEs maintain records of eligible investors should IRS need to recapture tax credits. Further, IRS sometimes reviews NMTC claims as part of its regular field

³⁹ While CDFI Fund data identifies most NMTC investors that invest in pass-through entities, after the 3rd tier of pass-through entities for a given qualified equity investment is established, CDFI Fund data do not always identify the actual claimant. For example, in cases where a taxpayer eligible to claim NMTCs transfers the right to claim NMTCs to another taxpayer, CDFI Fund data do not capture the transfer.

⁴⁰ IRS officials assumed that claimants would be able to claim no more than 5 percent of the amount of qualified equity investment that attributed to the taxpayer in the CDFI Fund data. Investors can claim 5 percent of their investment in tax credits for the first 3 years of the 7-year NMTC compliance period and 6 percent in the last 4 years. Because IRS used tax returns filed in 2005 and the first NMTC awards did not take place until 2003, all of the investments would have still been within the first 3 years of the 7-year compliance period.

audits. This means that IRS auditors reviewing tax returns of corporations or individuals that also claim the NMTC would seek documentation that the taxpayer claimed the correct NMTC amount. IRS officials also intend to continue to review claimants' tax returns when the NMTC amount claimed is significant. IRS officials concluded that the potential benefits generated from developing a comprehensive system to track NMTC investor compliance for each NMTC transaction would likely be outweighed by the burden it would place on taxpayers and that the above steps should be adequate to ensure compliance.

Our guidance on internal controls notes that federal agency management should weigh the costs and benefits of processes to provide reasonable assurance that agency objectives, including ensuring effective and efficient operations and compliance with applicable laws, are met.⁴¹ Our review indicates that IRS weighed the costs and benefits associated with its NMTC compliance monitoring efforts and has taken steps it believes will ensure that IRS will be able to meet the agency's goals of identifying noncompliant CDEs and NMTC claimants.

The CDFI Fund is responsible for monitoring CDEs to ensure that CDEs are compliant with their allocation agreements through the New Markets Compliance Monitoring System (NCMS) and, on a more limited basis, by making site visits to selected CDEs. The NCMS compiles data from other CDFI Fund databases that track investor behavior and project details to identify when a CDE may be falling out of compliance with its allocation agreement. CDFI Fund databases rely on data that CDEs self-report to the CDFI Fund. However, the CDFI Fund has several mechanisms in place that help ensure that compliance data collected are accurate and reliable, such as comparing census data to self-reported CDE data for some data fields and providing written instructions and a help desk to call when CDEs have questions about how to report information to the CDFI Fund.

According to CDFI Fund officials, the CDFI Fund has conducted more site visits to CDEs in recent years than in the program's earlier years in an effort to monitor compliance. CDFI Fund officials said that they conducted five NMTC specific site visits in Fiscal Years 2008 through 2009. In 2007, we reported that the CDFI Fund conducted two site visits in 2005

⁴¹ GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: Nov. 1999).

and an additional two site visits in 2006.⁴² CDFI Fund officials indicated that they are more likely to make a site visit to a CDE when they have reason to believe that the CDE is not in compliance with the terms of its allocation agreement or is in danger of falling out of compliance. Although these site visits do not yield generalizable results to measure CDEs' compliance rates with their allocation agreements, they do supplement the information that the CDFI Fund receives through NCMS. In addition, CDEs and investors may also monitor potential compliance concerns. For example, in our 2007 report, we noted that investors we surveyed were generally concerned about the potential that CDEs could be noncompliant with program requirements and that they play an active role in ensuring that CDEs remain compliant with NMTC program requirements.⁴³

Since falling out of compliance with the terms of the allocation agreement does not trigger a recapture of NMTCs from investors, in cases where a CDE is found to be out of compliance with its allocation agreement the actions taken by the CDFI Fund are generally limited to measures such as barring the CDE from applying for NMTC awards in future rounds. In other cases, the CDFI Fund may agree to modify the terms of a CDE's allocation agreement so that the CDE will come back in compliance with the allocation agreement. In general, the requirements to which CDEs agree to adhere in their allocation agreements are more stringent than the requirements that trigger a recapture of NMTCs. For example, CDEs may agree to invest closer to 95 percent of their allocation in low-income communities when the statute requires 85 percent to avoid triggering a recapture of NMTCs by the IRS. If a CDE were to agree to invest 95 percent of its allocation in a low-income community and fail to meet that requirement, it would be out of compliance with its allocation agreement, but would remain compliant with the NMTC program's statutory requirements.

Our analysis of the CDFI Fund's efforts to ensure CDEs remain compliant with their allocation agreements indicates that the CDFI Fund has weighed the costs and the benefits to provide reasonable assurance that the agency's objectives for monitoring CDEs compliance with their allocation agreements are met, including ensuring effective and efficient operations and compliance with applicable laws.

⁴² [GAO-07-296](#).

⁴³ [GAO-07-296](#).

Conclusions

Congress designed the NMTC to promote investment and economic development in low-income communities. Our previous reports on the NMTC program indicated that the NMTC appears to increase investment in low-income communities by participating investors, and the analysis included in this report indicates that the NMTC program supports a range of low-income community businesses and residents projects. The benefits generated from economic development projects supporting the NMTC program vary depending on the nature of the project and can be difficult to quantify. Applying statistical techniques to assess the benefits of the NMTC program to low-income communities presents challenges, in part, because such a large area of the country, and portion of the population, is eligible to receive NMTC investment. As a result, our analysis does not allow us to determine the extent to which these projects and their resulting benefits to low-income communities would be realized absent the NMTC.

The low-income community businesses and residents appear to benefit from projects supported by the NMTC. However, the NMTC program faces challenges should it be extended beyond 2009. For example, the complexity of NMTC transaction structures appears to make it more difficult for CDEs to execute smaller transactions and results in less equity ending up in low-income community businesses than would likely end up there were the transaction structures simplified. In addition, current economic conditions have likely contributed to lower prices that investors are willing to pay to purchase the right to claim the NMTC, which also decreases the amount of equity available for low-income community businesses and the amount of debt that CDEs can leverage based on the available equity.

Additional information on NMTC pricing and fees associated with NMTC transactions that reduce the amount of the subsidy ultimately reaching low-income communities would lead to a better understanding of the benefits of the program in relation to its costs. Such information would also give Congress and the Treasury useful information to make assessments about how to best structure the program, whether through simplifying the current structure by altering related parties rules or changing the program to function as a grant, to maximize the amount of NMTCs that reach low-income community businesses. Changing the related parties rule might have the effect of simplifying the program. However, it would not address concerns associated with relying on the sale price of the tax credits to generate funds to invest in low-income community businesses. Improving available information on each

individual project would also likely allow for a more accurate assessment of the program's impacts.

Matter for Congressional Consideration

Should the program be extended beyond 2009, to ensure that the maximum amount of capital ends up in low-income community businesses, Congress should consider offering grants to CDEs that would provide the funds to low-income community businesses. If it does so, Congress should require Treasury to gather appropriate data to assess whether and to what extent the grant program increases the amount of federal subsidy provided to low-income community businesses compared to the NMTC; whether the grant program otherwise affects the success of efforts to assist low-income communities; and how costs for administering the program incurred by the CDFI Fund, CDEs, and investors would change. One option would be for Congress to set aside a portion of funds to be used as grants and a portion to be used as tax credit allocation authority under the current structure of the program in a future allocation round to facilitate comparison of the two program structures.

Recommendations for Executive Action

We recommend that the Secretary of the Treasury take the following three actions.

Should the program be extended beyond 2009 and absent a broader restructuring of the program, to ensure that the CDFI Fund has complete data on the amount of capital flowing to low-income community businesses from the sale of NMTCs to investors, we recommend that the Secretary of the Treasury direct the CDFI Fund Director to collect data that show the sale price of NMTCs from CDEs to investors, fees paid by QALICBs to close NMTC transactions, and the amount of equity that the CDE projects it will leave in the QALICB at the end of the 7-year period during which investors can claim tax credits.

To more effectively assess the outcomes generated by the NMTC program in low-income communities, should the program be extended beyond 2009, we recommend that the Secretary of the Treasury direct the CDFI Fund Director to continue improving strategies for collecting NMTC project-level data that clearly identify the potential outcome of each project without the potential for double-counting the outcomes of some projects or undercounting the outcomes of others.

Additionally, to ensure that the CDFI Fund understands which projects have stalled or are not going to be completed and whether the criteria for

funding selection could be improved, we recommend that the Secretary of the Treasury direct the CDFI Fund Director to collect data on the failure rate of NMTC projects.

Agency Comments and Our Evaluation

We provided a draft of this report to the Director of the Community Development Financial Institutions (CDFI) Fund and the Commissioner of Internal Revenue. We received written comments from the Director of the Community Development Financial Institutions (CDFI) Fund; her comments are reprinted in appendix IV. The Commissioner of Internal Revenue did not provide written comments. The CDFI Fund and the IRS also suggested several technical changes to the report, which we incorporated where appropriate.

The CDFI Fund agreed with a number of observations in the report and agreed with our recommendations that the CDFI Fund collect additional data on the program and refine their current data collection systems. The CDFI Fund also agreed with our observation that the current application of the related parties test may have unintended consequences of limiting equity investments and increasing administrative fees associated with the NMTC program.

However, the CDFI Fund expressed concerns with our Matter for Congressional Consideration that in a future allocation round, Congress should consider testing whether providing grants to CDEs that would, in turn, provide funds to low-income community businesses in lieu of allowing investors to claim tax credits for making investments in CDEs, would improve the program. The CDFI Fund said that it is not clear that such a change will make the federal subsidy more efficient, indicating that the NMTC is likely more cost-effective than a grant because investors pay some taxes when exiting NMTC transactions. According to our analysis, the leakage caused by investors paying less than a dollar to purchase the right to claim a dollar in tax credits and the significant fees generated by NMTC transaction structures means that it is likely that a lower portion of the subsidy is actually channeled to the low-income community business than may be under a grant program. Even if a grant program were marginally more expensive to the government than the current NMTC program, which we are not certain would be the case, if a larger portion of the subsidy reached low-income community businesses, the grant program could be more cost-effective.

The CDFI Fund also said that changing the NMTC program to a grant program would require significant programmatic changes and that it could

not use its current process for allocating tax credits to instead allocate grants. In the report, we acknowledge that switching the NMTC program to a grant program will require the consideration of a number of design issues and that changing the program could impose additional administrative costs on the CDFI Fund. We do, however, conclude that the similarities between the NMTC's current programmatic structure and other grant programs (application advertisement, the review and scoring of applications by peer review panels, determinations by agency staff regarding the amounts of NMTC allocations to winning applicants, and processes for monitoring compliance and gauging outcomes) make it likely that the CDFI Fund could substantially use its current processes for allocating the tax credits to instead allocate grant funds to CDEs. Although we agree administrative changes would be required, we believe those changes could build upon current processes. In addition, the CDFI Fund manages several grant programs already, making it likely that the CDFI Fund could leverage this administrative capacity and expertise to administer the new markets program as a grant.

The CDFI Fund also said that changing the NMTC program to a grant program could cause program compliance to suffer because the grant program would lack rigorous investor oversight. Although we acknowledge that investors have contributed to program compliance, under a grant program both lenders and CDEs would likely have incentives to provide oversight, perhaps even more than under the NMTC program. The involvement of lenders in businesses may increase under a grant-based program because lenders could make loans directly to low-income businesses and have direct recourse to the underlying assets of the business whereas under the current program the leveraged lender does not have recourse to the assets of the low-income business if the business were to default on its repayment of the loan. Moreover, as we say in the report, under a grant program the involvement of CDEs in assisting low-income businesses might be made a requirement of the equity investment or grant since these businesses may be inexperienced in obtaining significant credit. The importance of CDE involvement in program compliance and oversight was particularly evident in our case studies, in which we heard that CDE involvement, including asset management activities, increased the confidence of some lenders in making loans because they knew the CDE and believed that the CDE would monitor the low-income businesses throughout the lending period. The grant program could also include penalties for CDE's failure to make low income community investments in accordance with program rules.

The CDFI Fund also expressed uncertainty that CDEs will be able to attract the requisite debt at the same rates and terms as are currently available if the NMTC investment incentive is replaced with a grant, noting that the debt and equity investor are, in many cases, the same entity. Although our analysis does not address whether the same rates and terms would be available, the leveraged model was created with the intention of separating the tax benefits of the tax credit investor from the economic returns from the leveraged lender—meaning that the structure’s design was intended to ensure that the leveraged lender would be able to receive a return on investment sufficient to justify only their portion of the investment. Further, according to several economic development experts we interviewed, because under the current model the leveraged lender generally does not have access to the underlying assets of the low-income community business in which the CDE invests, many potential leveraged lenders have been unwilling to participate in the NMTC program—particularly in light of current economic conditions. If a grant program were structured so that the leveraged lender had access to the underlying low-income community business’ assets in cases where the business fails, it is possible that more lenders may be willing to participate in the program.

Although we believe the concerns raised by the CDFI Fund can be addressed or may not be borne out in a grant program, we do believe that these and other issues merit study if Congress creates a grant program. Hence, our Matter for Congress includes the option that the CDFI Fund be required to assess the results of a grant program in comparison to the tax credit.

Finally, the CDFI Fund noted its efforts to work with Congress to increase investor participation by allowing investors to use the NMTC to offset Alternative Minimum Tax (AMT) liability. This would help place the NMTC on equal footing with other similar tax incentives, including the Low-Income Housing Tax Credit (LIHTC) and the Historic Rehabilitation Credit. The CDFI Fund stated that this change would stabilize the current market of NMTC investors and attract new investors. Although this could be the case, our work did not address whether such changes to the NMTC program would have these effects. We note, however, that although LIHTC program investors are allowed to use LIHTCs to offset AMT liability, the selling price for LIHTCs has fallen to a point where Congress temporarily converted a portion of the LIHTC program to a grant. Furthermore, if investors were allowed to use the NMTC to offset AMT liability, the price of the credit would need to rise above its previous levels to negate the likely benefits of changing it to a grant program.

We are sending copies of this report to interested congressional committees, the Commissioner of Internal Revenue, the Director of the Community Development Financial Institutions Fund, and other interested parties. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you staff have questions about this report, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Staff who made major contributions to this report are listed in appendix V.

A handwritten signature in black ink that reads "Michael Brostek". The signature is written in a cursive, flowing style.

Michael Brostek
Director, Strategic Issues

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The Honorable Richard C. Shelby
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Committee on Banking, Housing, and Urban Affairs
United States Senate

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The Honorable Dave Camp
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Committee on Ways and Means
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Appendix I: Objectives, Scope, and Methodology

Based on consultations with your offices, this final mandated report: (1) describes where and how Community Development Entities (CDE) are using New Markets Tax Credits (NMTC) to invest in low-income communities and targeted populations; (2) assesses how CDEs use NMTC financing to offer favorable financing terms to low-income community businesses and describes options for simplifying NMTC investment structures; (3) describe how, if at all, NMTC investments support low-income community development; and (4) updates our review of how effective the Internal Revenue Service (IRS) and the Community Development Financial Institutions (CDFI) Fund have been in monitoring CDEs' and investors' compliance with the NMTC program.

To describe where and how CDEs are using the NMTC to invest in low-income communities, we analyzed the CDFI Fund's Community Investment Impact System (CIIS) Transaction Level Report that contains self-reported data for reported NMTC projects through fiscal year 2008. Specifically, we used CIIS to develop summary statistics for the number and location of projects. We also used CIIS data to summarize the types of projects in which CDEs invest, the percentage and amounts of NMTC investments for different CDE types, the portion of total project costs that are financed through NMTC investments, and the amounts and relative percentages of different types of financing for NMTC projects.

Given that the CDFI Fund requires CDEs to report information on project characteristics and financing once a year, CIIS data may not capture the most current information for all existing projects. However, the CIIS data that we used represents the most current available information on the status of the program. For some analysis, we were unable to use CIIS data for all available projects because CDEs may not have reported information for all required fields.

We interviewed CDFI Fund officials with knowledge of the CIIS about the steps they take to ensure its accuracy, and reviewed the computer programs the CDFI Fund uses to generate its NMTC databases. We determined that the data we used in this report were sufficiently reliable for our purposes.

To supplement our analysis of CIIS data for each objective, we conducted case studies of nine CDEs. Specifically, we interviewed representatives from these CDEs and systematically collected documentation contained in CDE project files to learn more about how CDEs decide which projects to fund using their NMTC allocations. In addition, we interviewed local economic development officials, lenders, and other subject-matter experts

to examine how projects funded, in part or entirely, with NMTC allocations may contribute to economic development in low-income communities.

To capture the range of projects supported by NMTC investment, we used a purposeful sampling technique to identify the nine CDEs for case study analysis. To develop our sample, we used CIIS and NMTC application data to identify CDEs that received NMTC awards during the 2005 and 2006 allocation rounds. We limited our CDE selection to organizations receiving awards in these allocation rounds to examine projects with NMTC investments that were more indicative of the current NMTC program structure. To identify similarities and differences in projects by geographic area, we selected CDEs that serve low-income communities in each of the four U.S. Census Bureau regions (West, Midwest, Northeast, and South). The four low-income communities we identified were located in Los Angeles, California; Chicago, Illinois; New York, New York; and Washington, D.C. We selected two CDEs in each community. To capture variations in projects located in urban and rural communities, we selected one CDE with investments in rural projects located in Maine and New Hampshire. To examine the potential differences in investment strategies between nonprofit and for-profit CDEs, we selected nonprofit and for-profit organizations for our case studies. We also selected CDEs of varying asset sizes to examine variations in organizational capacity and the execution of NMTC investments. We identified options for simplifying the NMTC program through interviews with representatives from CDEs, qualified active low-income community businesses (QALICB), and investors.

Our case study results cannot be generalized to the full population of CDEs that have received NMTC allocations. Because the nature of project data, how it is collected, and how it is recorded varies by CDE, in some instances we relied on testimonial evidence obtained from CDE representatives, which we were not always able to substantiate with documentation. Also, given the volume and nature of community development activities in low-income communities and limitations with available data and available statistical techniques, we were unable to establish a causal link between a NMTC project and the changes in economic conditions in a community.

To describe and evaluate the extent to which NMTC investments appear to offer more favorable terms and conditions to borrowers in low-income communities, we reviewed and described common NMTC financing structures and analyzed CIIS data to analyze the terms and conditions for

NMTC projects. Through our case studies, we identified how leveraged NMTC transaction structures and subsidized interest rate transaction structures provide benefits to low-income community businesses. We also used NMTC investor data from the CDFI Fund to review changes in the demand for NMTCs by investors over time. In addition, we used CIIS data to identify the frequency with which CDEs report using NMTC allocation authority to offer more favorable terms and conditions for loans and other financial products. We used information obtained from our case studies to identify the processes that the CDEs we reviewed use to assess the eligibility and viability of potential NMTC projects, and to obtain supplemental information from NMTC project files about the favorable terms and conditions these CDEs offer in conjunction with NMTC financing.

To describe how NMTC investments may contribute to economic development in low-income communities, we analyzed CIIS data on outcomes associated with projects that are in part or in whole supported by NMTC investment. Through our case studies, we interviewed representatives from CDEs and financial institutions, local economic development officials, and other subject-matter experts in each of the U.S. Census Bureau's four regions to obtain information about the contextual factors that are important to assessing economic conditions in low-income communities. We collected and analyzed documentation from CDE project files regarding how the CDEs we reviewed assess the outcomes of their projects on the communities in which they exist. We also collected and analyzed testimonial evidence obtained through our case studies to identify and summarize how and the extent to which current economic conditions have affected NMTC program activities.

To describe and evaluate the effectiveness of measures to ensure that CDEs and investors are in compliance with the NMTC program, we met with officials from IRS and the CDFI Fund. We also collected and analyzed documents on the status of CDFI Fund and IRS compliance monitoring efforts. We compared the information obtained to GAO's Standards for Internal Control in the Federal Government to assess the effectiveness of measures taken by IRS and the CDFI Fund to monitor compliance.

We conducted this performance audit from September 2008 to January 2010, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe

that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: NMTC Investment Data by State, Fiscal Years 2003 through 2008

State	Total dollar amount of investment	Dollar amount per capita	Percentage of all loans and investment	Number of projects	Percentage of NMTC projects
Alaska	\$37,978,424	55.3	0.30	23	1.09
Alabama	71,131,651	15.3	0.57	10	0.47
Arkansas	22,351,073	7.8	0.18	15	0.71
Arizona	235,904,081	36.3	1.88	45	2.13
California	1,208,528,336	32.9	9.65	257	12.17
Colorado	142,265,617	28.8	1.14	59	2.79
Connecticut	101,027,293	28.9	0.81	10	0.47
District of Columbia	189,636,869	320.4	1.51	22	1.04
Delaware	64,490,138	73.9	0.51	7	0.33
Florida	146,887,678	8.0	1.17	29	1.37
Georgia	132,099,181	13.6	1.05	16	0.76
Hawaii	286,195	0.2	0.00	1	0.05
Iowa	103,800,268	34.6	0.83	16	0.76
Idaho	22,465,154	14.7	0.18	18	0.85
Illinois	205,879,374	16.0	1.64	68	3.22
Indiana	128,735,168	20.2	1.03	20	0.95
Kansas	15,201,077	5.4	0.12	2	0.09
Kentucky	380,231,286	89.1	3.03	83	3.93
Louisiana	862,539,451	195.6	6.88	96	4.55
Massachusetts	697,153,422	107.3	5.56	121	5.73
Maryland	408,771,661	72.6	3.26	39	1.85
Maine	216,657,193	164.6	1.73	19	0.90
Michigan	273,872,011	27.4	2.19	33	1.56
Minnesota	349,942,905	67.0	2.79	79	3.74
Missouri	464,481,135	78.6	3.71	57	2.70
Mississippi	204,035,342	69.4	1.63	35	1.66
Montana	995,308	1.0	0.01	2	0.09
North Carolina	368,608,411	40.0	2.94	38	1.80
North Dakota	11,428,689	17.8	0.09	2	0.09
Nebraska	32,191,630	18.1	0.26	2	0.09
New Hampshire	48,373,626	36.8	0.39	6	0.28
New Jersey	388,761,424	44.8	3.10	44	2.08
New Mexico	30,112,118	15.2	0.24	4	0.19
Nevada	652,388	0.3	0.01	1	0.05

**Appendix II: NMTC Investment Data by State,
Fiscal Years 2003 through 2008**

State	Total dollar amount of investment	Dollar amount per capita	Percentage of all loans and investment	Number of projects	Percentage of NMTC projects
New York	1,184,947,158	60.8	9.46	100	4.74
Ohio	575,835,516	50.1	4.60	172	8.15
Oklahoma	264,840,433	72.7	2.11	48	2.27
Oregon	361,838,881	95.5	2.89	58	2.75
Pennsylvania	326,283,735	26.2	2.60	51	2.42
Puerto Rico	1,634,384	0.4	0.01	2	0.09
Rhode Island	236,870,697	225.4	1.89	25	1.18
South Carolina	116,486,899	26.0	0.93	17	0.81
South Dakota	34,652,816	43.1	0.28	4	0.19
Tennessee	133,702,989	21.5	1.07	51	2.42
Texas	284,996,298	11.7	2.27	53	2.51
Utah	110,284,073	40.3	0.88	24	1.14
Virginia	314,165,784	40.4	2.51	37	1.75
Vermont	5,023,705	8.1	0.04	1	0.05
Washington	484,742,478	74.0	3.87	57	2.70
Wisconsin	445,072,159	79.1	3.55	117	5.54
West Virginia	63,637,250	35.1	0.51	11	0.52
Wyoming	15,917,456	29.9	0.13	3	0.14
Total	12,529,292,310	40.7	100.00	2,111	100.00

Source: GAO analysis of CDFI Fund data.

Note: Dollar amounts are in constant 2008 dollars. Per capita calculations are based on the estimated 2008 population.

Appendix III: Description of Primary Uses of NMTC Financing, by Investment Type

Purpose	Definition
Business	Financing to for-profit and nonprofit businesses with more than five employees or in an amount greater than \$35,000 for the purpose of expansion, working capital, equipment purchase or rental, or commercial real estate development or improvement.
Microenterprise	Financing to a for-profit or nonprofit enterprise that has five or fewer employees (including the proprietor) and in an amount no more than \$35,000 for the purpose of expansion, working capital, equipment purchase or rental, or commercial real estate development or improvement.
Real estate	Financing for rehabilitation of office, retail, manufacturing, or community facility space. Financing may include acquisition costs. Includes mixed-use real estate that combines both commercial and residential uses. Excludes acquisitions without rehabilitation.
Commercial construction, permanent, acquisition without rehabilitation	Financing for: (1) predevelopment financing; (2) construction or permanent financing; or (3) acquisition without rehabilitation of office, retail, manufacturing, or community facility space. Includes mixed-use real estate that combines both commercial and residential use.
Commercial rehabilitation	Financing for the rehabilitation of office, retail, manufacturing, or community facility space. Financial note may include acquisition costs. Includes mixed-use real estate that combines both commercial and residential uses. Excludes acquisitions without rehabilitation.
Housing construction, multifamily	Financing for predevelopment financing, or construction of multifamily housing.
Housing rehabilitation, multifamily	Financing for the rehabilitation or acquisition of multifamily housing.
Housing construction, single family	Financing for predevelopment financing, or construction of single-family housing.
Housing rehabilitation, single family	Financing for the rehabilitation or acquisition of single-family housing.
Other	Financing other activities not specifically defined.

Source: CDFI Fund.

Appendix IV: Comments from the Department of Treasury



DIRECTOR

DEPARTMENT OF THE TREASURY
COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND
601 THIRTEENTH STREET, NW, SUITE 200 SOUTH
WASHINGTON, DC 20005

January 21, 2010

Mr. Michael Brostek
Director, Tax Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Brostek:

Thank you for providing the Community Development Financial Institutions (CDFI) Fund with the opportunity to comment on the draft GAO report, "New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, But Could be Simplified" (GAO-10-334).

As with the other evaluations you have conducted of the NMTC Program, we appreciate your team's familiarity with the program's administration and implementation, including: the scoring of applications by the CDFI Fund; the procurement of NMTC investments and the deployment of funds by the Community Development Entities (CDEs); and compliance monitoring on the part of the CDFI Fund and the IRS.

The CDFI Fund concurs with several of the observations that you have made as part of your case study analysis, including the following:

- NMTC investments are used to help fill project financing gaps, generally supporting 20 percent to 30 percent of the total project costs for a particular project.
- CDEs offer financing at rates and terms that benefit low-income community businesses, including equity-like investments and loans with interest rates as much or more than 50 percent below market.
- The majority of the monetized value of the tax credits is passed along to the borrowers. The CDFI Fund believes that this high rate of pass-through is directly attributable to the fact that the selection criteria employed by the CDFI Fund in the competitive review process rewards CDEs that commit to steering the economic benefits of the tax credits towards the low-income community borrowers.
- Alternative sources of financing are generally not available to finance the NMTC projects, or to the extent such financing is available, the terms and conditions of the NMTC financing make the projects less expensive and the use of NMTCs is more attractive than other sources of financing.

The CDFI Fund also agrees with the GAO's observation that the current application of the related party rules, which requires that the test for relatedness be applied after the NMTC investment is made, may have the unintended consequence of limiting equity investments in businesses and real estate projects, and driving up administrative fees for CDEs participating in leveraged transactions. The CDFI Fund solicited public comments on this particular issue in the summer of 2009, and anticipates implementing revisions to this requirement in advance of the 2010 NMTC allocation round.

With respect to the Recommendations for Executive Action that you have made in the Report, the CDFI Fund generally agrees with the GAO's recommendations regarding the collection of additional information from awardees. The CDFI Fund will explore options for altering its current data collection tools to collect the type of information suggested by the GAO in this report, and will also consult with the Urban Institute (with whom it has contracted to perform a longitudinal evaluation of the NMTC Program) to see whether it will be able to collect some of this information from program participants as part of its case study evaluations. The CDFI Fund also agrees with the GAO's recommendation that it further refine its data reporting system to eliminate the potential for "double counting" or "undercounting" outcomes in cases where projects were financed by multiple CDEs. To this end, the CDFI Fund had already begun efforts to refine its data reporting system in its updated version of the Community Investment Impact System, and, in consultation with the GAO, has improved its analysis process of the historical records to more accurately account for transactions that were financed by multiple CDEs.

The Report also included a Matter for Congressional Consideration, in which the GAO recommended that Congress establish a program whereby all or a portion of the NMTC allocation authority be provided in the form of grants to CDEs, and that the CDFI Fund undertake an analysis of the efficacy of this type of approach. The CDFI Fund has several concerns regarding this recommendation:

1. **It is not clear that such a change will make the federal subsidy more efficient.** As purely a matter of cost to the Federal budget, the NMTC is likely more cost-effective than a grant, since investors in NMTCs are required to pay taxes on the value of their NMTC investments, a revenue stream that would disappear if the investment credits are converted to grants to the CDEs (many of which are non-profits).
2. **Switching from a tax credit to a grant will require significant programmatic changes on the part of the Treasury Department.** Contrary to the GAO's assertions, the CDFI Fund could not "use its current processes for allocating the tax credits to instead allocate grants." In fact, such a change would alter all aspects of program implementation, including the following: (i) IRS regulations would have to be amended and new CDFI Fund regulations governing the administration of grants would need to be drafted; (ii) the CDFI Fund's application materials and selection processes would have to be altered to provide for a more substantive review of the awardee's financial capacity to administer the grant; (iii) the CDFI Fund would have to create a disbursement tracking system to award and monitor the funds, in a manner that satisfies Federal grant-making requirements; (iv) award agreements would have to be modified and all awardees would have to agree to the terms and conditions governing uses of Federal grant dollars, which entails a host of new burdens for awardees; and (v) compliance elements normally undertaken by the IRS as part of tax audits would be shifted to the CDFI Fund.
3. **Program compliance could suffer without rigorous investor oversight.** Currently, NMTC investors, as well as the CDEs, engage in extensive due diligence to ensure that each NMTC transaction will remain in compliance for the entirety of the seven-year period. If the program is converted to a grant program, the extra layer of investor due diligence will disappear, which could lead to higher incidences of non-compliance.
4. **It is quite likely that CDEs will be unable to attract the requisite debt if the NMTC investment incentive is removed.** The GAO recommendation seems to presume that the low-income business, if it receives a grant from the CDE equivalent to the equity-equivalent portion of the combined equity/debt investment, will be able to attract the same amount of debt capital to its projects, and on the same rates and terms. But this may not be true since, in many cases, the debt investor and the equity investor are the same entity. It is not clear that, absent the credit incentive on the equity side, that same entity would be willing to make a stand-alone debt

**Appendix IV: Comments from the Department
of Treasury**

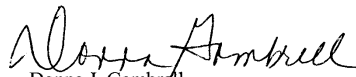
investment into the business. It's also very unlikely that the debt-investor will offer long-term interest-only debt products for seven years, which is currently the case when the debt investment is twinned with the tax credit investment.

Although the CDFI Fund has strong reservations about the grant proposal, it does share the GAO's interest in ensuring that the maximum amount of subsidies are provided to businesses and real estate projects in low-income communities. That is why the CDFI Fund emphasizes this consideration as part of the application review process, and is committed to exploring ways to reduce transactional costs by revising the compliance requirements pertaining to related party transactions. The CDFI Fund is also exploring options with Congress regarding increasing investor participation in the program, including the option discussed by the GAO whereby NMTC investments could be used as an offset against the Alternative Minimum Tax (AMT). This would help to put the NMTC Program on equal footing with other Federal tax incentives, stabilize the current market of NMTC investors, and help to attract new investors, including high-worth individuals, to the NMTC investor market. The CDFI Fund believes that these solutions, particularly when compared with the costs and uncertainties of a grant-replacement program, represent the most effective means of ensuring the best possible outcomes for businesses and real estate projects in low-income communities.

Finally, though not a specific focus of the GAO's evaluation, the GAO did note that approximately two-thirds of NMTC investments (by dollar amount) are being made in support of real-estate development activities, and just one-third in support of operating businesses. The CDFI Fund will be exploring ways to help maximize the potential for the NMTC Program to be used in support of small businesses operating in low-income communities.

Thank you again for the opportunity to review and comment upon your draft report. We appreciate your efforts and the collaborative relationship that you fostered during the course of your review.

Sincerely,


Donna J. Gambrell
Director

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110, or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Kevin Daly, Assistant Director; LaKeshia Allen; Thomas Gilbert; Catherine Hurley; Cristian Ion; Ed Nannenhorn; Jungjin Park; Sabrina Streagle; and Elizabeth Wood made key contributions to this report.

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