2008-04

Community Development
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Working Paper

FEDERAL RESERVE BANK OF SAN FRANCISCO

Addressing the Prevalence of Real Estate Investments in the New Markets Tax Credit Program

A Study Conducted for the Federal Reserve Bank of San Francisco and the United States Department of the Treasury's Community Development Financial Institutions Fund

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Fall 2008
Working Paper 2008-04
http://frbsf.org/cdinvestments/

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Acronyms

AMI	Area Median Income
ATS	Allocation Tracking System
CDC	Community Development Corporation
CDE	Community Development Entity
CDFI	Community Development Financial Institution
CIIS	Community Investment Impact System
GAO	Government Accountability Office
ILR	Institutional Level Report
IRS	Internal Revenue Service
NMTC	New Markets Tax Credits
QALICB	Qualified Active Low-Income Community Business
QEI	Qualified Equity Investment
QLICI	Qualified Low-Income Community Investment

Preface

The New Markets Tax Credit (NMTC) program was created by Congress in December 2000, at the end of the Clinton administration. When initially passed, the program was to provide a total of $15 billion in tax credits between 2001 and 2007 to subsidize investments in businesses and real estate developments serving low-income communities. In 2005, Congress supplemented the program with an additional $1 billion to encourage investments in the Gulf Opportunity Zone, a selection of census tracts in areas of Louisiana, Mississippi, and Alabama that were affected by Hurricane Katrina. In 2006, the NMTC program was extended through 2008 and received an additional $3.5 billion in tax credit authority (New Markets Tax Credit Coalition 2007b).

The NMTC's future is uncertain. The Community Development Financial Institutions Fund (CDFI Fund) of the U.S. Department of the Treasury is currently awarding the last round of tax credit allocations. The President has requested that the program be extended through 2009, and Congress is considering extending the program as part of the 2009 Fiscal Year budget. As the NMTC program awaits reauthorization, now is an excellent time to consider its effects on low-income communities. The program's impacts have not been studied in a comprehensive way, though the Urban Institute recently launched a major research project to do just that. Although its study will not be concluded for several years, there are some important issues that can be investigated now. This paper seeks to identify the types of investments being made through the program, as well as the program's stakeholders and major beneficiaries.

The NMTC program is complex and unfamiliar to most people, so Section One will explain how the program works and will provide a description of the investors, investees, and intermediary organizations participating in the program. It includes an analysis of the investments being made and the distribution of investment dollars across geographic areas in order to understand how effectively the NMTC targets various types of low-income communities. Unlike other studies analyzing the NMTC program, this paper uses a number of datasets from the CDFI Fund, which administers the program. A goal of this paper is to use these data to provide information that may help outsiders become acquainted with the program and provide a case for understanding the impact of the NMTC on low-income communities, while addressing some of the often-cited concerns about the program.

Section Two focuses on one specific perception of the NMTC: that a disproportionate number of the investments made through the program have been in real estate projects. It examines this assumption by analyzing three types of NMTC investments: (1) investments in operating businesses for the purpose of expanding operations; (2) investments in operating businesses for the purpose of purchasing or rehabilitating real estate; and (3) investments in "real-estate businesses" (e.g., developers) for the purpose of developing real estate. Although the number of NMTC investments made to operating businesses and real estate businesses is roughly even (49 percent were made to operating businesses vs. 51 percent made to real estate businesses), approximately 66 percent of the NMTC dollars invested have been invested in real estate businesses. Section Two discusses the arguments in favor and against the "real estate tilt," and addresses the main reasons for why it has emerged as a characteristic of the program. The paper ends with a summary of various policy options that could be used to increase the amount of investments in operating businesses.

In addition to the data made available by the CDFI Fund, the ideas in this paper were developed with the help of insights from various NMTC experts, as well as interviews with staff from ten community development entities (CDEs), who shared information about their investments in low-income communities, experiences with the program, and suggestions for policy changes.

This research was made possible through funding from the Federal Reserve Bank of San Francisco and access to data and other information from the CDFI Fund. This paper benefited significantly from the support and guidance of David Erickson and Ian Galloway of the Federal Reserve Bank of San Francisco, and Matt Josephs, Jim Greer, and Pol Siris of the CDFI Fund. University of California, Berkeley, Professor John Quigley served as my faculty advisor, and Tim Lambie-Hanson helped in developing ideas and editing drafts throughout the research process.

Summary

The New Markets Tax Credit (NMTC) has led to a large amount of investment in low-income communities that are typically underserved by lenders and investors. The program has already spurred over $10 billion in investments to low-income community businesses in its first few years and has been chosen as one of the Top 50 Innovations in American Government by Harvard University's Ash Institute for Democratic Governance and Innovation (CDFI Fund 2008, 2008b). Loans and equity investments made with the help of the NMTC almost always include attractive terms like lower interest rates, lower origination fees, flexible underwriting standards, and higher-than-typical loan-to-value ratios. The NMTC encourages investment by organizations and individuals who either have never made community development investments or would not be able to make such attractive investments for borrowers without the subsidy offered by the tax credit.

Despite its innovative methods and glowing praise by analysts, the NMTC program is not without its critics. A frequently-voiced concern about the program is the perception of its "real estate tilt." Indeed, roughly 66 percent of all NMTC dollars invested through 2006 were made to real estate developers to finance the acquisition or rehabilitation of commercial, residential, and mixed-used real estate property.

The emphasis on real estate investment has developed for several reasons, some internal and some external to the NMTC Program, but mainly because investors see real estate as more profitable and less likely to fall out of compliance with NMTC restrictions. Real estate deals are often more profitable because they are well collateralized and carry less financial risk to investors, generally do not have prohibitive third-party expenses, and can often be further subsidized by other tax incentives. Real estate investments are also less likely to present compliance problems that could result in tax credit recapture. Most notably, real estate projects are fixed in location, so they cannot lose their compliance by moving out of a low-income community. Furthermore, the investments are usually large and longterm, making it unlikely that the investors will be repaid any principal on their investments within the seven-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.

The main arguments against having such a large proportion of real estate investments are that these investments are easier to make and are not the most needed in disadvantaged communities. Some also argue that real estate projects may be less likely to empower underrepresented groups of business owners, and the projects may not create as many quality jobs as other types of investments. However, real estate projects can certainly have positive impacts on low-income communities in ways such as serving as a catalyst for additional development, providing greatly needed facilities, and helping businesses expand.

The legislative intent of the NMTC program is not entirely clear, but many stakeholders expected it to support minority entrepreneurs, create jobs, and empower residents of low-income communities by providing them with much-needed private investment. A reorientation of the program toward financing operating businesses may help achieve these important goals while making the program seem more worthy of long-term authorization and expanded tax credit authority. Some policy changes to achieve a balance or even attain an emphasis on business lending include changing recapture penalties and restrictions to reduce the incentive to invest in real estate, changing the allocation process to favor CDEs that pledge to make business investments, and increasing the value of the tax credit to provide additional subsidy to business investments.

Section One: Background and Description of New Markets Tax Credit Program

History and Formation of the Program

The New Markets Tax Credit (NMTC) program was created by a bipartisan coalition in Congress towards the end of President Bill Clinton's second term in office. The concept of the program was to encourage investment in low-income urban and rural areas–places that usually cannot access capital as easily or cheaply as wealthier communities. Perceptions of higher lending risk in these communities have led many investors to loan money and make investments only in more affluent areas, or to charge higher rates for capital in low-income areas to compensate for the perceived additional risks. The NMTC program was designed to correct for this failure by providing tax incentives to those who invest in businesses and development projects in low-income areas, which would ideally lead to business creation and improvement, the creation of jobs, and increased social capital among residents. The official establishment of the NMTC program in 2000 was partly made possible by the success of the Low Income Housing Tax Credit program of 1987, the founding of the Community Development Financial Institutions (CDFI) Fund within the Treasury Department in 1994, and advocacy and policy work by community development advocates who later formed the New Markets Tax Credit Coalition (Armistead 2005).

How the Program Works

The Allocation Process

The framework of the New Markets Tax Credit program is fairly complex. The Treasury Department's CDFI Fund, investors, and businesses in low-income communities are connected through intermediary groups called community development entities (CDEs). CDEs have been formed by a wide variety of institutions, including community development corporations (CDCs) and other local nonprofits, CDFIs, small business investment companies, real estate development companies, venture capital companies, insured depository institutions, investment banks, and governmental entities. CDEs also vary in geographic scope. Some confine their activities to one locality, while other, larger CDEs serve communities across the country. The CDFI Fund certifies CDEs and allocates tax credit authority to them and, together with the Internal Revenue Service (IRS), monitors their investments to ensure their compliance with NMTC restrictions.

Once designated as a CDE, an organization can apply for tax credit allocation authority. Since 2003, the CDFI Fund has conducted annual competitions to award tax credit authority to CDEs. Each CDE requests a certain amount of credits to allocate to investors, who in turn give the CDE capital to invest in low-income communities. The CDEs' applications are assessed and scored in four categories: business strategy, capitalization strategy, management capacity, and community impact. Each category is equally weighted with a maximum 25 points each, but CDEs can earn up to 10 "priority points" if they have a track record of successful investments in disadvantaged businesses or communities, and/or if the CDE commits to making investments in unrelated entities. Allocations can be awarded to CDEs in any location so long as the investments are made in qualifying low-income communities. Except for Gulf Opportunity Zone funds, which are restricted to areas affected by Hurricane Katrina, there are no quotas for allocating NMTC funds to any states or regions, unlike the Low Income Housing Tax Credit program, which has some similar features to the NMTC program.

The allocation process is very competitive. Each year, CDEs apply for a far greater amount of tax credit allocation authority than the NMTC program is authorized to award. As shown in Table 1, in the 2007 allocation process, $27.9 billion was requested by CDE applicants, but only $3.9 billion was awarded (New Markets Tax Credit Coalition, October 2007). Each year, or "round" of applications, has seen similar results. Because of the overwhelming demand for allocations, the CDFI Fund must be selective about which groups to support. The sixth round of allocations will be awarded in the fall of 2008, and $3.5 billion will be allocated. By the end of this round, $19.5 billion of tax credit allocation authority will have been distributed to CDEs (GAO 2007). In order to continue the allocations in future years, Congress must reauthorize the program.

Table 1: ***Allocation Availability and Demand, Rounds 1 through 6***

Application Round	**Available Allocation** (in billions)	**Application Demand** (in billions)
Round 1 (2001–2002)	$2.5	$26.0
Round 2 (2003-–2004)	$3.5	$30.4
Round 3 (2005)	$2.0	$22.9
Round 4 (2006)	$4.1	$28.4
Round 5 (2007)	$3.9	$27.9
Round 6 (2008)	$3.5	$21.3
Total	**$19.5**	**$156.9**

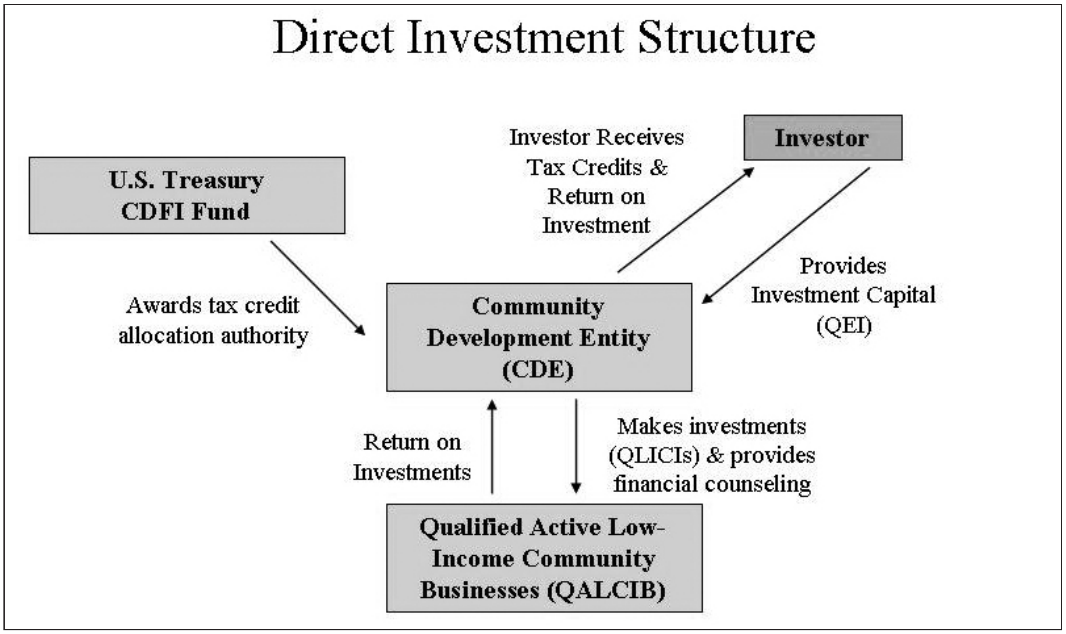
Sources: New Markets Tax Credit Coalition 2007a, CDFI Fund 2008, internal CDFI Fund data

Making the Investments (Turning QEIs into QLICIs)

The CDEs that are awarded tax credits must allocate them within five years of the award. This is the second step of the NMTC administration process. The CDEs negotiate with investors to trade the tax credits for cash investment in the CDE. In return, the investor receives a credit worth 39 percent of the investment made in the CDE. The credit is a dollar-for-dollar reduction in tax liability, so it covers only taxes owed to the government, and the value of the credit is spread over seven tax years. The capital provided to the CDE is referred to as "qualified equity investments," or QEIs. The CDE uses the QEIs made by the investors to make "qualified low-income community investments," or QLICIs. QLICIs are generally made in the form of loans or investments with better-than-market terms to businesses in low-income areas. There are four types of eligible QLICIs: (1) loans to or investments in Qualified Active Low-Income Community Business (QALICBs); (2) financial counseling and other services; (3) loans to or investments in other CDEs, provided that those funds are in turn used to finance QALICBs or financial counseling and other services; and (4) purchase of qualifying loans from other CDEs. The CDEs have one year from the time they receive the QEIs to invest substantially all (generally 85 percent of the proceeds) as QLICIs. The vast majority (over 95 percent) of all QLICIs have been made in the form of loans to or investments in QALICBs, including both operating businesses and real estate developers.

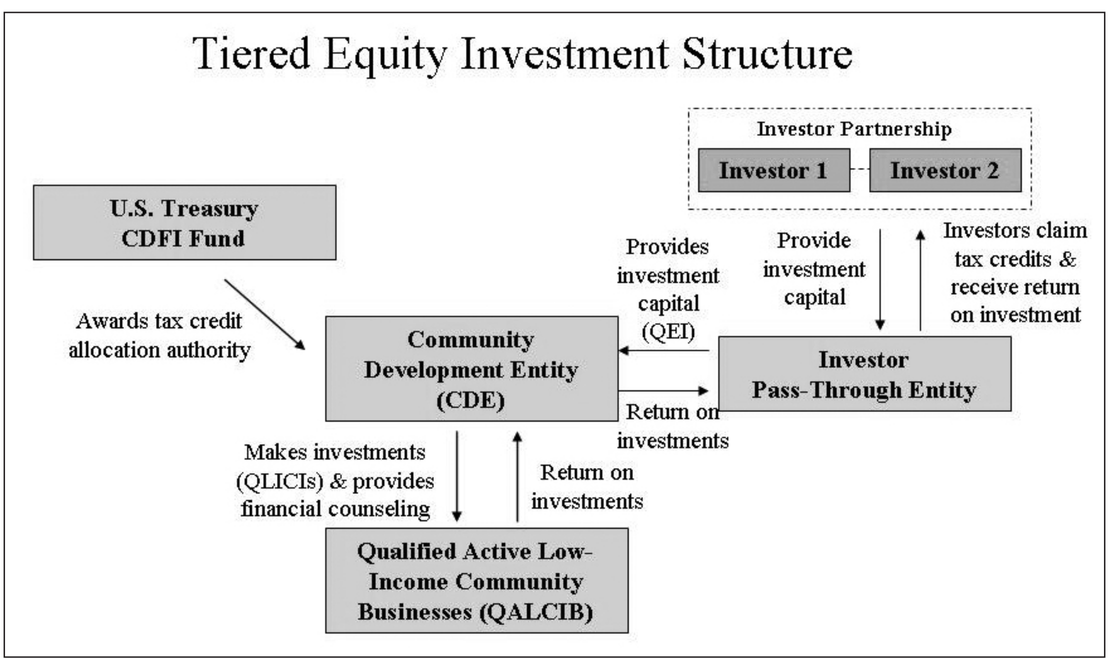
There are three main structures of NMTC investments. In the simplest model, the direct investment structure, a single investor makes a QEI in a CDE and that capital is passed down to a qualified active low-income community business (QALICB), minus any CDE fees such as legal expenses. This model, shown in Figure 1, accounts for about 46 percent of all QLICIs made (GAO 2007).

Figure 1: ***Direct Investment Structure***



Another type of investment model is the tiered equity investment structure. In this model, multiple investors partner to provide equity or loans. They use a pass-through entity to combine the capital and make the QEI in a CDE. The pass-through entity is often managed by the CDE. Each partner can withdraw his or her share of the initial investment after seven years. In the meantime, the partners receive tax credits and returns on their investments. About 13 percent of all QLICIs have been made through a tiered equity structure (GAO 2007). A diagram of this structure is shown in Figure 2.

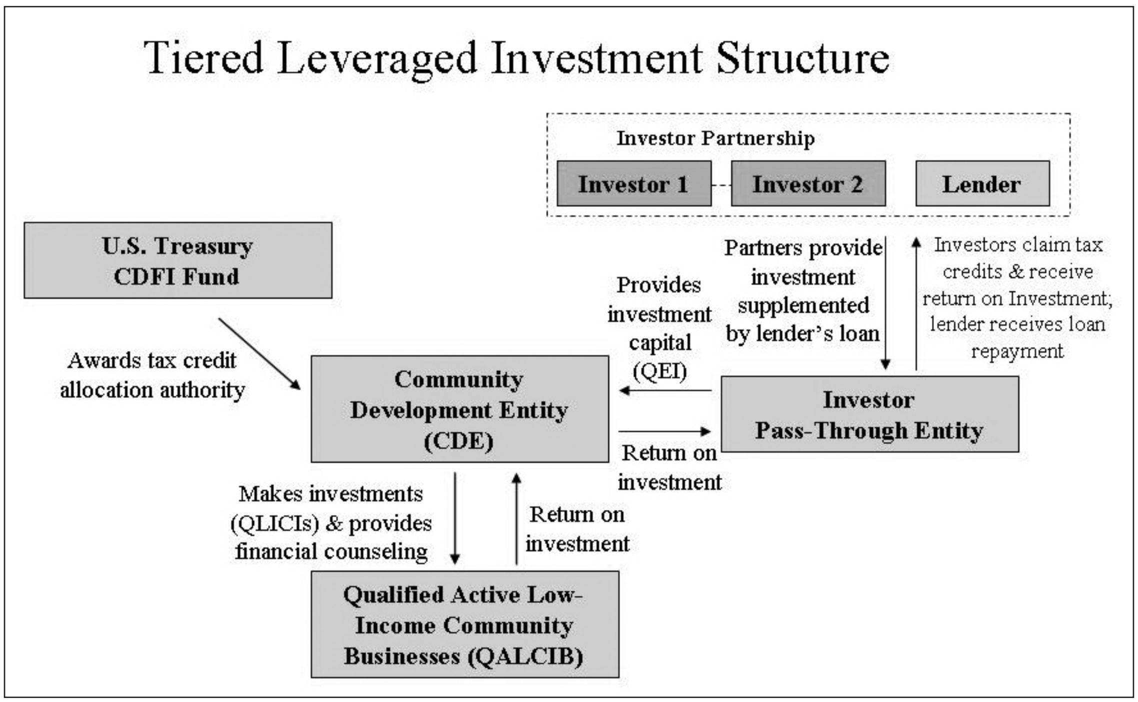
Figure 2: ***Tiered Equity Investment***



The third main model for NMTC investments is the tiered leveraged investment structure, which makes up about 41 percent of QLICIs (GAO 2007). In this structure, as shown in Figure 3, investors form an investor partnership, which then borrows money from a lender, typically a bank, in order to make a larger QEI. After combining their equity with the capital from the loan, the partnership then makes a QEI in a CDE.

In return for their qualified equity investments (QEIs), the partners receive tax credits for 39 percent of the full QEI made, including the capital provided by the lender. They may also receive some return on the investment during the initial seven years. The lender is paid interest during the first seven years, as the QALICB makes loan payments to the CDE. The lender does not receive tax credits, and it cannot receive principal payments until the end of the seven-year term in order for the investment to comply with NMTC restrictions.

Figure 3: ***Tiered Leveraged Investment Structure***



The tiered leveraged investment structure is attractive to investors because they are able to claim the full amount of the tax credit, not just 39 percent of the investment they made, even if the business fails or defaults on the loan (GAO 2007). The arrangement is attractive to bankers because it allows them to make investments with a lower loan-to-value ratio, thus carrying less risk (GAO 2007). It is also attractive to the borrowers because, in most instances, most if not all of the investor's equity remains with the QALICB at the end of the seven-year period since investor returns are generated through the value of the tax credit. The tiered leveraged structure is becoming increasingly popular, though it can become complex as multiple tiers of investors are added (Wells 2005).

Monitoring and Compliance

The IRS reserves the right to recapture the value of the tax credits should any one of three things happen: if the CDE loses its designation as a CDE; if the CDE fails to invest substantially all of the QEI proceeds as QLICIs; or if the investor redeems its QEI before the end of the seven-year holding period. If any of these things happen and the IRS recaptures the credits, the investors lose their right to claim remaining tax credits they have received, and they must pay back any credits they used in previous tax years, plus a penalty fee and interest (Armistead 2005). The recapture provision is seen as excessively harsh by investors and may deter some of them from making investments in CDEs; it also may lead investors to find some investments more attractive than others if they carry less risk of recapture.

Characteristics of Program and Participants

Community Development Entities (CDEs)

How CDEs Are Formed

Organizations apply to the CDFI Fund to become certified CDEs. To be considered, the organization must be a legal, domestic entity at the time of the application, have a primary mission of serving low-income communities, and maintain accountability to the residents of its targeted low-income communities (CDFI Fund 2005a). Certified CDEs can apply for their own allocations of credits; receive loans and investments from other CDEs that have received allocations of credits; and sell loans to other CDEs that have received allocations of credits.

For-Profit and Mission-Driven CDEs

CDEs can be mission-driven or for-profit entities, but CDEs making QLICIs must be for-profit, since investors can only receive NMTCs for making equity investments into the CDE. Mission-driven organizations like nonprofits, government agencies, and CDFIs can form for-profit subsidiaries as their CDEs. To help involve the community in NMTC investments, the program requires that all CDEs, regardless of type, must have community members serve on their boards. These board members can be residents, owners of businesses, representatives of charitable organizations, or members of community groups within the low-income communities, including clergy members (CDFI Fund 2005a). The presence of these board members helps ensure that CDEs will invest in projects that are important to community members.

The NMTC investments are fairly evenly divided between for-profit and mission-driven CDEs. Mission-driven CDEs have made about 55 percent of all QLICIs, as opposed to 45 percent by for-profit CDEs. Despite the strong presence of mission-driven CDEs, most borrowers or "investees" are for-profit businesses. Both types of CDEs make most of their investments in for-profit QALICBs; 77 percent and 87 percent of QLICIs by mission-driven and for-profit CDEs went to for-profit QALICBs, respectively.

The Most Active CDEs

About 130 CDEs by the end of 2006 had made a total of 1,504 investments in QALICBs. Of these investments, more than one-third (525 QLICIs) were made by ten of the most active CDEs. Most of these CDEs were mission-driven entities or had mission-driven parents, like government organizations, CDFIs, or nonprofits.

Table 3: ***CDEs with the Largest Number of Deals (Top 10 CDEs make more than one-third of QLICIs)***

Organization Name	Number of QLICIs	Percent of All QLICIs	Cumulative Percent
National New Markets Tax Credit Fund, Inc	82	5.5%	5.5%
HEDC New Markets, Inc	68	4.5%	10.0%
Key Community Development New Markets LLC	63	4.2%	14.2%
Wachovia Community Development Enterprises, LLC	50	3.3%	17.5%
Zions Community Investment Corp.	49	3.3%	20.7%
ESIC New Markets Partners LP	48	3.2%	23.9%
Massachusetts Housing Investment Corporation	45	3.0%	26.9%
Local Initiatives Support Corporation	43	2.9%	29.8%
Wisconsin Community Development Legacy	41	2.7%	32.5%
Advantage Capital Community Development	36	2.4%	34.9%

Note: CDEs shaded in gray are mission-driven or have mission-driven parent organizations.
Source: CDFI Fund CIIS Data, Report Year 2006

The total value of QLICIs made by the end of 2006 exceeded $5.5 billion. Ten CDEs together made up nearly one-third of these investments. These CDEs may be such powerhouses of investment because they have dedicated resources to making themselves highly competitive in the tax credit allocation process and have made it a priority to make investments quickly and efficiently. Some of these CDEs also prefer to make short-term loans so they can recoup their capital and redeploy it in other worthy projects, which increases the amount of investments they are able to make.

Table 4: ***CDEs with the Greatest Number of Investments (Top 10 CDEs make nearly one-third of QLICI dollars)***

Organization Name	Total Amount of QLICIs	Percent of All QLICIs	Cumulative Percent
ESIC New Markets Partners LP	$315,498,392	5.7%	5.7%
Wachovia Community Development Enterprises, LLC	$209,029,768	3.8%	9.5%
Key Community Development New Markets LLC	$203,629,328	3.7%	13.2%
National New Markets Tax Credit Fund, Inc	$187,207,424	3.4%	16.6%
HEDC New Markets, Inc	$178,844,981	3.2%	19.9%
Banc of America CDE, LLC	$150,355,432	2.7%	22.6%
Local Initiatives Support Corporation	$150,255,964	2.7%	25.3%
Phoenix Community Development and Investment Corporation	$124,196,000	2.3%	27.6%
Paramount Community Development Fund, LLC	$123,208,216	2.2%	29.8%
National Trust Community Investment Corporation	$122,592,114	2.2%	32.0%

Note: CDEs shaded in gray are mission-driven or have mission-driven parent organizations. National Trust Community Investment Corporation was classified as a for-profit CDE in some rounds and a mission-driven CDE in others.
Source: CDFI Fund CIIS Data, Report Year 2006

Investors

The tax credits can be claimed by both firms and individuals with federal tax liability. Most investors are financial institutions, other corporations, or individual investors. Unfortunately, the CDFI Fund does not track transactions in which investors sell their equity in a CDE and transfer rights to claim tax credits to other investors. Because of this, it is difficult to quantify the number of investors participating in the NMTC program. Table 5 shows the U.S. Government Accountability Office's analysis of the CDFI Fund data that do exist.

Table 5: ***Tax Credit Claimants***

Investor Type	Number of Claimants	Percent of Claimants
Bank or other regulated financial institution	155	37.8%
Individual investor	132	32.2%
Other corporate investor	76	18.5%
Other	47	11.5%
Total	**410**	**100.0%**

Source: GAO 2007 (GAO analysis of CDFI Fund Data)

The GAO also conducted a survey of NMTC investors to gauge their reasons for investing in the NMTC program. When asked which factors had a very great to moderate effect on their decisions to invest in the program, the investors reported that they wished to improve conditions in low-income communities (90.1 percent of those surveyed), obtain return on investment (82.1 percent), create or retain jobs (77.8 percent), obtain the tax credit (76.7 percent), expand lending relationships with special-purpose borrowers (52.0 percent), and comply with government regulations like the Community Reinvestment Act (41.2 percent) (GAO 2007, 26).

The NMTC has attracted new investors over time. About 69 percent of investors who made QEIs in 2006 were new to the program (GAO 2007). Through the analysis of its own survey data and information from the CDFI Fund, the GAO found that the NMTC has led corporate investors to shift investments from higher-income communities into low-income communities, without increasing the overall amount they invest. In contrast, individual investors seemed to be increasing their total investments in order to participate in the program, rather than shifting investments from nonqualifying areas (GAO 2007, 4). It was outside the scope of the GAO's analysis to determine if the increased investment by NMTC investors took the place of investment by non-NMTC investors in these low-income communities, rather than supplement their activity.

Qualified Active Low-Income Community Businesses (QALICBs)

The QALICBs that have received NMTC investments are diverse. At the time the QLICIs were made, the QALICBs range in age from newly formed to 148 years old. Most QALICBs are newly created businesses; more than half (about 52 percent) were less than two years old when they received QLICIs. The overwhelming majority of QLICIs, approximately 82 percent, were made in for-profit businesses; about 17 percent were made in nonprofit businesses, and the remaining 1 percent was made in tribal organizations and other types of businesses. The number of QLICIs made in QALICBs was almost evenly split between real estate (51 percent) and non-real estate, or "operating" businesses (49 percent).

The annual gross revenue of QALICBs ranged from essentially zero revenue to over $800 million, and their employment ranged from zero full-time workers to more than 4,300 workers. More than 13 percent of QLICIs were made in minority-owned or controlled businesses, more than 10 percent were made in women-owned businesses, and more than 5 percent were made in businesses owned or controlled by low-income entrepreneurs.

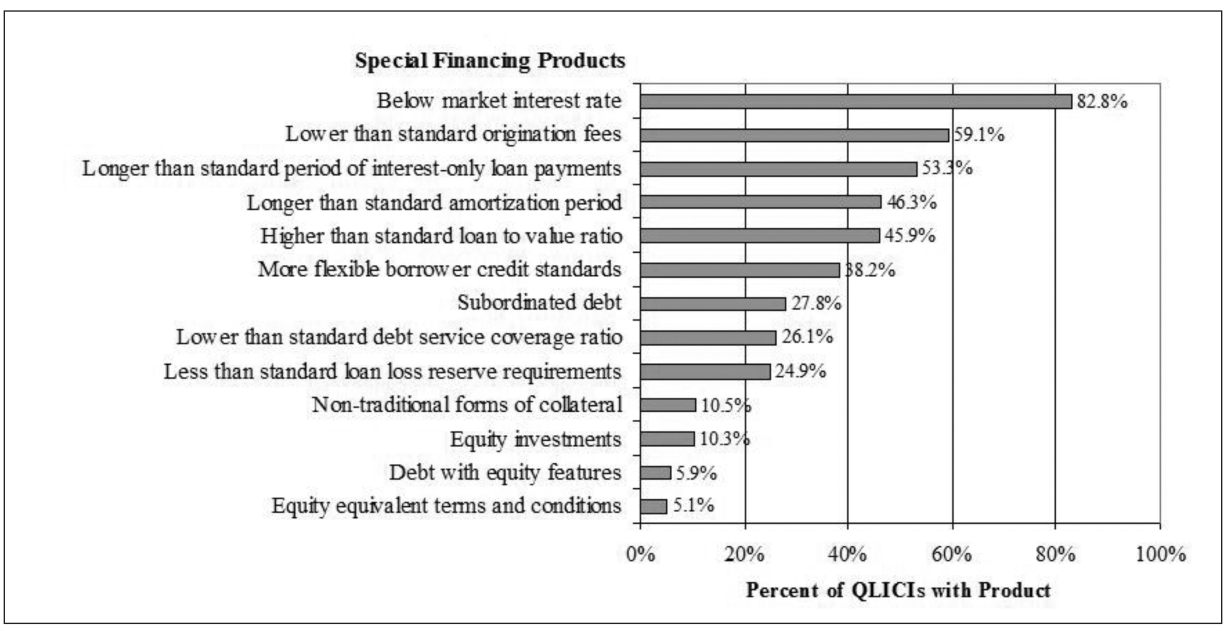
Characteristics of Qualified Low-Income Community Investments (QLICIs)

Rates and Terms

QALICBs benefit from the NMTC by gaining access to much-needed capital, usually with more attractive features than investors would otherwise offer. Since businesses in disadvantaged areas often have higher-risk profiles and cannot receive prime-rate loans, the most common form of assistance that QLICIs offer is loans with below-market interest rates. Other common financing products are loans with lower fees, longer terms, and higher loan-to-value ratios than are typically available in the lending market. One interesting option provided in the form of QLICIs is subordinated debt. In subordinated loans, the lender agrees that should the borrower fall into receivership, the subordinated loan will be paid back after other debts are settled. These are typically more risky loans to issue, and in the general lending market they would probably require much higher interest rates than standard loans.

Another popular product is a longer-than-standard period of interest-only payments on a loan. Often CDEs will make QLICIs that are nonamortizing loans with a seven-year term. In other words, they require borrowers to make interest payments during the first seven years and then pay a balloon payment (the principal) at the end of the term. This allows the CDE to keep the initial QEI invested in a low-income business. As required by NMTC restrictions, if any portion of the principal is repaid before the seven-year period passes, the CDE must find a new QALICB in which to redeploy the capital within one year. The interest-only payment system helps the CDE avoid the hassle and risk of making a new investment.

Figure 4: ***Most Popular Flexible and Nontraditional Financing Products***



Source: CDFI Fund CIIS Data, Report Year 2006

Purposes of QLICIs

As discussed earlier, there are four different types of QLICIs, but the vast majority of all QLICIs are those made as loans to or investments in QALICBs. These QALICBs are classified by the CDFI Fund as either "non-real estate businesses" (i.e., operating businesses), or "real estate businesses" (i.e., those that develop or lease properties to others). The CDFI Fund also monitors the use of the QLICI dollars to determine whether the purpose of the investment was to support real estate or non-real estate activities. Combining the classifications of QALICBs with their use of the investment dollars leads to three primary types of QLICIs:

1. Non-real estate QLICIs made in operating businesses includes equity investments, working capital loans, and fixed asset loans. Working capital loans can help serve as temporary, stop-gap financing to cover wages, rent, utilities, or other operating expenses. Fixed assets are non-real estate tangible property, such as equipment, furniture, and machines, but may not include inputs in production that will be consumed or converted into cash (GAO 2007).

2. Real estate QLICIs made in operating businesses typically support the acquisition or rehabilitation (including expansion) of facilities, including owner-occupied retail facilities; industrial or manufacturing facilities; warehouses and storage facilities; and community facilities, such as charter schools and health centers.

3. Real estate QLICIs made in real estate businesses generally support the development, acquisition, or rehabilitation of real estate projects (commercial, mixed-use, homeownership, or community facilities) that will be sold or leased to other users.

NMTC investments have supported a wide variety of projects, including coal companies, charter schools, health-care facilities, condominiums, timberlands, religious institutions, child-care providers, supermarkets, restaurants, museums, hotels, performing arts centers, pharmacies, convenience stores, manufacturers, processors, distributors, trucking companies, printing companies, waste management companies, sporting goods stores, business incubators, office buildings, shopping centers, substance abuse treatment facilities, car dealerships, florists, and recording studios (CDFI Fund 2007b).

Not all businesses in low-income communities may receive QLICIs. Some uses of QLICIs are expressly forbidden, such as financing racetracks, gambling facilities, tanning salons, massage parlors, liquor stores, and golf courses. The program forbids financing projects with residential rental housing as the principal use, but mixed-use developments are allowed, so long as nonresidential uses make up at least 20 percent of the income generated by the development.

Although many practitioners expected the NMTC program to help provide equity and counseling for existing business operations, the largest portion of QLICIs goes towards real estate projects. These QLICIs may, for instance, provide loans with lower-than-market rates for an existing business to expand its operations, or they may provide loans for a retail development that would accommodate commercial tenants. One of the main criticisms of the NMTC program is that it has allowed too many real estate QLICIs at the expense of investments that would have a greater impact in revitalizing communities (Armistead 2005a). This debate is explored in greater depth in Section Two.

Areas Served by QLICIs: Degree of Economic Distress

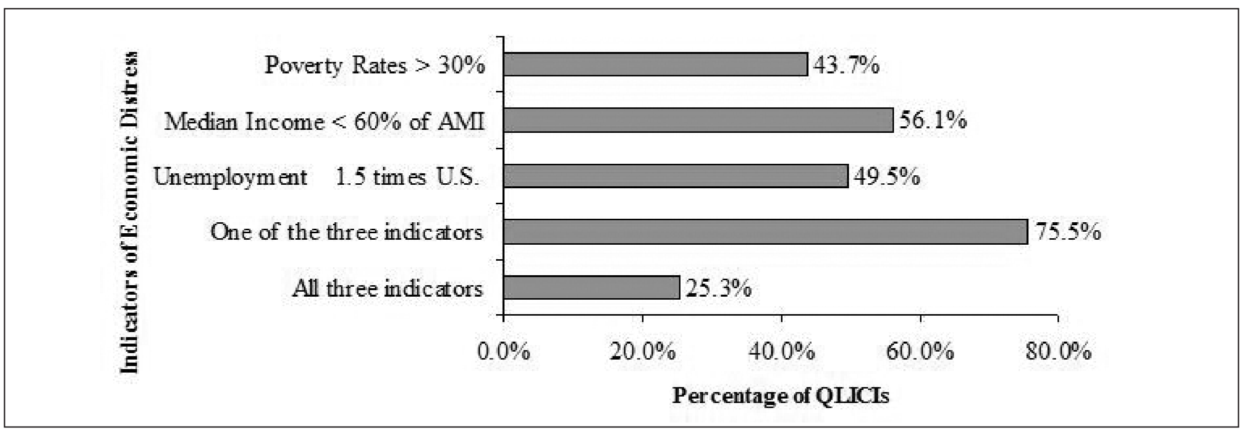
The New Markets Tax Credit program was created to help low-income communities gain access to capital. Only QALICBs in designated low-income census tracts may receive QLICIs. Census tracts are generally eligible if they have a poverty rate of at least 20 percent or a median family income of up to

80 percent of the metropolitan area or statewide median, whichever is greater, as reported by the 2000 Census. With these loose guidelines of eligibility, about 39 percent of census tracts in the United States qualify for NMTC investments (Armistead 2005). Through 2006, eight hundred different census tracts, about 3 percent of the qualified tracts, have received NMTC investments.

The CDFI Fund tries to target NMTC activity to "areas with greater economic distress," which it considers to be places with poverty rates greater than 30 percent, tracts with median incomes of less than 60 percent of applicable area median income, and areas with unemployment rates at least 1.5 times the national average. When applying for allocations, CDEs can indicate that they intend to serve these areas. Part of the allocation process includes the "Community Impact Section," worth one-quarter of each application's possible points. CDEs earn more points in this area if they demonstrate intent to serve more severely disadvantaged communities. It is becoming increasingly necessary for CDEs to pledge the majority of their activities to these communities in order to compete successfully for tax credit allocations (Armistead 2005).

Using the competitive allocation process, the CDFI Fund has successfully encouraged CDEs and investors to target more highly distressed communities than the NMTC statute requires. As shown in Figure 5, more than 75 percent of the number of QLICIs made prior to 2007 were in communities that met at least one condition demonstrating "greater economic distress." More than one-quarter of the QLICIs were made in communities meeting all three qualifications.

Figure 5: ***Qualified Low-Income Community Investments (QLICIs) in Areas of Economic Distress***



Note: Most investments are classified in multiple categories. Census tracts with multiple QLICIs are counted for each QLICI made.
Source: CDFI Fund CIIS Data, Report Year 2006

As further demonstrated in Table 6, only a small percentage of eligible tracts have received NMTC investments, but these tracts are more distressed on average than qualified tracts, and much more distressed than the average U.S. census tract. NMTC-qualified tracts (and especially tracts that have received QLICIs) have, on average, a much greater proportion of people of color than nonqualified tracts.

Table 6: ***Demographic Characteristics of Census Tracts***

	All U.S. Census Tracts	NMTC Qualified Census Tracts	Census Tracts with QLICIs
Number of Tracts	64,758	24,830	800
Mean %Unemployed	6.5%	10.1%	12.0% **
Mean Median Family Income (MFI)	$50,950	$33,330	$31,786 **
Mean MFI as a Percentage of AMI	104.0%	70.0%	64.6% **
Mean Percentage in Poverty	13.5%	23.5%	28.0% **
Mean Percentage Nonwhite	25.7%	41.8%	46.9% **
Mean Percentage Latino	11.6%	18.8%	20.5%

*Note: Statistically significant differences in means between qualified census tracts with no QLICIs and tracts with QLICIs are indicated, ** = significant at .01 level, * = significant at .05 level.*
Source: CDFI Fund CIIS Data, Report Year 2006

Areas Served by QLICIs: Urban vs. Rural

The New Markets Tax Credits program was designed to aid both urban and rural low-income communities. The NMTC has been most widely used in larger urban areas, and rural areas seem to be particularly at risk of not receiving funds. In the first round of allocations, CDEs representing rural areas received 20 percent of tax credit allocations, but in the second round this dropped to 15 percent (Armistead 2005). Through 2006, only 17 percent of projects financed with QLICIs were located in nonmetropolitan areas. These projects accounted for just 8.4 percent of the QLICI dollars invested during this period.

In 2006, Congress passed the Tax Relief and Health Care Act, which extended the NMTC program through 2008 and provided an additional $3.5 billion in credit authority. Along with these expansions in the program, Congress specifically instructed the CDFI Fund to change its allocation process to better target rural areas, which it did with respect to the 2008 NMTC allocation round (New Markets Tax Credit Coalition 2007). Under this round, the CDFI Fund will not announce award determinations until the fall of 2008.

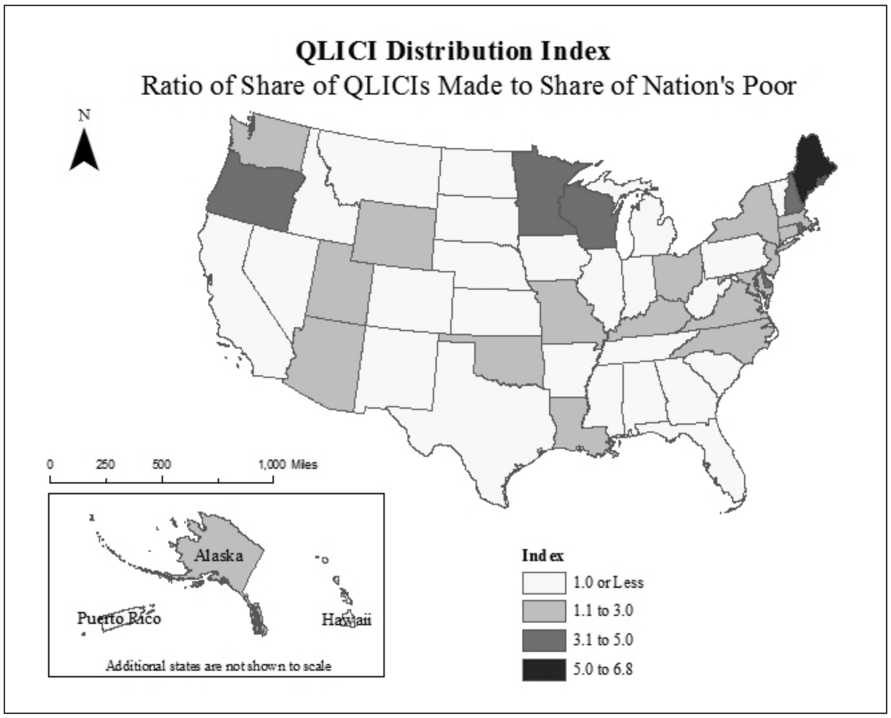
Areas Served by QLICIs: States

There is no quota for distributing NMTCs equally among states. As a result, some states have received much more money in QLICIs than others. This is probably because CDEs are authorized to make investments in only a few states, and some of the most active CDEs have concentrated their efforts in the same geographic areas, which then receive a large number of investments. This leaves other states without many CDEs to serve them.

For transactions made before 2007, California received the greatest number of QLICIs, 149. Ohio and Massachusetts also received a large number, 124 and 110, respectively. In terms of total money invested through QLICIs, California and New York both received over $550 million in investments to QALICBs. The state with the next largest amount of investments received was Ohio, with about $325 million. The only states that did not receive any QLICIs by the end of 2006 were Kansas, South Dakota, and Vermont, but CDEs certified to make QLICIs in these states were awarded tax credit allocations in the most recent allocation round (CDFI Fund 2007a).

One of the ways a census tract qualifies for NMTC investments is by having a high proportion of residents who are in poverty. Since one goal of the NMTC is to target investment in poor areas, it is useful to compare a state's share of NMTC investments to its share of the nation's population living in poverty. The map below shows an index of the distribution of QLICIs. The index was calculated by finding the ratio of the state's share of total QLICI dollars invested in the United States to the state's share of the nation's population living in poverty, as measured by the 2000 Census. Because they are eligible for NMTC investments, the District of Columbia and Puerto Rico were treated as states in this analysis.

Figure 6: ***Comparison of QLICI Dollars to Population in Poverty***



Data Sources: 2000 Census, Summary File 3; CDFI Fund CIIS Data, Report Year 2006

An index of 1.0 would indicate a proportional level of investments given the state's population in poverty. The states shown in yellow received a relatively small amount of investments, given their share of the nation's poor. The darker states received a relatively larger share of investments. The states with the highest values of the index were Maine (6.8), the District of Columbia (4.8), and Rhode Island (4.5). The states with the lowest values were Puerto Rico (0.01), Hawaii (0.01), Nevada (0.02), and Montana (0.02). Kansas, South Dakota, and Vermont had index values of 0.00, since they received no QLICIs before 2007.

However, this index takes into account only a state's share of the nation's poor, not other signals of economic distress that the CDFI Fund considers. Another method that would factor in signals of distress other than poverty would be to compare the percentage of the nation's qualified census tracts that are in a given state to that state's share of the total dollars invested through QLICIs. Furthermore, since access to CDEs with tax credit allocations is essential to receiving NMTC investments, it would be interesting to compare an area's potential supply of credits (as measured by the total credits received by CDEs qualified to serve the area) with the potential demand or need for investments (as measured by such demographics as poverty, median income, and unemployment). It would be valuable to conduct this type of analysis to gain a better idea of how well the NMTC investments are distributed geographically and to determine if some kind of action, such as encouraging certification of CDEs in targeted areas, would improve the equity of the distribution.

Concerns about the New Markets Tax Credit Program and Limitations of Existing Analysis

Very little research has been conducted on the New Markets Tax Credit program, partly because the program is still young, but also because it is complex, and little specific data about investors and NMTC community investments are publicly available. Most analysis of the program focuses on surveys of investors and CDEs, often with small samples. While these studies offer interesting information, the authors readily admit that they cannot determine the effects of the NMTC program without a significant analysis of NMTC data. The Urban Institute recently began a large project to investigate the impacts of the program and address common concerns about how the program functions and which types of investments it targets. One such issue is the prevalence of investments in real estate projects. The rest of this report focuses on this specific debate, using data from the CDFI Fund's ATS (Allocation Tracking System), CIIS (Community Investment Impact System), and ILR (Institutional Level Report) data.

Section Two: The Prevalence of Real Estate Investments among NMTC Investments

A common observation about the NMTC program is that most QLICIs (in terms of number and value) are made for the acquisition or rehabilitation of property. This phenomenon is often referred to as the "real estate tilt" of the NMTC (Armistead 2005). Specifically, most of these transactions are investments made to property developers to purchase, construct, or improve spaces that will be leased to tenant businesses. The immediate beneficiaries of NMTC subsidies are the investor, who makes the investment and is able to claim the tax credit, and the investee, typically a real estate developer of some kind, who will obtain financing with better-than-market terms. As discussed further below, benefits may also flow through to tenant businesses in the form of reduced rent and to residents of the low-income communities in the form of access to needed goods and services.

Because the NMTC program is a place-based subsidy, transactions will qualify for the NMTC so long as the project is in a qualified low-income community and the real estate business meets all the other requirements to be a QALICB. There are no explicit requirements that the projects result in job creation, local hiring, community asset building, or developing underrepresented groups of entrepreneurs like minorities, women, or low-income individuals. This is not to say that real estate projects do not benefit these groups; few would disagree that real estate projects serve as catalysts for increased investment in low-income communities. In addition, real estate projects can house much-needed community businesses and service providers like grocery stores, hospitals, and charter schools. However, the dominance of real estate projects has concerned some stakeholders and deserves to be analyzed to determine its magnitude and likely impact on the success of the overall NMTC program.

This section presents information on the characteristics of the real estate tilt, such as its size, how it has changed over time, and how real estate projects compare to non-real estate projects in terms of community demographics and QALICB characteristics. Following this analysis, there is a brief summary of the main arguments opposing and in support of the dominance of real estate investments, as well as a discussion of the primary causes of the real estate tilt. The paper concludes with a list of possible policy actions that could reduce the size of the real estate tilt.

Statistics on Real Estate and Business Investments

Size of the Tilt toward Real Estate

Most NMTC projects, about 62 percent, are real estate investments. As discussed earlier, some real estate projects are undertaken by real estate developers (real estate QLICIs made in real estate QALCBs), while other projects consist of acquiring or rehabilitating real estate for use by the borrower's own business (real estate QLICIS made in non-real estate QALICBs). This is an important distinction. Table 7 shows that 938 real estate QLICIs were made by the end of 2006; most of these, 732, were development and rehabilitation projects by real estate companies. The borrowers or investees of these projects are real estate businesses and the capital is used for acquiring or rehabilitating real estate, most likely with the end-goal of leasing the space to retail or commercial business tenants.

Table 7: ***QLICIs by Types of Projects***

	Type of QALICB		
Purpose	**Non-Real Estate (Operating Business)**	**Real Estate**	**Total**
Business	511 (34.0%)	18 (1.2%)	529 (35.2%)
Real Estate (Total)	206 (13.7%)	732 (48.7%)	938 (62.4%)
Commercial Construction, or Acquisition w/o Rehab	137	270	407
Multifamily Housing Construction	0	4	4
Single-Family Housing Construction	0	11	11
Commercial Real Estate Rehabilitation	69	437	506
Multifamily Housing Rehabilitation	0	8	8
Single-Family Housing Rehabilitation	0	2	2
Microenterprise	3 (0.2%)	0 (0.0%)	3 (0.2%)
Other	21 (1.4%)	13 (0.9%)	34 (2.3%)
Total	**741 (49.3%)**	**763 (50.7%)**	**1,504 (100.0%)**

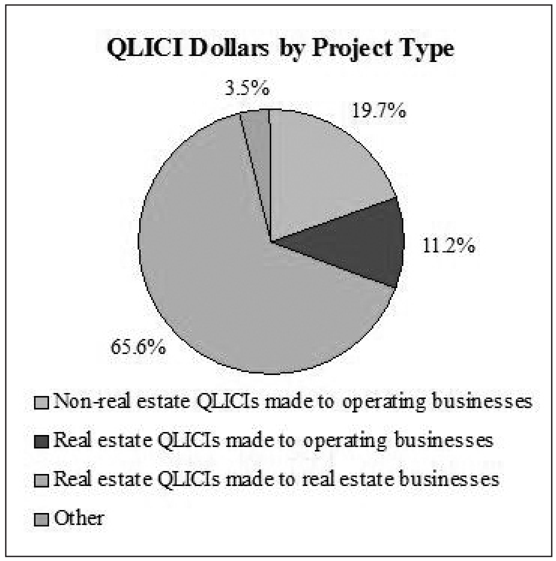
Source: CDFI Fund CIIS Data, Report Year 2006

The remaining real estate transactions, 206 QLICIs, were made in "operating businesses," which are companies whose business activities are not the development or leasing of real estate. These businesses typically use the QLICIs to buy or rehabilitate properties in order to expand their operations. These transactions will be referred to here as "real estate financing for operating businesses," or simply "real estate for operating businesses."

The overwhelming purpose of both types of real estate investments is the acquisition and rehabilitation of commercial real estate, though there have been some residential projects financed with QLICIs. Mixed-use projects are also common, and they are categorized in Table 7 as "commercial."

About 35 percent of all QLICIs were made in operating businesses for non-real estate expenses such as working capital or acquiring fixed assets like equipment and machines. As discussed in Section One, less than 20 percent of QLICIs made in Fiscal Years 2003 through 2005 were for fixed assets, and less than 5 percent were made for working capital (GAO 2007, 31). Unfortunately, the CDFI Fund no longer makes this distinction between types of non-real-estate-based business financing in the CIIS data they collect and analyze.

Figure 7: ***Share of QLICIs***

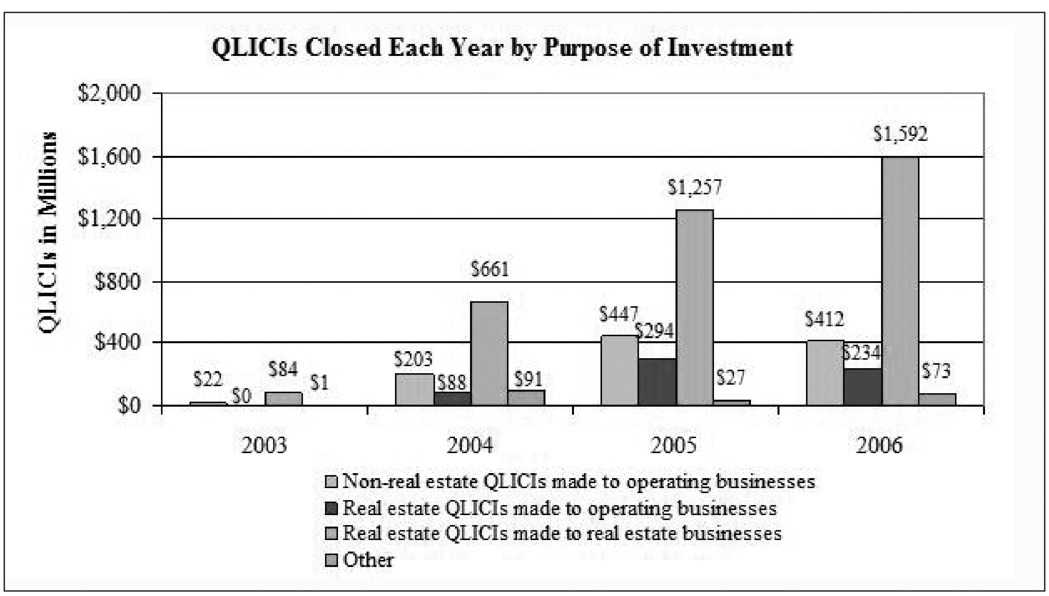


Source: CDFI Fund, CIIS Data, Report Year 2006

The dominant purpose of QLICIs has always been to finance real estate investments in real estate businesses such as developers. While about 51 percent of QLICIs go toward these real estate investments, these investments represent a larger percentage of the dollar value of investments; more than 65 percent of dollars invested have gone toward these projects.

As shown in Figure 8, the sum of these real estate investments closing each year has increased faster and more consistently than QLICIs of any other purpose. These QLICIs are investments made in real estate firms for the purpose of acquiring or rehabilitating real estate. Investments in operating businesses for real estate purposes are shown in purple. These investments have become more common in recent years, but they are still a small share of investments relative to the QLICIs in real estate businesses for real estate projects. Non-real estate investments in operating businesses are shown in blue. The growth of these investments too has been vastly outpaced by QLICIs in real estate businesses.

Figure 8: ***Purpose of QLICIs Made Between 2003 and 2006***



Source: CDFI Fund, CIIS Data, Report Year 2006

The value of non-real estate investments adds up quickly because they tend to be quite large. The average real estate QLICI in real estate businesses is nearly $5 million, whereas the average non-real estate QLICI is only about $2.1 million. Real estate investments to operating businesses are also comparatively small; they are valued at less than $3 million on average.

Table 8: ***Original Amount of Financing by Project Type***

Project Type	n	Total Investments	Mean	Standard Deviation	Smallest	Largest
Non-real estate QLICIs made in operating businesses	511	$1,087,363,543	$2,127,913	$3,713,592	$1,950	$31,500,000
Real estate QLICIs made in operating businesses	206	$617,139,332	$2,995,822	$3,435,757	$71,324	$17,300,000
Real estate QLICIs made in real estate businesses	732	$3,613,422,840	$4,936,370	$6,347,582	$19,452	$51,000,000
Other	55	$191,981,790	$3,490,578	$3,896,822	$20,134	$17,000,000
Total	**1,504**	**$5,509,907,505**	**$3,663,502**	**$5,299,476**	**$1,950**	**$51,000,000**

Source: CDFI Fund CIIS Data, Report Year 2006

CDE Characteristics and Purposes of Investments

QLICIs in real estate businesses for real estate purposes are the most common type of QLICI among both mission-driven and for-profit CDEs. However, these real estate projects make up a greater percentage of for-profit CDEs' QLICIs than mission-driven CDEs. Mission-driven CDEs, such as those formed by nonprofits, CDFIs, or government entities, may be more likely than for-profit CDEs to make investments in operating businesses because these investments are usually smaller and potentially less profitable than QLICIs to real estate businesses.

Table 9: ***CDE Organization Structure and Number of QLICIs Made by Project Type***

Investment Purpose	For-Profit CDEs	Mission-Driven CDEs	Total
Non-real estate QLICIs made in operating businesses	178 (28.2%)	300 (39.1%)	478 (34.2%)
Real estate QLICIs made in operating businesses	85 (13.4%)	116 (15.1%)	201 (14.4%)
Real estate QLICIs made in real estate businesses	369 (58.4%)	351 (45.8%)	720 (51.5%)
Total	**632 (100%)**	**767 (100%)**	**1,399 (100%)**

Source: CDFI Fund CIIS Data, Report Year 2006

Community Characteristics and Purposes of Investments

Relatively few qualified census tracts have received investments. A total of 753 census tracts received a QLICI from one of the three main categories: non-real estate QLICIs made in operating businesses, real estate QLICIs made in operating businesses, and real estate QLICIs made in real estate businesses. Of these 753 tracts, only 58 received QLICIs of two or more of these types. In other words, more than 90 percent of census tracts receiving one of the three main types of QLICIs received only one of these types of investments.

Interestingly, there seem to be some differences in the tracts that receive business investments, such as working capital and fixed assets financing versus other types of investments. Among the tracts receiving QLICIs, QLICIs in non-real estate businesses tend to go to the least distressed areas. This may lend support to the argument that business lending is difficult to do, particularly in low-income communities, and that the NMTC may not be as effective at bringing business lending to the most distressed areas when compared to real estate projects.

Table 10: ***Demographic Characteristics of Census Tracts Receiving QLICIs***

	Types of QLICIs Received in Census Tracts				
	All Tracts Receiving QLICIs	Only QLICIs in Operating QALICBs for Non-Real Estate	Only QLICIs in Operating QALICBs for Real Estate	Only QLICIs in Real Estate QALICBs for Real Estate	Two or More QLICI Types
Number of Tracts	753	276	106	313	58
Mean %Unemployed	11.8%	6.4% **	11.2%	10.2%	12.4%
Mean Median Family Income (MFI)	$32,675	$34,288	$32,037	$31,866	$30,528
Mean MFI as a Percentage of AMI	66.6%	72.9% **	64.6%	62.7%	61.9%
Mean Percentage in Poverty	27.4%	23.9% **	27.3%	30.0%	30.3%
Mean Percentage Nonwhite	45.6%	40.3% *	46.8%	50.1%	44.4%
Mean Percentage Latino	19.9%	15.5%	30.9%	20.8%	14.9%

*Notes: Table includes only tracts that have received one of the three main types of investment. An additional 47 tracts received another type of QLICI, like microenterprise or other investments. Statistically significant differences in means between census tracts with one of the three main types of QLICIs and tracts with only QLICIs in operating QALICBs for non-real estate purposes are indicated, ** = significant at .01 level, * = significant at .05 level.*

Source: CDFI Fund CIIS Data, Report Year 2006

In addition to bringing capital to the areas that need it most, the NMTC can also aid underrepresented entrepreneurs, who may find it difficult to acquire investments in their low-income community businesses. Although the NMTC does not explicitly target QALICBs owned by racial or ethnic minorities, women, or low-income individuals, these businesses should be included in the program in great numbers, since these entrepreneurs make up a large number of low-income community residents.

Currently, of these traditionally underrepresented groups, minority-owned businesses are receiving the greatest number of QLICIs. Among the three main types of QLICIs, business real estate investments seem to be the best at targeting minority- and women-owned businesses. Few QLICIs are made in businesses with low-income owners. Non-real estate QLICIs are better targeted toward these groups than

QLICIs made in real estate QALICBs, but the difference between the two is minimal. Interestingly, none of the three types of investments has been made in large number to businesses with low-income owners. Presumably, these individuals could benefit most from improved access to capital and better rates and terms than are traditionally available.

Table 11: ***Type of Project by Business Characteristics***

	Minority-Owned or Controlled Business	Women-Owned or Controlled Business	Low-Income Owned or Controlled Business
Non-real estate QLICIs made in operating QALICBs	11.4%	9.4%	6.9%
Real estate QLICIs made in operating QALICBs	22.5%	21.5%	4.3%
Real estate QLICIs made in real estate QALICBs	10.6%	7.5%	3.6%
Total	**13.4%**	**10.2%**	**5.1%**

Notes: 1,093 transactions are included in the total. Not all transactions had information on firm characteristics. Transaction/note-level data (so some projects/businesses are counted twice).

Source: CDFI Fund CIIS Data, through 2006

Concerns about the Real Estate Tilt

Because QLICIs for real estate make up a significantly large percentage of all NMTC investment dollars, and particularly because such a great percentage of these real estate QLICIs is made in real estate businesses like developers, the "real estate tilt" of the NMTC has been a subject of debate (Armistead 2005, Seidman 2007). The main criticisms of the real estate tilt are that these investments do not provide the most needed types of capital, are less likely to build social capital among targeted groups of underrepresented entrepreneurs, and are less likely to create quality jobs.

Unfortunately, though, the NMTC statute is vague and does not give much guidance for understanding whether job creation and targeting underrepresented entrepreneurs is a priority. When originally passed, the NMTC was supported by a broad base of members of Congress, the Clinton administration, and industry leaders. However, each group seemed to favor creating the program for different reasons. Conservatives liked the program because it offered a way to stimulate private investment without the federal government assuming a large role. Liberals seemed more interested in the program's potential to create jobs and bolster underrepresented entrepreneurs. Both groups saw the program as a means to break down the financing gap that has prevented low-income communities from achieving economic development success (Roberts 2005).

Perhaps it was in order to accommodate all these goals that the statute was written in vague terms and left for the Bush administration to interpret and implement. However, because of the lack of guidance from Congress, it is difficult to make the case that the real estate tilt was actually unintended and should be corrected. Despite this, we can assess the arguments opposing and in favor of using the NMTC to subsidize real estate investments in hopes of understanding if changing the program to minimize the real estate tilt is warranted and desirable.

Providing the Most Needed Capital

One of the more potentially compelling arguments against real estate investments is that these types of projects are more likely to be implemented without the tax credit, such that the credit essentially "sweetens" deals that would be done anyway (Armistead 2005). By using tax credit allocations to subsidize real estate deals, there are fewer credits available for subsidizing business operations investments. Typically, business operations lending is difficult to do. Since these investments are generally not backed by real estate, they are often undercollateralized and, as a result, carry greater risk to investors. In contrast, real estate investments are less risky: if the borrower defaults or becomes insolvent, the investor can take possession of the property and recoup the capital invested. Because real estate investments are so much easier to make, some people consider them to be the "low-hanging fruit" of the NMTC program.

Since the NMTC is supposed to make otherwise infeasible deals possible, the prevalence of real estate investments could be a legitimate concern, given that it is difficult to assess which investments truly need the credit and which investments could be made without it.

Targeting Special Groups of Business Owners

Another main argument against real estate investments is that they may be less likely to benefit underrepresented groups of entrepreneurs. Although supporting underrepresented entrepreneurs is not a specific goal of the NMTC program, it is an important way to grow social capital in low-income areas. Some stakeholders are concerned that real estate businesses may be less likely to be locally-owned, minority-owned, or female-owned than other types of QALICBs. This concern seems isolated to real estate businesses like developers rather than operating businesses that use the NMTC to acquire or rehabilitate real estate. As shown in Table 11, QLICIs in operating businesses for real estate projects tend to target underrepresented entrepreneurs more effectively than other QLICIs, even QLICIs that are financing business operations. In fact, QLICIs in real estate businesses do target these entrepreneurs to a lesser degree than do the other two types of QLICIs, but there does not seem to be a substantial difference between QLICIs in real estate businesses and those in non-real estate businesses for non-real estate purposes.

Creating Quality Jobs

Some stakeholders have also voiced concern that real estate projects may not actually create many jobs relative to business operations projects (Armistead 2005). In fact, it seems that real estate projects create more jobs. The CDFI Fund asks CDEs to project the number of jobs that will be created as a result of each QLICI. These data are presented in Table 12. According to these projections, it seems that the largest contributor to job creation is the real estate project undertaken by real estate businesses such as developers. In fact, about 84 percent of new jobs will be created by real estate projects undertaken by real estate QALICBs, if these projections are accurate. The next largest contributor to job creation is operating businesses that undertake real estate projects. The two types of real estate QLICIs also contribute to job creation through construction work, but these jobs are considered temporary and are not counted in Table 12. Of the most common types of projects, non-real estate QLICIs actually offer the least projected jobs created.

Table 12: ***Total Predicted Job Creation (Business and Tenant Jobs)***

	Type of Business		
Project Purpose	**Operating (Non-Real Estate)**	**Real Estate**	**Total**
Business Operations	9,012.5	1,194	10,206.5
Microenterprise	6	n/a	6
Other	125	0	125
Real Estate	3,390	72,454	75,844
Total	**12,533.5**	**73,648**	**86,181.5**

Note: Not all QLICIs have job creation projections.
Source: CDFI Fund CIIS Data, through 2006

A secondary argument is that the real estate projects undertaken by developers are typically commercial projects like malls, which provide retail jobs that are often low-wage and offer minimal prospects for advancement. Jobs in other sectors may offer better wages and more opportunities for disadvantaged residents. Unfortunately, the CDFI Fund does not track the businesses that become tenants in projects financed through QLICIs. Because of this, it is not possible to analyze the differences in jobs created.

In Defense of Real Estate

Despite the criticism of real estate investments, it is clear that these projects can have major benefits. They can improve their communities and serve as a catalyst for additional improvements, they can help existing operating businesses expand, and as previously discussed, the projects can create large numbers of permanent jobs.

Improving Real Estate in Communities

Real estate projects can provide much-needed construction and improvements to existing facilities in low-income communities. Examples of real estate projects include community centers, day-care centers, charter schools, affordable housing, manufacturing facilities, shopping centers, and hospitals. These projects can serve as a catalyst for neighborhood change, from lowering vacancy rates and reducing crime to cleaning up environmentally contaminated brownfield sites. These improvements can lead to additional investment in neighborhood projects that do not receive NMTC assistance.

Helping Existing Businesses Expand

Real estate projects also help existing businesses expand their operations. Real estate projects have helped schools expand their facilities so they can serve more students, increased medical-center capacity, and allowed small manufacturers to increase the scale of their production. Moreover, QLICIs in real estate projects for operating businesses often help these businesses move into owner-occupied spaces. By owning their own buildings, small businesses can operate more efficiently and save on overhead costs, potentially increasing their profitability (interview with Frank Altman). The distinction between real estate projects for operating businesses versus developers and other real estate companies is important. By helping operating businesses to acquire real estate, this can also free up their resources for working capital, equipment, and other non-real estate expenses (interview with Julia Rubin).

Creating More Jobs

Real estate projects create jobs through construction, business expansion, and by bringing in tenant businesses to low-income communities. Real estate projects have greater projected job creation rates than non-real estate projects. Real estate projects not only seem to create more jobs, but they appear to do so at a cheaper rate, in terms of dollars of project cost per job created.

Why the Tilt toward Real Estate Exists

Several factors drive the NMTC's tilt toward real estate. These factors fit into two categories: compliance concerns and profitability concerns. Real estate deals are less likely to present compliance problems that could result in credit recapture, particularly since the businesses are less likely to lose their QALICB status and are less likely to return capital early. Furthermore, real estate deals are often more profitable because they carry less risk, generally do not have prohibitive third-party expenses, and have a higher likelihood of qualifying for additional tax incentives.

Meeting the "Substantially All" Requirement

Some of the most significant factors contributing to the real estate tilt are the NMTC program's severe recapture provisions. As mentioned, the IRS may recapture the NMTC tax credits if the CDE facilitating the investment loses its designation as a CDE; if the CDE does not invest "substantially all" of investors' QEIs into qualifying low-income communities; or if the investor redeems its QEI prior to the conclusion of the seven-year holding period. If any of these events occur, the investors lose their right to use tax credits they have been given, and they must pay back any credits they used in previous tax years, plus a penalty fee and interest (Armistead 2005). This recapture penalty is stricter than penalties in place under the Low Income Housing Tax Credit Program, and it has been widely criticized by industry leaders (Novogradac 2002). The recapture provision may deter some investors from making investments in CDEs, and it may make some deals more attractive than others from a compliance point of view.

One of the most stringent policies is that CDEs must invest "substantially all" of investors' money (the QEIs) into QALICBs over the seven-year period during which investors are claiming the tax credits. Specifically, a CDE must invest 85 percent of the total QEIs as QLICIs. If any part of the principal is repaid in those first seven years, the CDE must generally reinvest the capital into another QALICB within twelve months. Some CDEs find it burdensome to identify new projects, underwrite the investments, and redeploy the capital. In addition, investors are often weary of making an investment in a CDE if they feel there is some risk that the capital will have to be redeployed in other projects. In order to avoid recovering any of the QEI during the seven year compliance period, some CDEs make long-term, nonamortizing investments so that the principal will not be returned to the investors before the compliance period has passed.

Small investments and those with equity structures are often paid back in fewer than seven years, making them more troublesome for CDEs. In particular, smaller, working-capital loans and venture capital investments are likely to be repaid sooner than larger investments made in the form of loans (Seidman 2007). Real estate QLICIs are large and are usually structured as long-term loans. This makes them better suited to CDEs that fear repayment of the principal during the compliance period.

While some CDEs will be attracted to real estate investments for this reason, other CDEs are eager to have the capital returned so they can make more loans with it. There are several CDEs that operate NMTC loan funds, so as capital is returned, new investments are quickly made. These CDEs generally have an established pipeline of projects from which they can easily select new investments. Other CDEs have set up NMTC "hold funds" of businesses that will await financing until other QALICBs return the principal invested (interviews with Doug Bystry and Richard Campbell).

Keeping the "Q" in QALICB

Another part of meeting the "substantially all" provision is keeping investments in qualified businesses. Investors can face recapture of their credits if a QALICB ceases to be qualified. One of the requirements for a business to be considered a QALICB is for it to be located in a low-income census tract. If the business moves out of the low-income community and into a more affluent area that is not approved for NMTC investments, it may no longer be a qualified business and the move may trigger recapture of the credits. Since real estate cannot move, real estate projects will not lose their QALICB status and thus pose less risk of recapture (Seidman 2006, Rubin and Stankiewicz 2005, Armistead 2005).

In addition to moving, QALICBs can also "grow out of compliance" if their business activities shift into nonqualified communities (interview with Matthew Reilein). For example, in order to be a QALICB, businesses must meet three conditions: at least 50 percent of total gross income of the QALICB must come from operating in a low-income community, at least 40 percent of tangible property used by the business must be located in the community, and at least 40 percent of services provided by employees for the QALICB must be conducted in a low-income community (Armistead 2005). If a business acquires additional property outside a low-income community or its workers start providing services or sales in more affluent areas, they may become noncompliant.

This compliance measure applies to nonprofits, too. For example, one CDE in California wanted to make an investment in a homeless services center for use by a local nonprofit. Although the organization's seventeen other sites were all located in qualified census tracts, its administrative office was located in a nonqualified tract, which means that the organization could not be considered a QALICB (Wells 2005). This is just one example of how complex the QALICB status can be. Because normal business operations are multifaceted and change over time, the tests for compliance are particularly complex for operating businesses as opposed to a piece of real estate.

In contrast, QALICBs can often establish separate corporations for the purpose of purchasing real estate, and then have the separate corporation "lease" the space to the primary corporation. This allows the QALICB to isolate its investment in real estate from its other operations. Since real estate cannot move or grow out of compliance, the QALICB established for the purpose of the investment will be safer.

Finally, QALICBs can fall out of compliance if they start performing nonqualified services. If the owners of a convenience store QALICB convert it into a liquor store, for example, it will fall out of compliance and its investors could face recapture of their tax credits. This is another way in which operating businesses are at greater risk.

So, in summary, moving out of a low-income community, "growing out of compliance," and performing nonqualified services can all lead businesses to lose their QALICB status. Each of these risks is less substantial for real estate projects, since real estate cannot move and the ownership in real estate can be isolated from other business activities through separate incorporation. These aspects make real estate projects seem less risky in terms of compliance and avoiding tax credit recapture.

Even if a QALICB falls out of compliance, all hope is not lost for its investors. There are two ways in which investors can avoid recapture if a QALICB falls out of compliance. First, CDEs have a "cure period" that they can use to withdraw the capital from the noncomplying business and reinvest it in another QALICB. The length of the cure period is six months, and the CDE can use only one cure period for each QEI.

In addition to using the one-time cure period, recapture can be avoided if investors can prove to the IRS that they had a "reasonable expectation" that the business would remain in the low-income community when the investment was made (Armistead 2005, Seidman 2007). The concept of a reasonable expectation is based on a vaguely defined regulation created by the IRS. CDEs and investors spend a substantial amount of time and money hiring consultants, accountants, and attorneys to assess QALICBs before making investments in order to ensure that their investments will pass the reasonable expectations test.

Real Estate Investments Have Less Economic Risk

Investors favor real estate deals because they carry less financial risk; the property serves as collateral on the investment. This makes investors favor real estate deals. Several CDEs interviewed for this paper mentioned lack of valuable collateral as a primary concern when choosing to make non-real estate investments. In addition, real estate investments tend to perform better than many investments in working capital. This is often because the QALICB receiving working capital investments must rent its space, and thus generally faces higher occupancy costs. By acquiring its own space through a real estate QLICI, an operating business can reduce its costs and use its resources more efficiently (interviews with Doug Bystry and Frank Altman).

Third Party Transaction Costs

Real estate investments are also less likely to face prohibitive third-party transaction costs. Each time a CDE makes a QLICI, it must pay substantial legal, accounting, and consulting fees. Larger CDEs in particular seem to rely on third-party organizations to analyze the compliance risks of individual investments. These transaction costs may be so large that smaller projects cannot bring in enough revenue to make the deals worthwhile. Real estate deals, though large in the amount of the investment, are generally simpler and require less analysis of compliance risks, so they can have lower third-party costs (Interview with Michael Johnson and Deborah Dubin). Even when they do face higher transaction costs, real estate QLICIs can still be profitable because they are so large and tend to perform better than investments that finance business operations.

Ability to Package NMTC with Other Tax Incentive Programs

Finally, real estate investments can be more profitable because they often qualify for additional government subsidies in the form of tax incentives. The NMTC program is meant to provide a "shallow subsidy" for projects that may not be feasible without additional assistance. While over $19.5 billion in subsidized equity investments will be provided during the first seven years of the NMTC, the resulting QLICIs usually represent a small portion of a project's total costs. To make deals more attractive and increase the effect of the NMTC, the credit is often "packaged" with other tax incentives (Seidman 2006). According to the most recent GAO report on the NMTC, the most common tax credits packaged with the NMTC are state and local tax abatements, Historic Rehabilitation Tax Credits, Empowerment Zone and Enterprise Community funding, brownfields tax incentives, and the Historic Rehabilitation Easement Deduction (GAO 2007). Some consider the ability to use the NMTC with other incentives unnecessary "double dipping" from public funds (Rubin and Stankiewicz 2005), though others may argue that many of these deals, particularly those in the most distressed communities, require significant subsidies in order to be economically viable.

Many real estate projects are eligible for historic-preservation tax incentives and brownfield mitigation incentives, but non-real estate projects like investments in working capital and fixed assets are not eligible. The ability to package the NMTC with other credits like these makes real estate deals more attractive and probably contributes to the real estate tilt of the NMTC program (Seidman 2007).

As shown in Table 14, both real estate projects to real estate QALICBs and real estate projects for operating QALICBs are more than twice as likely to receive additional public funding than non-real estate projects. Moreover, for projects undertaken by real estate QALICBs, the median funding from public sources other than the NMTC is about four times as great as the median for non-real estate projects.

Table 13: ***Additional Public-Source Financing by Project Type***

Project Type	N	Projects Receiving Additional Public Funding	Percent Receiving Additional Public Funding	Median Additional Public Funding
Non-real estate QLICIs made in operating QALICBs	198	30	15.3%	$685,000
Real estate QLICIs made in operating QALICBs	114	43	37.7%	$703,931
Real estate QLICIs made in real estate QALICBs	356	131	36.8%	$2,697,747
Other	22	4	18.2%	$200,000
Total	**690**	**208**	**30.1%**	**$1,775,128**

Note: Not all projects reported in the CIIS included public financing data.
Source: CDFI Fund CIIS Data, Report Year 2006

Policy Alternatives

In summary, there are many reasons why investors favor real estate investments, chief among them the fact or perception that these investments are safer from recapture and are more profitable, on average, than investments to finance business operations. Since several aspects of the program, like the recapture provisions, affect the behavior of investors, these restrictions and other features of the program could be changed to encourage more investments in business operations.

Easing Restrictions and Recapture Penalties

The NMTC has a strict recapture provision. Many investors are so concerned about recapture that they choose to make investments based on the level of recapture risk. Because real estate investments carry less risk of recapture, investors gravitate toward them. Perhaps by easing NMTC restrictions to reduce recapture concerns, the appeal of real estate investments would be reduced. Several recommendations are provided below.

Allow the Recapture Amount to "Burn off" Over Time

One mechanism for reducing recapture penalties would be to allow the recapture amount to "burn off" over time. Under current policies, if investors face recapture, they must forfeit not only the right to claim future tax credits on an investment, but they must return all the tax credits they claimed from the investment, plus a penalty fee and interest. So if a project is in compliance until the seventh year, when the investment falls out of compliance, the investor must pay back all the credits, including the credits claimed while the investment was in compliance. The recapture policy in place for the Low Income Housing Tax Credit (LIHTC) Program is less severe in this way. Rather than seven years, like the NMTC, the LIHTC compliance period is fifteen years. However, starting in the eleventh year, the amount of recapture liability begins to "burn off," so that during years 11–15, fewer and fewer tax credits will have to be repaid if a project falls out of compliance (Recapitalization Advisors, Inc. 2002).

A "burn-off" model might work for the NMTC, too. The value of the credit is 5 percent of the QEI in the first three tax years and 6 percent of the QEI in the remaining four years. So, for example, after year 4, the recapture amount could start to be phased down, perhaps to 2 percent or 3 percent for the first three years, rather than the full 5 percent. An even more drastic change would be to allow for a full "burn off" of used tax credits. In other words, if a recapture event arose, investors would lose the ability to claim any remaining years' credits but would not be required to pay back credits claimed in past years.

The "burn off" provision would reduce the severity of recapture for all investments, but it would particularly help reduce the current bias against reinvestment (interview with Michael Novogradac). The current, severe recapture provisions have led investors to favor large, long-term investments (like real estate projects), so that they will not have to reinvest capital in the initial seven-year compliance period, which would involve underwriting new projects. The "burn off" model would reduce the risk investors face if they are in compliance with an initial investment, but fall out of compliance on a later investment made with the same QEI.

In order to incorporate a "burn-off" provision in the NMTC, Congress would have to revise the NMTC statute. It seems unlikely that Congress would support a full "burn off" of the tax credit, and anything less than that would probably have only marginal impact. Investors would still be dissuaded from making smaller investments and QLICIs in projects that could somehow fall out of compliance.

Allow Short-Term Investments

Another option would be to reduce the seven-year compliance period for certain types of investments that need shorter investment terms. For example, venture capitalists tend to make investments that are only two or three years in length; these investors often need the flexibility to withdraw equity and sell a company at an opportune time. Being forced to wait seven years to redeem an investment or reinvest capital is a hardship for venture capitalists. Since their investments tend to be smaller and less focused on real estate, venture capitalists tend to make business operations investments to finance start-ups, working capital, and research and development. Making the program friendlier to venture capitalists could increase investment in operating businesses.

The Community Development Venture Capital Alliance has lobbied for various changes to the NMTC, such as allowing for short-term investments. A solution it has proposed is a provision for venture capitalists to make short-term investments in businesses and receive a truncated tax credit (Armistead 2005). So, for example, if an investment lasts only three years, the investor could claim the tax credit in years 1 through 3 (for a total of 15 percent of the QEI), and the credits claimed would not be subject to recapture. This would be similar to a full "burn off" of the tax credit, but this provision could potentially be limited to business equity investments in order to target investments for operating businesses. Congress would have to amend the NMTC statute to create such a provision.

Broaden the Reasonable Expectations Test

Finally, broadening the reasonable expectations test may also reduce the risk and complexity of making business operations investments. Investment due diligence can be extremely complicated and expensive for many business operations projects. In fact, transaction costs can be so high that smaller projects may not even be worthwhile. One way to mitigate these circumstances would be to broaden the safe harbor of the reasonable expectations test (interview with Frank Altman). Recall that the reasonable expectations test, if passed, provides a safeguard for investors against recapture if a QALICB falls out of compliance. So long as investors can prove they had a "reasonable expectation" that the QALICB would stay in compliance, they can avoid recapture.

Providing proof of this reasonable expectation can be complicated, and the rules issued by the IRS are not always clear. This has resulted in anxiety among investors and a significant reliance on third-party consulting, legal, and accounting services to investigate investments and provide due diligence. Expanding the types of evidence that can be used to prove reasonable expectations would help. For example, if a QALICB signs a seven-year lease in a low-income community, this should be sufficient evidence that it intends to stay in the community during the compliance period (interview with Frank Altman). Furthermore, at this time it is unclear how much protection the reasonable expectations test offers to investors if the QALICBs in which they invest start performing nonqualified services. It would be helpful for the IRS to give specific guidance on how investors should protect themselves when making investments.

Simplifying the reasonable expectations test in this way would cut down on transaction costs and make some projects on the margin of profitability, feasible. The benefits of broadening the safe harbor of the reasonable expectations test would likely benefit all investors and CDEs, but particularly those making investments in non-real estate projects. While this change could result in the issuance of a greater number of small-business loans, it is unlikely to make venture capital investments sufficiently profitable to induce a critical mass of investors to invest through the program (interview with Michael Novogradac). The IRS would have to change the recapture restrictions to make this possible. The IRS periodically changes restrictions and requests comments from industry stakeholders.

Change the Allocation Process

Another way to encourage investments in businesses for operations financing would be to reward CDEs that commit to making such investments. Each year the CDFI Fund conducts a competition for awarding tax credit allocations to CDEs. Each CDE applies for allocations and receives a score from independent readers, as described in Section One. Perhaps the CDFI Fund could use the competitive allocation process to steer CDEs toward investments in business operations, or even more broadly, toward operating businesses in general, regardless of whether the QLICIs are made in real estate, working capital, equipment purchases, or other uses.

Award Additional Points for Commitment to Investing in Operating Businesses

The CDFI Fund could target investments in business by awarding CDEs more points in the allocation process if they commit to making a certain percentage of their investments in operating businesses. In 2007 the CDFI Fund developed a system for targeting allocations to CDEs that serve nonmetropolitan areas. The New Markets Tax Credit Coalition suggested the allocation of "priority points" to reward qualified CDEs with strong track records of making investments in nonmetropolitan communities (Rapoza 2007). Although this change was not implemented, the concept could be used for targeting CDEs that make investments in operating businesses.

Unfortunately, there are several challenges and potential unintended consequences of this type of policy change. Most significant, it would be difficult to decide the number of additional priority points a CDE would be awarded for committing to make investments in operating businesses. Awarding too few points would have little or no effect on CDE investment behavior, while awarding too many points could actually tip the balance too far toward business investments (interview with Michael Novogradac). In addition, assigning additional points to CDEs could be seen as further complicating an already complex allocation system. Finally, since the NMTC statute does not clearly indicate that operating business investments are preferable to investments in businesses like real estate developers, CDEs may see it as unfair (interview with Michael Johnson and Deborah Dubin).

Create Separate Application Pools for CDEs

One way of avoiding the difficult decision of how many priority points to award to CDEs would be to establish instead two separate application pools–one for CDEs making real estate investments and one for CDEs making investments in operating businesses (interview with Michael Novogradac). CDEs wishing to use allocations to make both types of investments could apply to both pools. This model would be similar to the process used to allocate credits in the 2007 allocation round to CDEs planning to invest in the Gulf Opportunity Zone (Rapoza 2007).

One difficulty with this plan is that it is unclear whether investments in operating businesses for the purpose of acquiring or rehabilitating real estate would belong in the real estate applicant pool or in the operating business pool. Also, industry stakeholders have resisted efforts to separate the applicants into pools for other purposes. The New Markets Tax Credit Coalition urged the CDFI Fund not to establish separate allocation pools for the purpose of targeting investments in nonmetropolitan areas (Rapoza 2007).

Change the Value of the Tax Credit

Since a concern about non-real estate investments is that they are not profitable enough to lure investors, another option to target investments in operating businesses would be to increase the subsidy for these types of investments. The value of the tax credit is currently 39 percent of the amount invested (the QEI), with the value of the credit spread over seven years. Perhaps the value of the credit could be increased for investments made in non-real estate businesses. A tax credit value of 60 percent to 70 percent may be a sufficient additional subsidy to make more business operations investments possible (interview with Michael Johnson and Deborah Dubin).

Although several of the CDEs interviewed for this paper saw this option as attractive, it comes with significant implementation problems. First, if the amount of tax credits allocated is not increased at the same time, the change may make CDEs even less likely to invest in operating businesses since they would have to use a greater portion of their tax credit allocation to do so. Second, though expanding the credit while increasing its value for operating business investments may help with this problem, both changes would have to be made by Congress. This would be difficult, since the program not only has not been permanently extended, but expanding it and increasing the value of the credit for some types of investments would cost the federal government more money in foregone tax revenue. Third, just as with allocating additional points to CDEs committing to making operating business investments, it would be difficult to know how much to change the tax credit value. And finally, as with several other policy alternatives, increasing the value of the tax credit would give a clear preference to business operations lending, which may or may not be justified given Congress's vague goals in creating the NMTC statute.

Expand Data Collection

Part of the difficulty in gauging the effects of the real estate tilt stems from the fact that there is little information on the types of tenants that occupy real estate developments financed with the help of New Markets Tax Credits. Tenants range from homeless shelters to PetSmart stores (Swibel 2004). Many CDEs making real estate investments require their borrowers, either explicitly or implicitly, to provide special concessions to their tenants, such as lower rents or guaranteed space for social service organizations (interview with Zachary Boyers). However, no one knows if this behavior is typical of CDEs, and without this information it is hard to determine the community impacts of QLICIs made in real estate QALICBs.

The CDFI Fund uses its Community Investment Impact System (CIIS) to monitor investments. Each year, CDEs must complete a report for the CDFI Fund detailing the characteristics of each outstanding

QLICI. The data for each QLICI are updated throughout the seven-year compliance period. The CDFI Fund requires data such as the location of the project, the number of jobs the project is expected to create, the purpose of the QLICI, and characteristics of the borrower. CIIS data do not include information on tenants, whether commercial or residential, that lease space in NMTC real estate developments. Furthermore, there is no measure of how much rent tenants pay or any types of benefits they receive from the developer. Some CDEs volunteer this type of data already, but this happens rarely and the information they include is often vague and incomplete.

The CDFI Fund could require additional data-points in the annual CIIS report to measure the characteristics of tenants. This policy change would not have a direct effect on the dominance of real estate projects, but it would provide the CDFI Fund with much-needed data to help analyze the impacts of real estate projects and come closer to understanding if the NMTC program is subsidizing the most needed types of developments in low-income communities.

Many CDEs, particularly those making QLICIs in real estate QALICBs, would likely oppose this expansion of data collection. CDEs already feel burdened by completing the annual CIIS report, and in the interviews conducted for this paper several noted that each change in the data requirements means they must redesign their record-keeping methods and begin collecting new data from their investors and borrowers. These inconveniences could result in higher administrative costs, which the CDEs would pass on to borrowers in the form of higher fees.

Let Present Trends Continue

A final option is to make no changes to the NMTC program and let present trends continue. Maybe there is no need to change the system, or maybe it would be best to wait until the program receives a long-term extension before making such changes. Several CDEs interviewed felt that no changes are necessary, that investors have been more willing to consider non-real estate investments as the program has aged and as they have become more familiar with it. However, data on the types of investments made over time, shown in Figure 8, seem to indicate otherwise.

Investors are beginning to trust that CDEs will be able to find additional projects in which to redeploy capital if investments are returned in the initial seven-year compliance period, which could increase their willingness to make non-real estate investments. Other stakeholders have expressed that there are other programs better suited to small-business lending, and that it is not necessary to tweak the NMTC program to make these investments occur with greater frequency in low-income areas.

Conclusion and Considerations for Policy Change

Changing some aspects of the New Markets Tax Credit program could help it better serve low-income communities. Financing for operating expenses is hard to come by, especially in low-income communities. Without access to capital, new and expanding businesses are unlikely to thrive. Although the NMTC is supposed to close the investment gap between low-income and affluent communities, a good case can be made for retooling the program to encourage lending and equity investments in operating businesses.

Ultimately, however, the decision of whether or not to change the NMTC program to encourage more business investment is a political one. The vague statute and unclear legislative intent make it difficult to establish a firm case for changing policy to favor business operations. Additionally, some types of real estate are crucial to low-income communities and businesses, particularly real estate investments in operating businesses. These investments allow existing businesses either to expand or relocate their operations, and the data suggest they are more likely to benefit underrepresented groups of entrepreneurs than other types of NMTC investments. Because of this, if any policy change is to be made, great care should be taken to ensure that operating businesses will not find themselves at a disadvantage.

The greatest concern for the program at present is its long-term extension and expansion. Many stakeholders are worried that no more credits will be allocated when the program expires after this year, since Congress has not yet chosen to extend it to future years. Others are equally concerned that if the program is to have a substantial effect, the amount of annual tax credit allocations will need to be increased.

While issues like the real estate tilt may currently take second priority to the program's reauthorization, they need to be addressed while the long-term future of the program is being debated in order to ensure that the goals of the program are realized. Controversial issues in the program should be investigated and policy options should be proposed. The NMTC program is innovative and already is having an impact on low-income communities, and it makes the program appear even stronger if it can be changed slightly to have greater community impact.

In addition to the real estate tilt, other important questions deserve to be investigated. For instance, are geographic areas being served equally by the NMTC program? How are underrepresented groups of entrepreneurs benefiting from the program? And finally, how is the program contributing to job creation in low-income communities? The intentions of the program to help provide capital to low-income areas are important and the investment that the program has already spurred has been significant, but to fully achieve the potential of the program, the failures as well as the successes need to be understood.

Appendix I — Additional Tables and Figures

Figure A: ***Number of QLICIs Made in Each State***

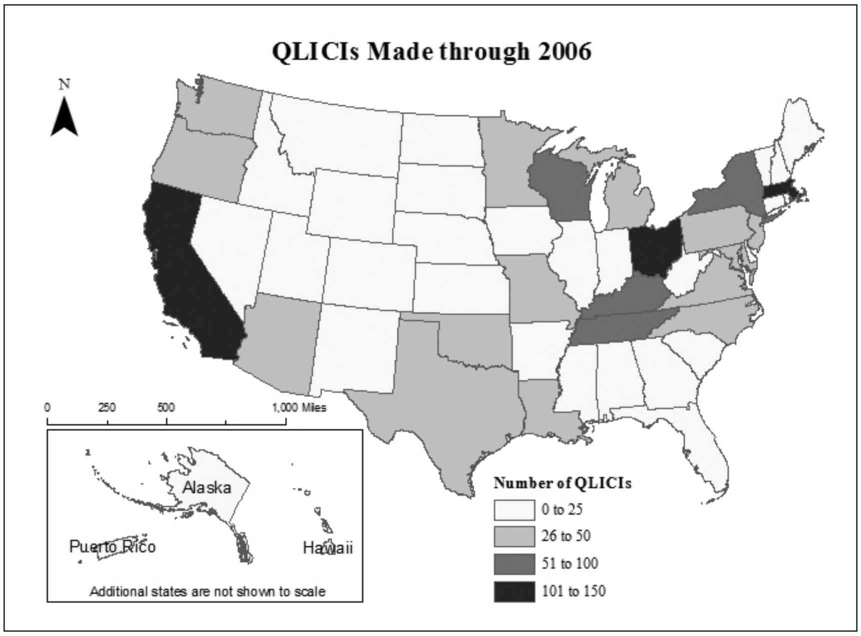


Figure B: ***Value of QLICIs Made in Each State***

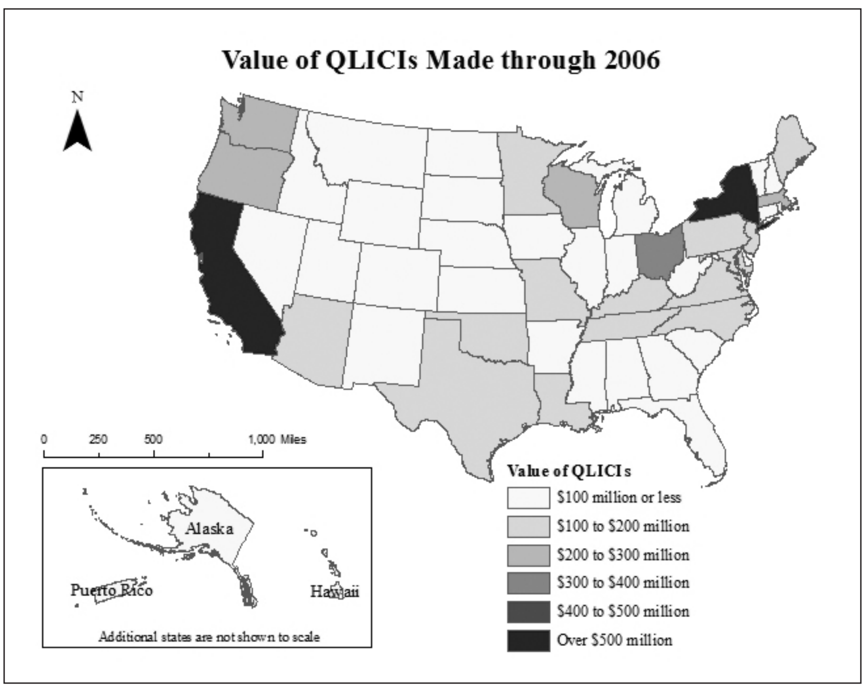


Table 15: *Summary of Policy Options*

Entity Responsible for Policy Change

Congress	IRS	CDFI Fund	None

Goal	Policy Option	Entity
Easing Restrictions and Recapture Penalties	***Allow Credit Recapture Amount to "Burn-Off" over Time*** How it would combat the issue: Reduce fear of recapture among investors, increase willingness of investors to reinvest capital in multiple projects and underwrite new projects, Challenges to Implementation: Convincing Congress it would be a revenue neutral (or revenue positive) policy change, choosing the right degree of "burn off" to be effective Potential Unintended Consequences: If too aggressive, it may discourage long-term investments in favor of making a "quick buck" through short-term investments	Congress
Easing Restrictions and Recapture Penalties	***Allow Short-Term Investments with Truncated Tax Credits*** How it would combat the issue: Allow venture capitalists and other investors to make short term loans and equity investments without fear of recapture Challenges to Implementation: Convincing Congress to adopt the change Potential Unintended Consequences: Could discourage long-term investments, though those projects may still be more profitable than short-term QLICIs, since the whole credit could be claimed over 7 years	Congress
Easing Restrictions and Recapture Penalties	***Broaden Reasonable Expectations Test*** How it would combat the issue: Lower the transaction costs for underwriting small investments Challenges to Implementation: Could be seen as weakening standards for compliance Potential Unintended Consequences: Could increase noncompliance, though this seems unlikely	IRS
Change the Allocation Process	***Award Additional Points in Allocation Process for Commitment to Business Investments*** How it would combat the issue: Encourages the use of the tax credit for business operations expenses Challenges to Implementation: Hard to find correct balance of points to award; "how much to reward business loans?" is a normative question Potential Unintended Consequences: Could tip balance in wrong direction; could cause animosity between CDEs; could reward CDEs that do not perform as well as others	CDFI Fund
Change the Allocation Process	***Create Separate Application Pools for Business and Real Estate Allocations*** How it would combat the issue: Allocates a portion of tax credits to subsidize small business finance Challenges to Implementation: Concept has been controversial among industry leaders; "how much real estate is too much?" is a normative question Potential Unintended Consequences: Could tip balance in wrong direction; could reward CDEs that do not perform as well as others, simply because they pledge to finance business operations	CDFI Fund

Table 15: *Summary of Policy Options (continued)*

Entity Responsible for Policy Change

Congress	IRS	CDFI Fund	None

Goal	Policy Option
Change the Value of the Credit	***Increase the Value of the Credit for Business Investments*** How it would combat the issue: Increases the amount of federal subsidy for business projects Challenges to Implementation: Difficult to find the appropriate amount for the credit; could lead to greater fiscal uncertainty; change would need Congressional support Potential Unintended Consequences: Could results in too much business investment at the expense of real estate or could even have the opposite effect- leading CDEs away from business deals if they must use more of their allocation amount per dollar invested
Expand Data Collection	***Collect Data on Tenants of Real Estate Projects*** How it would combat the issue: Require CDEs making QLICIs in real estate QALICBs for development projects to report data on tenants of real estate projects and the factors like decreased rent and guaranteed space in annual CIIS report; unlikely to produce a direct effect, but would help the CDFI Fund identify the community impacts of real estate projects. Challenges to Implementation: CDEs may strongly oppose it, since they already find it burdensome to report CIIS data and are particularly unhappy when the CDFI Fund changes the data it requests. Potential Unintended Consequences: Could increase transaction costs and result in higher fees to borrowers, though this would likely be minor
No Policy Change	***Let Present Trends Continue*** How it would combat the issue: No change, allow the program to run its course Challenges to Implementation: None Potential Unintended Consequences: Will likely allow real estate to dominate investments

Interview Acknowledgments

Frank Altman, *Community Reinvestment Fund and National New Markets Tax Credit Fund*

Zachary Boyers, *U.S. Bancorp*

Douglas Bystry, *Clearinghouse CDFI*

Richard Campbell, *Enterprise Corporation of the Delta*

Deborah Dubin, *Advantage Capital Partners*

David Erickson, *Federal Reserve Bank of San Francisco*

Alison Feighan, *Rapoza Associates*

Connie Freeman, *Oak Hill Banks CDC*

Paul Handleman, *Internal Revenue Service*

Howie Hodges, *Zions Bank*

Michael Johnson, *Advantage Capital Partners*

Matt Josephs, *U.S. Treasury, CDFI Fund*

David Latona, *Milwaukee Economic Development Corporation*

Tracy Luber, *Milwaukee Economic Development Corporation*

Brenda McDaniel, *Southern Appalachian Fund*

Michael Novogradac, *Novogradac & Company LLP*

Matthew Reilein, *JPMorgan Chase*

Julia Sass Rubin, *Rutgers–The State University of New Jersey*

Kerwin Tesdell, *Community Development Venture Capital Alliance*

Marc Vigo, *U.S.Treasury CDFI Fund*

Summary of Community Development Entities (CDEs) Interviewed

For-Profit | Mission-Driven

Advantage Capital Community Development Fund, LLC (Advantage Capital Partners)
Successful Allocation Rounds: 2002, 2005, 2006, 2007 — Total Allocations: $258,000,000
Institution Type: Venture Capital Fund — Areas Served: AL, LA, MS
Predominant Community Types: Urban — Predominant Financing Activities: Business Financing

Chase New Markets Corporation (JPMorgan Chase & Co.)
Successful Allocation Rounds: 2006, 2007 — Total Allocations: $300,000,000
Institution Type: Depository Institution — Areas Served: National
Predominant Community Types: Urban — Predominant Financing Activities: Real Estate Financing

Clearinghouse CDFI
Successful Allocation Rounds: 2002, 2005, 2006 — Total Allocations: $168,000,000
Institution Type: Loan Fund — Areas Served: California
Predominant Community Types: Urban — Predominant Financing Activities: Real Estate Financing

Enterprise Corporation of the Delta
Successful Allocation Rounds: 2002, 2006 — Total Allocations: $30,000,000
Institution Type: Loan Fund — Areas Served: AR, LA, MS, TN
Predominant Community Types: Urban — Predominant Financing Activities: Business Financing

Milwaukee Economic Development Corporation
Successful Allocation Rounds: 2005 — Total Allocations: $18,000,000
Institution Type: Loan Fund — Areas Served: WI
Predominant Community Types: Urban — Predominant Financing Activities: Business Financing

National New Market Tax Credit Fund, Inc. (Community Reinvestment Fund)
Successful Allocation Rounds: 2002, 2005, 2006 — Total Allocations: $168,000,000
Institution Type: Loan Fund — Areas Served: National
Predominant Community Types: Urban — Predominant Financing Activities: Loan Purchase from Other CDEs

Oak Hill Banks Community Development Corporation (Oak Hill Banks)
Successful Allocation Rounds: 2003, 2007 — Total Allocations: $60,000,000
Institution Type: Bank of Thrift — Areas Served: Ohio
Predominant Community Types: Rural — Predominant Financing Activities: Business Financing

Southern Appalachian Fund, LP (Kentucky Highlands Investment Corporation)
Successful Allocation Rounds: 2003 — Total Allocations: $2,000,000
Institution Type: Venture Capital Fund — Areas Served: AL, GA, KY, MS, TN
Predominant Community Types: Urban — Predominant Financing Activities: Business Financing

US Bancorp
Successful Allocation Rounds: 2006, 2007 — Total Allocations: $260,000,000
Institution Type: Loan Fund — Areas Served: National
Predominant Community Types: Urban — Predominant Financing Activities: Real Estate Financing

Zions Community Investment Corp. (Zions Bank)
Successful Allocation Rounds: 2003, 2007 — Total Allocations: $100,000,000
Institution Type: Loan Fund — Areas Served: AZ, CA, CO, ID, NV, OR, UT
Predominant Community Types: Urban — Predominant Financing Activities: Business Financing

Sources: CDFI Fund Searchable Award Database, http://www.cdfifund.gov/awardees/db/index.asp

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