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Enhancing New Markets Tax Credit Pipeline Flow: Maintaining a Continuous Deal Flow In Spite of Funding Gaps and Market Volatility

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The Community Affairs Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing a Working Papers Series. For submission guidelines and themes of upcoming papers, visit our website: www.frbsf.org/cdinvestments. You may also contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 215, San Francisco, California, 94105-1530. (415) 974-3467, David.Erickson@sf.frb.org.

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Case Study Acknowledgments [Appendix C]

The New Markets Tax Credit case studies formed the core of the thesis that I presented as part of my requirements for my Master of Science in Urban Planning at Columbia University. I would like to acknowledge Paul Brophy, Tracey Bryan, Chip Buttner, Tracy Ericson, Mark Hess, Patrick Sullivan, and Christa Velazquez for allowing me to interview them in the course of researching these case studies. I would also like to thank my readers, Dr. David Erickson, manager of the Center for Community Development Investments at the San Francisco Federal Reserve Bank, and Dr. Lynne Sagalyn, Professor of Real Estate at Columbia Business School. I am also indebted to my thesis advisor, Dr. Robert Beauregard, Chair of the Urban Planning Program at the Graduate School of Architecture, Planning, and Preservation at Columbia University.

Executive Summary

The New Markets Tax Credit (NMTC) is a relatively new and powerful tool for community development. Congress authorized $26 billion worth of credits between 2002 and 2009. There is a strong likelihood that it will authorize an additional $5 billion in NMTCs in 2010 and then again in 2011 (U.S. Treasury 2010). This large-scale program has attracted considerable industry and academic attention and the Government Accountability Office (GAO) has reviewed the program four times. However, the extreme market volatility and pipeline challenges caused by the recession provide an opportunity to evaluate the NMTC program from a new perspective.[1]

A survey by the Center for Community Development Investments of the Federal Reserve Bank of San Francisco in early 2010 yielded valuable insight from 53 NMTC stakeholders about their pipeline and market strategies [see Part II]. Respondents' NMTC pipelines outperformed their non-NMTC investments. Surprisingly, respondents increased their concentration in real estate activities during the recession and are assuming more risk now than they had before the recession began. These survey findings are consistent with three qualitative case studies that I developed as part of my spring 2010 Master's thesis on NMTC stakeholders' participation in neighborhood change projects (see Appendix C).

These NMTC stakeholders also affirmed their adherence to the original intent of the program: to attract market-rate investors to qualifying projects in low-income communities that would have locally controlled community benefits.[2] They use the leverage of NMTCs, local knowledge and social networks, and diverse coalitions of private, public, nonprofit, and grassroots organizations to source deals and build their NMTC pipelines. In particular, stakeholders use their cost-of-capital advantages derived from using NMTCs to push these community-benefiting projects past the funding tipping point. NMTCs have been making it possible for stakeholders to overcome financing gaps and keep projects in motion, despite severe credit market challenges.

The NMTC program's success is underscored by respondents' continued participation over several years and the repeat business from their clients that continue to use NMTC to fill capital gaps. At the same time, however, challenges persist, such as the falling value of the credits (GAO 2010: 23) and the transactional costs of executing–and exiting–NMTC investments (GAO 2010: 28).

Survey responses indicate that among Community Development Entities (CDEs) that have participated in NMTC in the past, interest in the 2010 NMTC allocation round has declined. This could result in an oversupply of credits and a further decline in their value. Congress and the Treasury Department, which administers the NMTC program, have begun a formal evaluation to determine how to boost demand and correct this imbalance. There are plans to enact some changes this year (2010), such as expanding the categories of tax offsets from NMTCs to include the Alternative Minimum Tax (AMT), which would bring wealthy individual investors into the NMTC marketplace (U.S. Treasury 2010).

In Part III, I offer recommendations for improvements to the NMTC program that draw on the survey responses and the NMTC literature. The most important recommendation is that Congress permanently authorize NMTC, as the perennial uncertainty surrounding the program's renewal reduces the supply of potential investors and may be a contributing factor in the declining value of the credits. Congress should also consider additional measures that would boost the supply of eligible investments and investor demand for NMTCs. These could include a re-evaluation of the definition of poverty, which would make more low-income communities eligible for investment; allowing NMTCs to offset the AMT; and creating an NMTC product with a shorter, more liquid holding period.

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1 In authorizing the NMTC Program, Congress mandated that GAO review the program four times. GAO has published *New Markets Tax Credit: Status of Implementation and Issues Related to GAO's Mandated Reports (2002), New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance (2004), New Markets Tax Credit: Minority Entities Are Less Successful in Obtaining Awards Than Non-Minority Entities (2009),* and *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified (2010).*GAO has also published *Tax Policy: New Markets Tax Credits Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance (2007).*

2 The NMTC program's intentions and outcomes are reviewed in Part I: The New Markets Tax Credit Program. For additional information, see Armistead (2005), and Rubin and Stankewiecz (2005).

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Part I: The New Markes Tax Credts Program

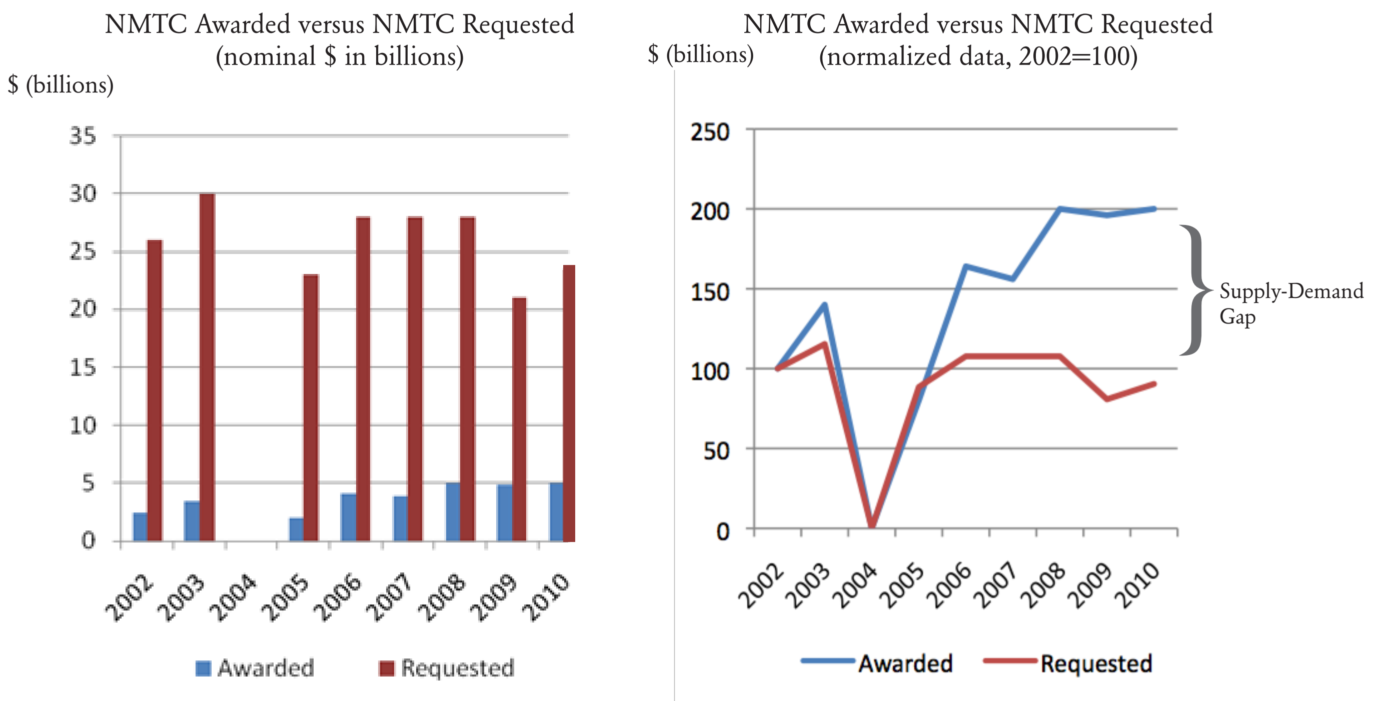
Background on the New Markets Tax Credit Program

Scale of the New Markets Tax Credit Program Investment

Between 2002 and 2009, the U.S. Congress authorized $26 billion worth of New Markets Tax Credits (NMTCs), and the U.S. Treasury Department anticipates congressional authorization of an additional $5 billion in 2010.[1] The volume of NMTCs has escalated rapidly, as can be seen in Figure 1, from a first-year allocation of $2.5 billion in 2002 to an annual allocation of nearly $5 billion in 2008, 2009, and 2010 (projected). There was no allocation in 2004.[2]

The Treasury Department reports that demand for NMTCs has greatly outstripped supply during each allocation round. When supply and demand data is normalized, however, supply has grown at a much faster rate than demand since 2005. The result is a widening gap in the marketplace's interest in NMTC, which hints at the possibility of market saturation. The Treasury Department's proposed program reforms have implicitly acknowledged this gap, as have analysis from the Government Accountability Office (GAO), and responses to the industry survey conducted by the San Francisco Federal Reserve to support this report (Gambrell 2009; GAO 2010; U.S. Treasury 2010).

Figure 1. NMTC Awards and CDE Demand



Sources: U.S. Treasury Dept. CDFI Historical Awards Database; NMTCC 2008:4; CDFI Fund June 9, 2010

There is no definitive figure on the amount of private investment that the NMTC has leveraged, but the New

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1 Competitive applications for the 2010 Round were due by June 4th (CDFI Fund June 9, 2010).

2 The chart on the left depicts the volume of NMTCs requested versus the amount that were allocated. This healthy demand contrasts with the chart on the right, where I have normalized the demand versus supply of NMTCs. For the chart on the right, demand and supply volumes were set equal to 100 for the year 2002. While, in real dollar terms, demand far exceeds supply as shown on the left, at the same time the relative increase in demand is not keeping up with the increased volume of credits offered by the Treasury Department.

Markets Tax Credit Coalition, the largest industry group, estimates that every $1 of NMTCs has raised an additional $1.12 in investment (NMTCC 2010: 17). In practice, NMTCs are nearly always leveraged with sources of public money as well as additional tax credits in a practice known as "twinning." This can result in even more significant public financing at the project level.

NMTCs have been awarded in every state, Puerto Rico, and the U.S. dependencies. Through 2008, California received $1.2 billion in NMTC investment, representing nearly 10 percent of total dollars and 12 percent of projects. New York, Louisiana, Massachusetts, and Ohio round out the top five recipients, whereas the District of Columbia, Rhode Island, Louisiana, Maine, and Massachusetts have the highest per capita totals.[3] Metropolitan areas have received more than 90 percent of NMTC awards, but the Community Development Financial Institutions (CDFI) Fund is now attempting to channel 20 percent toward rural areas (GAO 2010: 10).

Community Development Context

The United States has a history of financial disinvestment in poor communities, many of them communities of color. Federal Reserve Board Chairman Ben Bernanke recently described this history and its consequences in a 2007 speech commemorating the passage of the Community Reinvestment Act (CRA) of 1977. Fueled by racial tension and the rapid expansion of the suburbs, he said, many poor communities became isolated from mainstream social networks and labor markets, contributing to chronic multigenerational poverty. "Redlining," or explicit lender discrimination against certain communities, exacerbated the isolation. Redlining limited residents' opportunities to obtain mortgages, access credit for personal or business use, or accumulate wealth through savings and investments (Bernanke 2007). Many academic researchers and economists have interpreted long-term institutional disinvestment in poor communities as a market failure, most likely due to an asymmetry of information between the capital markets and investment targets about potential returns on investments in the communities that were being neglected (Caskey and Hollister 2001).

Many lenders claimed that the practice of avoiding certain communities was due to the risk of investing, and that their portfolios would be less competitive (and their losses greater) than those of other banks if they lent in these communities. Congress passed CRA to compel banks to reinvest in poor communities where banks accepted deposits, partly in exchange for the guarantee of government insurance on those deposits (Bernanke 2007).

To address this lack of access to essential financial services and credit, the federal government has experimented with a number of interventions during the past several decades. Many of these attempts have been met with criticism, however, such as a lack of community involvement and influence in projects, the types of companies that were attracted and the nature of the jobs that were created (Johnson 1995).

Against prevailing capital market and corporate sentiment, Michael Porter in 1994 argued that many disinvested communities represented lost opportunities for private profit. In particular, Porter honed in on the advantageous locations near central business districts and freeways of many of these poor communities, the availability of inexpensive labor, and the high population densities that represented enough aggregate purchasing power to rival less-densely populated but more affluent communities. Essentially, Porter proposed a variant of the market failure theory for these communities but advocated that outside capital forces intervene in them (Porter 1994).

Several urban planning theorists and practitioners directly rebutted Porter's strategy of attracting externally-directed investment to low-income communities. In particular, James Johnson (1995) claimed that Porter overlooked the value of social networks and social capital for allocating resources in poor communities. Johnson was joined by Susan Fainstein (1995), who also argued that the people who live and work in these communities are in the best position to know how capital should be invested, both for profit and social impact. Porter's hypothesis led to a vigorous debate over alternative causes and solutions for resolving a chronic lack of resources and opportunities for poor communities with renewed attention on the need for government intervention, and the importance of social networks, grassroots-based organizations, and local development corporations (Fainstein 1995; Johnson 1995).

In fact, many organizations aimed at local capacity development had arisen to address the investment void, capitalizing on their local knowledge, community networks, and social capital. In particular, Community Development

3 Congress authorized supplemental NMTC awards for Louisiana and adjacent areas as part of the federal relief effort following Hurricane Katrina.

Corporations (CDCs) were emerging as housing developers, owners and operators of community facilities, and social service providers (Gittell 1990; NCCED 1999). The rise of local CDCs was also part of a larger movement toward public-private partnerships to support neighborhood revitalization, economic development, and social service delivery. In the 1970s, local public-private partnership revitalization projects began to take the place of top-down, government investment in at-risk communities (Schultze 1977).

The public-private strategy expanded the resources available to governments by leveraging the expertise and capital of the private sector to achieve public policy and planning intentions. In addition, this involvement made the private sector a stakeholder, often with an equity incentive, in the success of revitalization efforts. Research on public-private partnerships operating in low-income communities has documented significantly more negotiation among roles, financial returns, and community benefits than would be anticipated by involving for-profit interests (Sagalyn 2007).

A new wave of financial institutions with social impact missions also began to invest profitably in poorer communities. These institutions began with pioneers such as ShoreBank in Chicago. In 1994, Congress passed the Community Development Financial Institutions (CDFI) Act to support these new institutions. They were locally controlled organizations that pooled public, nonprofit, and financial institution funding sources. The CRA, revised in 1995, created incentives for for-profit financial institutions to invest in these CDFIs. By definition, CDFIs focused on community development goals and, as a result, would accept lower financial returns and a higher level of risk (Caskey and Hollister 2001).

Legislative Intent of New Markets Tax Credits

As dissatisfaction with purely public solutions and redistributive policies grew throughout the late 1990s and third-way models (neither purely public nor purely private) began to gain traction, President Clinton and his economic policy team sought a novel solution in New Markets Tax Credits (NMTC) that would engage capital investors and empower the residents of poor communities with some local control over how capital would be invested (Phillips 2000; Rubin and Stankiewicz 2005). The Clinton team coined the phrase “new markets” to describe the poor urban, suburban, and rural communities that are the targets of the program, with investment channeled to projects that would have desirable community impacts, such as workforce development, job creation, business incubation, entrepreneurial growth, nonprofit expansion, blight removal, and the provision of needed services such as medical care (Armistead 2005).

The Clinton administration and Congress intended that the NMTC program would wed the capital markets with local community-based organizations, now referred to as Community Development Entities (CDEs) (Clinton 2000). These local organizations would deploy this capital to achieve fair investor returns and the maximum social benefit in underinvested communities, with full resident participation in determining how this would be achieved (Rubin and Stankiewicz 2005). These organizations, many of which are CDCs and CDFIs, invest in eligible projects in qualifying communities as determined by poverty and economic development measures at the census tract level. Currently, 39 percent of U.S. census tracts, home to 36 percent of the population, qualify for NMTCs (GAO 2010: 8). This strategy provides the CDE with leverage over the selection and development of qualifying projects.

In 2000, Congress passed the Community Renewal Tax Relief Act. The act stipulated $15 billion in allocation authority and authorized the NMTC program through 2007. Congress has reauthorized the program four times. It added a supplemental $1 billion of NMTCs as one of many investment tools in response to the devastation caused by Hurricane Katrina. As part of the federal response to the “Great Recession,” Congress added another $3 billion in NMTCs to the American Recovery and Reinvestment Act (ARRA), with half awarded retroactively to 2008 applicants that had not received an allocation during the first round (GAO 2010: 3). At this time, the CDFI Fund and the Obama administration anticipate that Congress will authorize $5 billion in NMTCs for 2010 and another $5 billion for 2011 (Gambrell 2009; U.S. Treasury 2010).

To attract private capital, investors receive federal corporate tax breaks that provide a low-risk minimum return and augment the returns that community-benefiting projects might return to equity investors. As described in a 2002 speech by former CDFI Fund director Tony Brown, NMTCs were expected to harness “patient capital” (Brown 2002). Because many investors are financial institutions, the purchase of NMTCs also helps them to fulfill their CRA obligations. The low-risk return by way of NMTC federal tax offsets–equal to 39 percent of the total equity

investment in a community-based organization, but which can be significantly higher owing to leverage—can be modeled as a fixed-income return to the investor.[4]

Depending on the structure of the deal, investors can also realize capital gains on the difference between the purchase price and redemption value of the credits, fees, interest, principal recapture if the project investment is a loan, or equity upside if the project investment is an equity stake. In the event that the financial institution records an annual loss, the tax offset can be carried back retroactively for one year or forward for up to 20 years (GAO 2010: 6). To further enhance investor returns and raise necessary capital, many NMTC-backed projects also incorporate other sources of subsidized public and nonprofit capital, which brings these additional funders into the coalitions as stakeholders (MHIC 2006:2,18,22,27; Travois New Markets LLC 2006:5,19).

The uncertainty surrounding the perennial renewal of the NMTC creates pipeline and investor risks. There is also investor risk associated with CDE default on the investment, CDE bankruptcy, or an IRS finding of NMTC ineligibility for the CDE's project investments. This risk is somewhat mitigated, however, by investment loss provisions in the tax code, IRS allowance for the redeployment of the NMTC, and IRS cure provisions for projects that fail NMTC eligibility tests (Novogradac 2010:3-5). The IRS ensures compliance with investment requirements.

Not only do NMTCs require the participation of multiple parties—investors and community-based organizations—but the spirit of the program has led to the development of large public-private coalitions. This is consistent with third-way options that gained in popularity during the Clinton administration (Erickson 2009). In particular, large redevelopment initiatives that are supported by NMTCs have united capital investors, community-based organizations, foundations, service delivery providers, grassroots and neighborhood organizations, public agencies, and elected officials (Armistead 2005).

Many types of projects are eligible for NMTCs. For-rent housing is the single greatest exception, as this can account for no more than 80 percent of any qualifying project. As a result, projects that do have large rental residential components devote at least 20 percent of their total value or square footage to community centers, charter schools, ground-floor retail, or mixed-use development (CDFI Fund website 2010). The framers of the NMTC had intended that investments would be channeled into business development, health and social services, community facilities, and real estate activities. A strong bias or "real estate tilt" has developed, however, with estimates that at least 65 percent of program dollars have financed real estate activities (Armistead 2005; Lambie-Hanson 2008: 21).

The NMTC program provides a great deal of flexibility in defining community benefits. Even from the beginning, the open-ended legislative intent led the CDFI Fund to solicit ideas from measuring impact from potential investors and prospective NMTC participants. In a 2002 address to the Community Development Venture Capital Alliance, former CDFI Fund Director Tony Brown stated: "we will need your assistance and cooperation in helping us design a process that will measure impact and sustainable economic growth from the funds you raise using NMTCs" (Brown 2002).

New Markets Tax Credit Program Implementation

Although Congress authorizes NMTC, the U.S. Treasury Department allocates the credits to community-based organizations. The CDFI Fund within the Treasury Department awards NMTCs through a competitive allocation process. According to Brown, Treasury Secretary Paul O'Neill "made creating jobs and improving living standards of people everywhere the standard by which to measure the impact Community Development Entities and Community Development Financial Institution have in the marketplace" (Brown 2004).

The CDFI Fund will only award NMTCs to a prequalified CDE. All CDFIs are automatically prequalified. Other organizations, including many Community Development Corporations, apply to be certified as CDEs. The CDFI Fund considers a number of factors during the certification process, including mission, financial capacity, resources, development track record, and social impacts in poor communities. Both for-profit and nonprofit CDEs can compete for NMTCs, but only for-profit CDEs can make equity investments in projects. As a result, many nonprofit CDEs spin off a wholly-owned, special-purpose CDE for NMTC (CDFI 2010a; GAO 2010: 5).

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4 The tax credit offsets are 5 percent of the total equity investment in years 1 through 3, and 6 percent in years 4 through 7.

Although there are more than 3,204 CDEs, the majority of the 396 NMTC awards have been concentrated among just a few incumbents (CDFI Fund 2010d). Many CDEs are wholly controlled by NMTC investors, such as banks or quasi-public development entities. A nonprofit CDE can also form a for-profit, special-purpose CDE in the event of a CDFI Fund award (GAO 2010: 5). Community Development Entities have specialized according to economic development, community benefit, investment criteria, and geographic scope. One of the consequences of this specialization is that a more limited CDE has less portfolio diversity and is more exposed to concentrated market risks.

The U.S. Department of the Treasury's process for distributing NMTC awards is complex. The NMTC applications require both quantitative and qualitative responses from CDEs regarding overall business strategy; portfolio performance; governance, community relationships; the use and rate of return of past NMTC allocations, including additional investment leveraged with NMTC awards; temporary and permanent jobs created; types of businesses attracted or created; community benefits attributed to past projects; projects that are in the investment pipeline; and the anticipated use of any new NMTC awards (CDFI Fund 2010a). In 2009, the CDFI Fund added a question to promote efforts to limit gentrification (CDFI Fund 2009).

Panels of evaluators with experience in business, real estate, or community development finance evaluate and rank the applications. Following this qualifying round, CDFI Fund staff determine the size of the NMTC allocation, if any, that it will award to each CDE. The allocation is based on the staff's estimation of the CDE's capacity to sell the credits to investors, the strength of the CDE's project pipeline, and the likelihood for rapid and successful deployment of the credits (GAO 2010: 6-8). After the CDFI Fund makes its awards, it provides to CDEs the written feedback and application score with the intention that this will assist CDEs in preparing stronger future applications (CDFI Fund 2010a).

Many industry representatives, the GAO, and critics have charged that the application and award process is lengthy, complex, and opaque. The awards process is based on subjective evaluations by community development and financial experts recruited by CDFI. Their evaluations are based on CDE's self-reported data and analysis for financial returns and community benefits, which are not standardized or synthesized in a prescribed manner.[5] The evaluations are not made available to the general public nor are they independently audited. Furthermore, the CDFI Fund does not keep follow-up data on failed or incomplete projects, which means that data cannot be used to shape future allocation decision making (GAO 2004, 2010).

Researchers have argued that the evaluation process favors NMTC applications that project higher returns on investment; present larger and less complex, "one-shot" projects; result in rapid and less thoughtful deployment of NMTC; and include backing from proven, well-funded banks. This may unintentionally penalize NMTC applications for projects with greater community benefits or those that are sponsored by smaller community-based financial institutions (Armistead 2005). Furthermore, the process contains opportunities to inconsistently apply standards that may result in a process bias favoring financial returns over community benefits (Rubin and Stankiewicz 2005).

Tax Credits and Community Investment

Federal, state, and local governments use tax credits extensively to support investments that are intended to promote the common good. Examples of successful programs include the Low Income Housing Tax Credit, Historic Tax Credit, Historic Rehabilitation Tax Credit, and Renewable Energy Tax Credits, to name a few. Several state governments have set up their own version of the NMTC program, so that it is possible for a project to qualify for both federal and state credits. Tax credits represent a loss of tax revenue to the government. As a result, the public value of these lost revenues must be carefully addressed (Howard 1997), albeit for the purpose of addressing a social need that is neglected by the market.

The social value of the credits derives from the authorizing legislation's requirement to invest "substantially all" of the proceeds from the sale of NMTCs into qualifying investments in low-income communities.[6] The net dollar value of NMTCs to communities is difficult to quantify, however. The CDFI Fund does not collect data on the amount that investors pay for the credits, which can be substantially less than face value. Investors do pay taxes on

5 The CDFI Fund requires CDEs to report the impact of their investment targets through the Community Investment Impact System (CIIS).

6 According to the "substantially all" test, the CDE must invest 85 percent in years 1 through 6 and 75 percent in year 7, by individual project or aggregate gross assets of the CDE.

the capital gains on earnings during the seven-year holding period and on the return on equity. The GAO (2010: 21) estimates that 50 to 65 percent of the tax offsets claimed by the investors remain as equity in businesses in low-income communities at the end of the holding period.

The investor's return depends largely on whether the investment is debt or equity, the amount of public subsidy that is part of the total qualified investment, and whether additional leverage is employed (see appendix B).[7] An NMTC return on debt can be as low as a net present value of 6 percent annually, and a return on equity can be as high as a net present value of 39 percent annually. By definition, for-profit and nonprofit CDFIs accept below-market returns as a tradeoff for furthering community development goals (Caskey and Hollister 2001). The levered or unlevered structure of the investment and the hurdle rate for investor returns (the investor's minimum required return) profoundly affects the social impact of the investment. The structure of the investment also plays a large role in the amount of subsidy available to further social impact and community benefits. For example, if part of the investment is forgivable debt, the investor passes through NMTC cost-of-capital benefits to subsidize the project or the end-users (such as a nonprofit tenant) (see the case studies in appendix C for more examples of investment scenarios).

There is inherent investor risk in NMTCs as a result of compliance and holding periods, transaction costs, and duration uncertainty in timing the redemption of credits according to corporate profits. NMTCs have been criticized for their complexity, which has fueled high legal, closing, and exit costs. For example, the related-party test prevents a CDE from controlling more than 50 percent of a business in which it makes a qualifying investment.[8] At closing, CDEs must also obtain a legal opinion that loans to qualifying businesses in low-income communities represent "true debt" that is not yielding an equity return. The cost of this legal opinion adds another layer of complexity to the investor's exit (GAO 2010: 19, 31). With the volatility of the market, and particularly the recent severe recession, many financial institutions had losses. As a result, they had to bank the credits for the future, reducing the credits' net present value.

While the real risk level has remained steady, the average expected rate of return for investors has declined, according to a 2007 GAO evaluation. In 2003, investors expected a rate of return of 8.2 percent, but by 2007, the expected rate of return had dropped to 6.8 percent. GAO hypothesized that this decline could stem from greater comfort and familiarity with the program, resulting in lower perceived risk that led investors to reduce their risk premium on these investments. Furthermore, more investors entered the NMTC marketplace, fueling more competitive pricing and reducing the spread. This greater comfort with the program came about even as the legal and transactional structures of NMTC investments grew more complicated. Another important contributing factor to the declining rate of return was investors' growing certainty that Congress would renew the program. At the outset of the program, potential investors reacted negatively to the uncertainty surrounding the program's reauthorization, demanding a higher risk premium that corresponded to a higher rate of return (GAO 2007: 27).

Because, as noted, demand for NMTCs consistently outstrips supply, credit prices should stabilize at a consistently high value. According to the GAO, however, investors appear to be paying less for tax credits than in previous years and they made fewer investments in NMTCs in 2009 than in previous years. In addition, investment by CDEs dropped from approximately $3.25 billion in 2008 to approximately $2.5 billion in 2009 (GAO 2010: i). This could result in a higher implied rate of return for investors if the spread increases between the net present value of the tax credit offset and the purchase price of the credits.

Given that investors have historically purchased the tax credits at 75 to 80 cents on the dollar, the value of the subsidy for achieving projects in the public good is immediately reduced by 20 to 25 percent. It appears that they may sell for as little as 50 cents on the dollar in 2010, if the trend of declining values continues (GAO 2010: 23). If a full $5 billion of credits are allocated, the potential immediate loss in the subsidy value would be at least $2.5 billion for low-income communities. The government's loss of revenue could be fairly long-term as investors in the credits can carry back the offset one year or forward for up to 20 years. A mitigating factor, however, is that corporate profits are generally correlated to government tax receipts, concentrating any tax revenue losses due to NMTCs in years when tax revenues are strong.

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7 Invested funds in a special-purpose entity can be combined with funds from a leveraged lender, and this larger total comprises the qualifying investment in the CDE. As a result, the investor can claim the larger qualified equity investment as an offset against corporate taxes, effectively multiplying the investment yield (Travois New Markets 2006; GAO 2010).

8 The New Markets Tax Credit Coalition has targeted the related-party test for repeal owing to the complexity and transaction costs it adds to NMTC deals (NMTCC 2008).

Assessing the Impact of New Markets Tax Credits

NMTCs are critical to pushing many projects over the funding tipping point. According to GAO, NMTCs are often used for "gap financing," at an average 36 percent of total project costs. (The CDFI Fund and the NMTC industry estimate the gap to be more akin to between 20 and 30 percent.) Approximately 85 percent of NMTCs are deployed as term loans (GAO 2010: 14). Community Development Entities have invested 65 percent of NMTCs in real estate projects, nearly all of which are commercial and mixed-use real estate development and rehabilitation. Community Development Entities have invested another 22 percent in businesses development in low-income communities (Lambie-Hanson 2008: 22). Partnership projects and projects sponsored by for-profit CDEs have a much greater "real estate tilt," while nonprofit CDEs are more likely to sponsor non-real-estate projects (57.5 percent) (GAO 2010: 13).

Stakeholders, oversight agencies, and academics have identified potential weaknesses in the NMTC program. One weakness is a possible excessive return for a private investor at the expense of meaningful community benefits. In addition, the awards allocation process may be biased toward more profit-driven organizations and deals that project (but do not necessarily deliver) the highest financial returns (Rubin and Stankiewicz 2005). Awards may also be unintentionally racially biased. According to the GAO, minority applicants are often less likely to win an NMTC allocation because minority control is often associated with smaller financial institutions or institutions with higher operating costs (GAO 2009: 7-8). Past awards have shown a bias toward commercial real estate development, which often results in fewer jobs, and those jobs have tended to pay less than other NMTC-backed projects. Also, NMTC projects may be applied to deals that would have occurred regardless of the subsidy. Another potential weakness is that the self-reported economic impact analysis of NMTC-backed projects may be methodologically flawed, so that a fair ranking among NMTC applicants may not be possible, potentially resulting in an award to a less-competitive project. Finally, the complexity of the program may be limiting its overall impact, and the application process may inherently favor for-profits over nonprofits and public entities (Armistead 2005; GAO 2010).

That NMTC-backed investments may have happened regardless of the NMTC represents one of the program's greatest challenges. The GAO has referred to this as a "but for" test in its evaluations. However, as their report notes: "limitations with available data make it difficult to isolate project impacts and GAO's analysis does not allow it to determine whether the projects supported by NMTC would have taken place absent the credit" (GAO 2010: i). Isolating the impact of NMTCs from other factors influencing business growth, job creation, or asset appreciation is extremely difficult. This difficulty is also an issue with development-focused financial institutions in general, as there is no standardized methodology for doing so (Lawlor and Nicholls 2008; Caskey and Hollister 2001).

Despite the complexity of the process and the issues surrounding the awards process and their allocation, many have heralded the NMTC as a success. In 2008, the Harvard Kennedy School of Government named the NMTC to a list of the 50 most important innovations in American government (Harvard Kennedy School 2009). In addition, the popular and industry press, academic researchers, and organizations representing the CDFI industry, such as the New Markets Tax Credit Coalition (NMTCC), have compiled numerous success stories that they attribute to NMTC. In fact, the NMTCC has compiled binders of press clippings that number in the hundreds of pages (NMTCC website 2009).

The use of the NMTC provides a lower cost-of-capital for projects, which can nudge them over the tipping point toward feasibility. The NMTC has successfully attracted the interest of the private capital markets (Chamberlain 2006). The GAO finds that individual and corporate NMTC investors shifted some of their investments from higher-income to lower-income communities as a result of the NMTC (GAO 2007: 34-37). Many NMTC deal structures allow advantageous financing and, as such, support higher community impacts. Although 85 percent of NMTCs are used for term loans, the credits are also used as debt with equity features or revolving lines of credit. Transactions can be structured with forgivable debt or paid-in equity, grants or subsidies, waived fees, capitalized interest, and other favorable terms that support the CDE's target investments. It is also possible to refinance NMTC loans with new NMTC loans if there are material changes in the original investment (GAO 2010: 14-16).

Proposed Reforms Under Consideration

The CDFI Fund is currently evaluating potential changes to the application and award process. It recently completed a public scoping process and will soon oversee an independent survey to CDEs. The Urban Institute will conduct the survey and develop the case studies, with a report due in 2011 (GAO 2010: 32). Secretary of the Treasury Timothy Geithner and CDFI Fund Director Donna Gambrell have also mentioned several possible changes in recent speeches (Geithner 2010; Gambrell 2009).

NMTCs are never purchased at face value, which further enhances the NMTC investor's return. The recent decline to 50 cents on the dollar in the NMTCs value, as noted above, could be a cyclical response to the recession or a structural problem owing to the enormous increase in the supply of NMTCs. In response to falling prices, the Obama administration is seeking ways to expand the pool of potential investors through additional incentives or an expansion of potential qualified investments (Gambrell 2009).

The Treasury Department is also advocating using the NMTC to offset the Alternative Minimum Tax (AMT), potentially attracting high net worth private investors to the marketplace. This AMT offset is already used to encourage investment in Low Income Housing Tax Credits and Historic Rehabilitation Credits. Although such an offset would lower federal tax revenues, any increase in the purchase price of the NMTC would result in a higher portion of invested dollars and more assets retained in low-income communities (GAO 2010: 24).

One major change that the CDFI Fund anticipates in 2010 would allow CDEs to apply the "related-party" rule before, rather than after, making an investment. The related-party rule is intended to prevent a CDE from investing in a captive low-income community business in which it has a 50 percent or greater ownership stake. By applying the rule before the investment, a CDE could make a much larger investment without violating the rule (Gambrell 2009).

Part II: Survey Insights into the NMTC Pipeline and Volatile Market Conditions

Introduction

With the goal of better understanding the current strategies of NMTCs in a time of market uncertainty, the San Francisco Federal Reserve's Center for Community Development Investments administered the NMTC survey at the beginning of 2010. Of the 53 NMTC stakeholders who responded, all were CDEs. The survey sought to answer the research question, "What project pipeline development strategies have NMTC participants used to maintain a continuous deal flow, in spite of funding gaps and market volatility?"

For the respondents, the NMTC pipeline has outperformed alternative investments during the recession and accounts for a growing share of assets, revenue, and human resources. Community Development Entities' investments continue to favor real estate, and this reliance is growing. Community Development Entities also devise their own methods of measuring community benefits, which influences their award allocations and the likelihood of receiving future allocations. Their success in meeting political and community interests appears to be correlated with their ability to source deals and additional public funds to keep their pipelines full.

NMTC investments are supporting a pipeline that can better withstand funding challenges and tremendous market volatility than alternative investments. The majority of the pipeline is sourced internally and from community-based relationships as well as larger revitalization and planning initiatives. Furthermore, this increasing commitment to NMTC demonstrates that the respondents have faith in future financial and community-building returns from continued participation in the program.

One of the most notable survey findings was that the CDEs that responded are nevertheless anticipating a pull-back in NMTC participation in the 2010 round, just as Congress is intending to pump another $5 billion worth of NMTCs into the community development and tax credit marketplace. With such a decline in interest in the face of growing supply, there is a possibility that the value of the credits will decline, possibly to as low as 50 cents on the dollar (GAO 2010: 28-29). To ensure that the full $5 billion is deployed, the CDFI Fund may be forced to make NMTC awards to projects that have lower underwriting quality or social impact.

When the price of NMTCs dips, CDEs must aggressively seek out supplemental capital to shore up project financing, or begin cutting the community benefits portion of projects that would have been subsidized if NMTCs were commanding a higher value. Most CDEs use the NMTC-subsidized capital to reduce financing costs in projects they believe will have a high social impact in impoverished communities. The reality is that although NMTCs constitute an important part of the capital stack for projects, CDEs are relying heavily on additional sources of public and nonprofit subsidies to fill the rest of their projects' financing gaps and leverage greater debt borrowing. (See appendix C for examples of project capital stacks that combine multiple funding sources.)

On June 9, the CDFI Fund reported strong demand in response to the call for 2010 applications, which would seem to contradict the survey's findings. It remains to be seen if this reflects many new entrants to the field, as opposed to the incumbents that participated in the survey. Furthermore, the awards are based on CDE interest and do not necessarily reflect investor interest in purchasing NMTC.

Research Design

Given the real estate tilt of the NMTC program and the impact of the recession on the national real estate market, learning more about how NMTC participants are managing in this crisis is of great importance. The current project therefore explores the strategies that NMTC participants are using to maintain a continuous flow of deals through their pipeline, despite funding gaps and market volatility.

Data Sources

Working in cooperation and close coordination with the San Francisco Federal Reserve Bank's Center for Community Development Investments (CCDI), we determined there was no existing data source that would yield insights as valuable and timely as those we could gain from launching our own survey. Researchers and the GAO have also raised concerns about the CDFI Fund's award and analysis methods, data collection standards, and lack of audits and follow-up evaluations (GAO 2007, 2010). Industry groups such as the New Markets Tax Credit Coalition (NMTCC) and Opportunity Finance Network (OFN) survey their members and produce public reports, but, again, we were seeking more detailed information about pipeline performance and the strategies that CDEs employ to overcome project financing challenges and market volatility.

On the basis of a review of previous research and secondary documents, as well as my own experience at a community bank assembling NMTC application and project data, I drafted the original survey instrument in late November 2009. David Erickson and Ian Galloway of CCDI reviewed the draft and made suggestions to improve clarity and response rates. We also reached out to Linda Davenport of the NMTCC and Donna Fabiani of the OFN to provide additional review. In addition to their current professional roles, both Davenport and Fabiani have extensive experience working with the CDFI Fund and the Department of the Treasury on NMTC and other community development tools. They provided additional suggestions to strengthen the survey. The final survey instrument is found in appendix E.

Wherever possible, the survey intent and results have been cross-referenced with secondary documents and research. Secondary documents include academic papers investigating NMTC, the extensive community development and public-private partnership urban planning and policy literature, and coverage in the industry and popular press. Additional research sources include the four congressionally mandated GAO investigations over the past six years, as well as findings that have been published by the CDFI Fund and academic researchers.

Implementation

We launched the survey in mid-January 2010. I administered the survey electronically using off-the-shelf, third-party software. We developed the mailing list using the email addresses listed in the CDFI Fund's historical awards database, as well as CCDI's proprietary community investment mailing list.

We had intended to initially keep the survey open for only two weeks, but extended the deadline twice owing to back-to-back severe winter storms in the mid-Atlantic and Northeast that kept many potential respondents out of the office for a few weeks. CCDI sent email reminders to the mailing list every two weeks and, ultimately, we kept the survey open for five weeks.

Survey Findings

Response Rate

Fifty-three NMTC participants responded to the online survey. The classification of the respondents is shown in Table 1. Nearly all (98.1 percent) self-identified as CDEs, and one self-identified as a CDFI, which is categorically prequalified as a CDE. This is to be expected as the core of the mailing list was made up of CDEs. Respondents also chose secondary self-identifying labels. Nonprofit CDEs, CDFIs, banks, for-profit mission-based organizations, Qualified Low-Income Community Businesses (QALICBs), consultants, and leveraged lenders were well represented.

Table 1. NMTC Participant Survey Respondents Secondary Self-Identifying Labels (N = 53)

Role	Percent	Count
Nonprofit	21.2%	11
CDFI	15.4	8
Bank	9.6	5
For-Profit Mission-Based Organization	7.7	4
QALICB*	5.8	3
Consultant	5.7	3
Leverage Lender**	5.7	3
CDFI Intermediary	1.9	1
Venture Fund	1.9	1
Mission-Based Depository Bank	1.9	1
Industry Group**	1.9	1
Real Estate Service Provider*	1.9	1

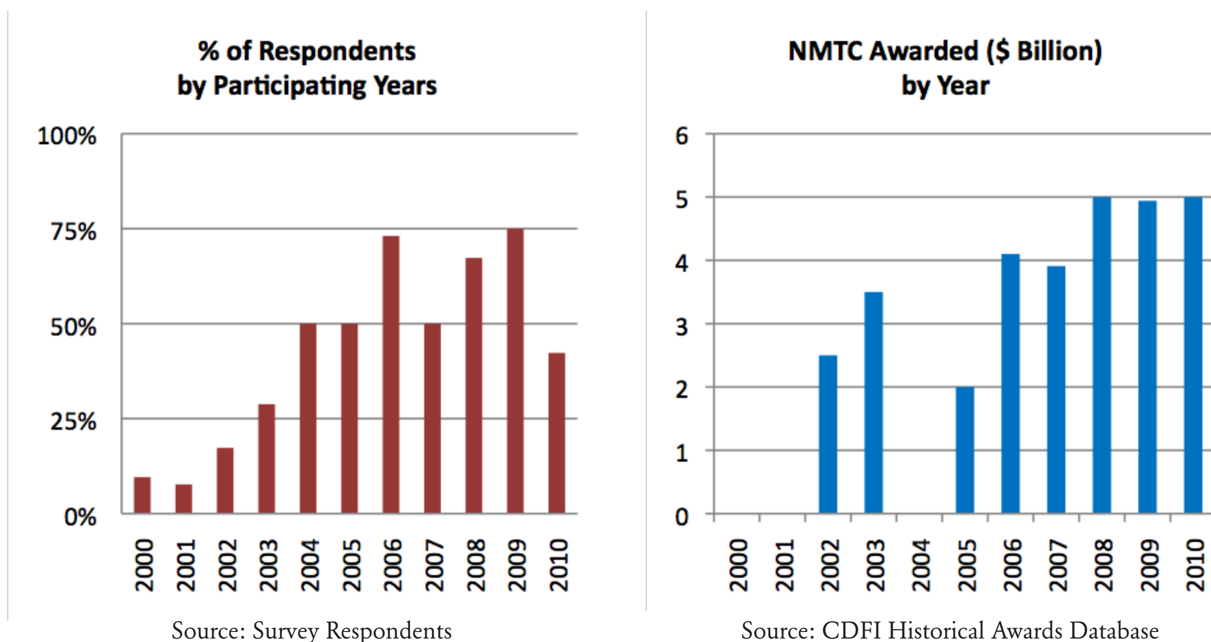
*Qualified Active Low-Income Community Business, as defined by the CDFI Fund

**Write-in self-identification choices provided by the survey respondents

Participation in the NMTC Program

Survey respondents demonstrated a long-term involvement in the NMTC program, with at least 50 percent participating each year beginning in 2004, but a lower predicted participation rate for 2010 (see Figure 2). Participation accelerated between the inception of the program and 2006. This reflects several factors, including a learning curve for the NMTC program, the strong performance by incumbents who gained early experience in the program, the growing availability of NMTCs, and the cultivation of a deal pipeline that made it easier to qualify for follow-on awards. Community Development Entities and investors also became more comfortable with the NMTC as it became more established and seemed less likely to expire. The following survey question about sourcing deals highlights the importance of repeat clients and referrals, which is a likely factor in the growth in participation rates over time.

Figure 2. Participation Rates in NMTC versus Total Awards



Source: Survey Respondents

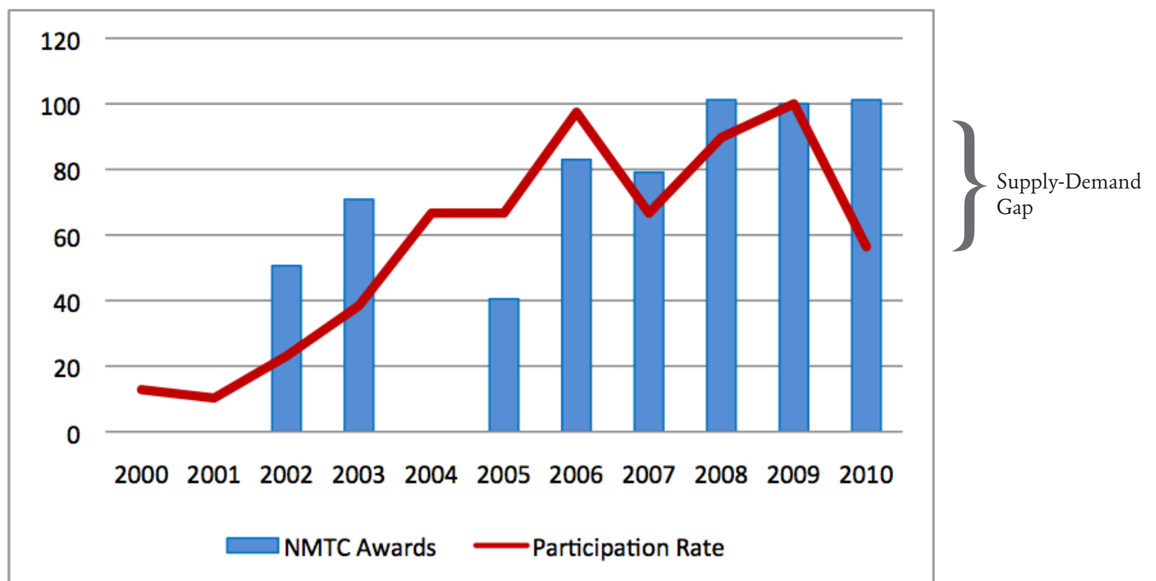
Source: CDFI Historical Awards Database

If the survey responses can be taken as a proxy for the NMTC industry as a whole, the decline in incumbent interest hints at a worrisome trend. Supply may be outpacing demand for NMTC. When the survey responses and the NMTC awards are normalized using 2009 figures, there is a disparity between the relative expected participation rates and availability, as shown in Figure 3. Community Development Entities that have received past awards may also foresee pipeline issues and, as a result, may choose not to participate in the 2010 round.

With this disparity between supply and demand, the value of the credits may continue to decline, a trend confirmed by a number of responses to a later survey question. Reforms are under consideration that could increase demand for the tax credits, however. In addition, investor demand may rebound as banks and financial institutions return to profitability and once again seek offsets to federal taxes on corporate profits.

There are also other possible responses to the supply-demand imbalance. There may be new entrants attracted to the increased capital gains made possible by cheap credits, or the CDFI Fund may lower the quality threshold for awards to CDEs. Community Development Entities, in turn, may lower their quality threshold for projects. Any of these responses could expose NMTC portfolios to greater underwriting risks, if cheaper capital chases more deals or underwriting standards become less stringent.

Figure 3. Relative Participation Rates versus Total Awards by Year (Normalized Data, 2009=100)



Sources: CDFI Historical Awards Database and Survey Respondents

Deal Sourcing

NMTC participants have developed a diverse set of pipeline sources for deals, but the majority source projects internally from board members, executives, or internal cultivation strategies (73.5 percent) or from the loan or underwriting department (38.8 percent), as shown in Table 2. Of respondents, 8.2 percent indicated that their deal sourcing has become more internally driven over time.

Additional important sources include repeat clients (53.1 percent), participation in larger revitalization or redevelopment efforts (46.9 percent), and relationships with public agencies (38.8 percent), grassroots organizations (34.7 percent), and membership organizations (30.6 percent from community development organizations and 20.4 percent from industry coalitions). CDFI intermediaries, executives who serve on other boards, and elected officials also contributed strongly to the pipeline.

Participation in public-private development coalitions has a strong positive impact on deal-sourcing. These include larger revitalization efforts (46.9 percent), public agencies (38.8 percent), grassroots organizations (34.7 percent), community development organizations such as Business Improvement Districts (30.6 percent), elected officials (12.2 percent), and religious institutions (8.2 percent).

These deal-sourcing responses highlight the importance of relationships, social networks, and community capital in building and maintaining the NMTC pipeline. Nearly one in five respondents (18.4 percent) stated that their deal-sourcing has become more externally driven over time. This is consistent with urban planning research that reinforces the importance of social networks in poorer urban neighborhoods (Johnson 1995). These findings also highlight the interconnectedness of the NMTC and community development industries, which is consistent with the network theory of gaining information and learning (Erickson 2009).

Table 2. Sourcing NMTC Deals (N = 49)

Source	Percent	Count
Internally: deals are sourced based on board members, executives, or internal cultivation strategies	73.5%	36
Repeat clients	53.1	26
Larger revitalization or redevelopment efforts	46.9	23
Internally: loan or underwriting department passes deals to us that do not qualify for traditional financing	38.8	19
Public agencies	38.8	19
Grassroots organizations	34.7	17
Community development membership organizations such as Business Improvement Districts	30.6	15
CDFI intermediaries	24.5	12
Industry coalitions	20.4	10
Executives who serve on other boards	14.3	7
Elected officials	12.2	6
Churches or other religious institutions	8.2	4
Consultants*	4.1	2
Direct community outreach*	4.1	2
Strategic partners*	4.1	2
Attorneys*	2.0	1
Developers bring deals directly*	2.0	1

*Write-in deal sourcing choices provided by the survey respondents

Funding Gaps and Fee-Driven Issues

Funding gaps and fee-driven issues affecting NMTC-backed projects have been widely noted and contribute to underwriting and execution risks that can compromise pipeline projects. Respondents were asked to rate the prevalence of these obstacles on a five-point scale. As shown in Table 3, funding gaps were more prevalent, with an average rating of 3.33, or between "generally" and "most of the time." Fee-driven issues were less prevalent, with an average rating of 2.14, or between "sometimes" and "generally."

Table 3. Prevalence of Funding Gaps and Fee-Driven Issues (N = 46)

	Very Rarely (1)	Sometimes (2)	Generally (3)	Most of the Time (4)	Every Project (5)	**Rating Average**	**Response Count**
Funding Gaps	2	10	14	11	9	3.33	46
Fee-Driven Issues	16	13	7	3	3	2.14	42

Twenty-three respondents also provided additional comments; the most common was the difficulty of accessing debt and leveraged lenders (nine responses). Transaction costs associated with the NMTC and the structure of CDEs received mention (three responses), as did insufficient equity, including owner equity contributions (two responses).

NMTC participants have developed strategic responses to funding gaps and fee-driven issues, as shown in Table 4. By far the most common response is to seek out additional sources of public subsidy (67.4 percent), followed by additional sources of private or foundation grant-based funding (41.9 percent). In a leveraged deal, this will increase the return on equity (ROE) to the investor and subsidize the cost-of-capital for the project.

NMTC participants frequently loosened their underwriting standards or restructured deals, potentially increasing their risk level but keeping the project as a performing credit. Many would allow a higher loan-to-value ratio (51.2 percent), find a new additional debt lender (37.2 percent), capitalize fees, which increases the loan amount or equity stake (34.9 percent), use a mezzanine loan (32.6 percent), allow longer amortization and interest-only periods (2.3 percent), or provide subordinated debt and equity (2.3 percent). Some NMTC participants would hedge their risk by using third-party credit enhancement (32.6 percent), requiring more collateral (23.3 percent), or seeking bond financing (20.9 percent).

NMTC participants also reduced their return by shrinking fees and spreads. They would waive standard fees (34.9 percent), reduce the loan payback spread (25.6 percent), or reduce the project ROI (4.7 percent).

Table 4. Strategic Responses to Funding Gaps and Fee-Driven Issues (N = 46)

Strategic Response	Percent	Count
Find public grant-based source of funding	67.4%	29
Allow higher Loan-to-Value	51.2	22
Find private or foundation source of grant-based funding	41.9	18
Find new debt lender	37.2	16
Waive standard fees	34.9	15
Capitalize fees or additional costs into debt or equity	34.9	15
Use mezzanine loan	32.6	14
Use third-party credit enhancement	32.6	14
Reduce loan payback spread	25.6	11
Client pledges additional collateral	23.3	10
Bond financing	20.9	9
Refinance outstanding debt for our clients to free up their cash flow	11.6	5
Reduce the project ROI	4.7	2
Longer amortizations and interest-only periods*	2.3	1
Provide subordinated debt and equity*	2.3	1
Find additional public subsidy* (for example, an SBA loan)	2.3	1

*Write-in strategic choices provided by the survey respondents

Statistical cross-tabs of funding gaps and fee-driven issues with later survey questions provided additional insight. This included the following findings:

- NMTC participants that "generally" encounter funding gaps and fee-driven issues are more than twice as likely to seek out public grant-based funding to support the project pipeline. This was also the most frequent response for those that encounter funding gaps "most of the time" or on "every project."
- The top-ranked portfolio categories prior to and during the recession to encounter funding gaps and fee-driven issues were: (1) real estate development, (2) pooled funds, (3) commercial development, and (4) nonprofit growth.
- NMTC participants that encountered funding gaps and fee-driven issues prioritized the reforms they favored as: (1) make NMTC a permanent program, (2) increase the annual NMTC allocation to $10 billion, (3) shorten the holding period for NMTC, (4) extend the carryback period up to five years for NMTC, and (5) make NMTC a "deeper tax" similar to LIHTC [Part III includes a discussion of this option].

Cost-of-Capital Advantages

The use of NMTC provides an advantageous cost-of-capital, often serving as "gap financing" and pushing projects over the funding tipping point. Of respondents, 42 answered this question, but seven had not been using NMTC prior to the start of the recession in December 2007. Later in the survey, respondents had a free-response opportunity to describe their use of cost-of-capital advantages during the recession. Responses are shown in Table 5.

The top responses reflected the real estate tilt of NMTC. NMTC participants used less expensive capital costs to reduce developer or project financing costs (91.4 percent), capitalize fees or pre-development funding (37.1 percent), and cover operating expenses (22.9 percent). Several NMTC participants increased the social impact of their projects by using pass-throughs to support nonprofits (20.0 percent). NMTC participants also capitalized separate loan funds (17.1 percent) or provided additional project equity (8.6 percent).

Table 5. Use of Cost-of-Capital Advantages due to NMTC Prior to the Recession (N = 35)

Use of Cost-of-Capital Advantages	Percent	Count
Reduced developer or project financing costs	91.4%	32
Capitalized fees or pre-development funding	37.1	13
Covered operating expenses	22.9	8
Used pass-throughs to support nonprofits	20.0	7
Capitalized a separate loan fund	17.1	6
Provided additional project equity*	8.6	3
Sized project so there was no excess capital*	2.9	1
Provided subordinated debt*	2.9	1
Capitalized gap equity*	2.9	1
Funded projects that would not have qualified*	2.9	1

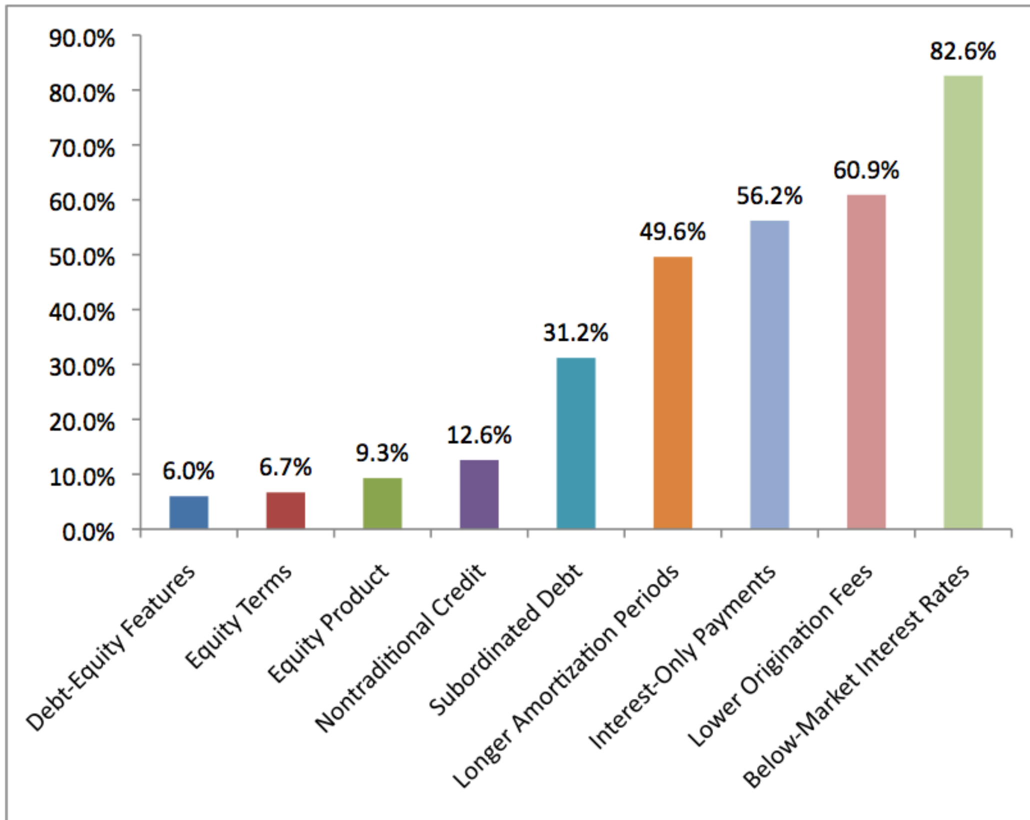
*Write-in use of cost-of-capital advantages choices provided by the survey respondents

Responses to a later free-response question illuminated the strategies that NMTC participants have been using during the recession. Thirty-three respondents concurred that NMTC provides a cost-of-capital advantage, while three responded that the question was not applicable to them. Five respondents used the below-market capital to provide additional equity (15 percent), five covered project funding gaps (15 percent), and two lowered debt service payments. One respondent forgave debt at the end of the seven-year holding period, one relaxed underwriting standards to allow a higher loan-to-value ratio, one passed through savings on the lower cost-of-capital to a nonprofit end-user, and one funded business expansion.

The survey also elicited additional commentary on the poor state of the NMTC capital market, one of the greatest threats to the NMTC project pipeline. Four respondents noted the challenging credit environment, one could not raise an investor fund in NMTC as it had done in the past and instead partnered with a major commercial bank community development corporation, and one sought nontraditional sources of capital investment. One respondent noted the declining value of NMTC, and another respondent noted the rising cost of conventional capital.

In general, the responses to the two survey questions were similar to GAO findings, as shown in Figure 4 (GAO 2010: 27). The GAO found that from 2003 to 2008, NMTC participants provided less expensive financing about 83 percent of the time, while our survey found that option had increased to 91 percent prior to the beginning of the recession. Survey respondents in both the GAO report and our survey most commonly relied on structural changes that relaxed the terms of the loans. Subordinated debt, nontraditional credit, equity, and debt with equity features were mentioned in both, but subordinated debt was much less common among our survey respondents. Equity injections and equity to cover project financing gaps seemed to grow during the recession, rising to approximately 15 percent of respondents.

Figure 4. Uses of Cost-of-Capital Advantages, FY 2003 to FY 2008



Source: GAO Analysis of CDFI Funds (GAO 2010: 27)

Debt and Equity Investment Strategy

Somewhat surprisingly, there has been a slight increase in higher-risk NMTC equity investment, despite the recession, although the average NMTC respondent still favors debt over equity instruments. This increase was also evident in the shift among survey respondents from using cost-of-capital advantages to an increased use of equity investments. On a five-point scale ranging from "primarily debt" (one point) to "primarily equity" (five points), forty respondents ranked themselves at an average of 1.65 before the recession and 1.95 after the recession, as shown in Table 6. Respondents on both the debt and equity side noted that the falling value of NMTC required them to source additional debt or equity in accordance with their overall debt-equity investment strategy.

It may be that the shift stems from a move away from subordinated debt to debt-with-equity features. As noted in the use of cost-of-capital advantages due to NMTC, more NMTC participants are using the less expensive capital and public or nonprofit capital sources to support higher leverage, and they are reserving the equity position in the capital stack for themselves.

Table 6. Debt and Equity Investment Strategy, Before and During the Recession (N = 45)

Time Period	Primarily Debt (1)	More Debt than Equity (2)	Equal Amounts of Debt and Equity (3)	More Equity than Debt (4)	Primarily Equity (5)	Rating Average	Response Count
Before the recession (prior to December 2007)	20	17	1	1	1	1.65	40
During the recession (from December 2007 to now)	17	19	3	3	2	1.95	44

Thirty-four of the NMTC participants provided write-in responses explaining how their debt-to-equity strategies have changed since the recession. (Three responded that the question did not apply to them, most likely because they had not been participating in NMTC prior to the recession.) Nineteen reported no change, and some noted the constraints of the related-party rule. Respondents also noted that lower NMTC value requires debt substitution (but not changed debt-equity proportions) from public sources to continue to make pipeline projects feasible.

Of the respondents who had changed their debt-equity strategy, the split was nearly equal between those seeking more debt and those seeking more equity. Of the eight that are seeking more debt, three were specifically seeking leveraged sources, and two were seeking public-private debt sources and credit enhancement. Two were seeking sponsors who would bring their own debt lenders to the capital structure. Of the seven seeking more equity, they were interested in lower leverage levels, lower loan-to-value ratios, and obtaining public equity subsidies. One respondent also noted the NMTC subsidy was producing less equity due to its lower price from investors.

Portfolio Allocation

As predicted by the well-documented real estate tilt of NMTC investments, the majority of CDEs primarily participated in real estate development and related activities before the recession, as shown in Table 7. In fact, 19 respondents (44 percent) weighted real estate at more than 75 percent of their portfolio, and 29 respondents (67 percent) weighted real estate at more than 50 percent. This tremendous exposure to real estate market volatility would have predicted a pullback from that sector as the recession deepened.

On the contrary, the weight of real estate development, and commercial development in particular, increased substantially during the recession, as shown in Table 8. By March 2010, 38 respondents were involved in real estate activities (84 percent), with 24 (53 percent) at a rate greater than 75 percent, and 26 (57 percent) at a rate greater than 50 percent. At the same time, the commercial real estate segment rose from the third-ranked allocation at 62 percent to second place at 71 percent. A large number of respondents also remained involved in mixed-use development with an inclusionary housing component, although the portfolio weight of that real estate segment remained relatively small.

Table 7. Portfolio Allocation Before the Recession (N = 43)

Ranked Portfolio Allocation before the Recession (Prior to December 2007)	**<25% (1)**	**25–50% (2)**	**50–75% (3)**	**75%+ (4)**	**Average Portfolio Weight of Participating Investor**	**Does Not Apply**	**Response Count**
1. Real estate development	5	6	4	19	3.09	7	41
2. Pooled funds	4	1	2	5	2.67	20	32
3. Commercial development	9	4	7	7	2.44	7	34
4. Venture funds	2	0	0	1	2.00	23	26
5. Nonprofit growth	10	2	5	1	1.83	12	30
6. Industrial or manufacturing expansion	13	2	2	1	1.50	10	28
7. Entrepreneurial or business incubation	8	2	0	1	1.45	17	28
8. Workforce development	8	0	0	1	1.33	16	25
9. Mixed-use development*	16	2	2	0	1.30	11	31
10. Blended-value projects	2	0	0	0	1.00	24	26

*Mixed-use development with inclusionary rental housing component

Non-real-estate activities were also well represented among NMTC participants' investment targets. Eighteen respondents invested in nonprofit growth prior to the recession and 19 during the recession (42 percent for both periods). The number of respondents investing in industrial or manufacturing expansion declined, with 18 investing prior to the recession and 16 during the recession (42 percent versus 36 percent). Entrepreneurial and business expansion investment also declined slightly, with 11 investing prior to the recession and 9 during. Open-ended responses to the question mentioned that NMTC participants also invested in health care operations before the recession and CDE to CDE lending and charter school expansion before and during the recession.

Table 8. Portfolio Allocation During the Recession (N = 45)

Ranked Portfolio Allocation During the Recession (From December 2007 to March 2009)	**<25% (1)**	**25–50% (2)**	**50–75% (3)**	**75%+ (4)**	**Average Portfolio Weight of Participating Investor**	**Does Not Apply**	**Response Count**
1. Real estate development	5	7	2	24	3.18	2	40
2. Commercial development	10	5	9	8	2.47	2	34
3. Pooled funds	2	3	0	2	2.29	17	24
4. Nonprofit growth	7	4	6	2	2.16	6	25
5. Workforce development	7	0	0	2	1.67	12	21
6. Industrial or manufacturing expansion	10	3	2	1	1.63	8	24
7. Entrepreneurial or business incubation	6	1	2	0	1.56	10	19
8. Mixed-use development*	15	2	3	1	1.52	7	28
9. Blended-value projects	2	1	0	0	1.33	18	21
10. Venture funds	3	0	0	0	1.00	17	20

*Mixed-use development with inclusionary rental housing component

Relative Importance and Performance of the NMTC Pipeline

The heavy weight of real estate investment in portfolios might suggest that NMTC pipeline investments have performed poorly compared with the non–NMTC pipeline during the recession. However, again, the contrary appears to be the case. As shown in Table 9, on a five-point scale of non–NMTC investments performing "much stronger" (one point) to NMTC investments performing "much stronger" (five points), the ranking shifted from investments (both non–NMTC and NMTC) performing about the same prior to the recession, to NMTC investments performing more strongly during the recession. In fact, the number of respondents choosing "non–NMTC: Stronger" dropped by more than one-half (from seven to three), and "non-NMTC and NMTC: about the same" by nearly one-half, from 16 to 9. "NMTC stronger" nearly doubled, from 8 to 14, and the number of respondents choosing "NMTC: much stronger" tripled, from two to six.

Even with the increasing concentration and tilt of real estate investments, NMTC portfolios with strong real estate components outperformed non-NMTC pipelines. This finding is particularly important given that survey respondents derive more than one-half of their revenues and assets from, and devote more than one-half of their human resources

to the NMTC pipeline (based on the 43 respondents to this question). In fact, several added to the open-ended response section that they are concentrating even more on the NMTC pipeline and hiring additional staff as a result. Since the recession began, 7 of the 43 respondents have increased their NMTC pipeline and 2 are new entrants.

Table 9. Pipeline Performance (N = 44)

Time Period	Non-NMTC Much Stronger (1)	Non-NMTC Stronger (2)	Non-NMTC and NMTC About the Same (3)	NMTC Stronger (4)	NMTC Much Stronger (5)	Rating Average	Does Not Apply	Total Count
Prior to the recession (before December 2007)	3	7	16	8	2	2.97	7	43
During the recession (from December 2007 to March 2009)	3	3	9	14	6	3.49	6	41

Statistical cross-tabs of the NMTC pipeline strength with other survey questions further illuminated funding gaps and the importance of proposed reforms. This resulted in the following additional findings:

- The top-ranked portfolio categories for the NMTC pipeline that were outperformining the non–NMTC pipeline prior to and during the recession were also those categories most likely to encounter funding gaps and fee-driven issues. Those categories were: (1) real estate development, (2) pooled funds, (3) commercial development, and (4) nonprofit growth.
- NMTC participants with a stronger NMTC pipeline ranked their top proposed program reforms as (1) make NMTC a permanent program, (2) shorten the NMTC holding period, and (3) extend the carryback period up to five years for NMTC offsets.

Community Benefits

NMTC participants seek community benefits as intended by the NMTC program. The perceived social return on NMTC investments is crucial to the CDE project pipeline. The competitive application for NMTC awards takes past achievements and future projections of community benefits into account, influencing the likelihood and size of future NMTC awards. Community benefits are broadly defined, but as shown in Table 10, survey respondents who answered the open-ended questions primarily focused on three main categories of benefits in impoverished census tracts. These are business and employment (92 percent), community services (30 percent), and real estate improvements (27 percent). Although there is a strong real estate tilt among respondents (84 percent participate in real estate activities), the community impacts that they seek are more focused on other community-building outcomes than just improvements to the physical environment.

Table 10: Community Impacts and Investments (N = 37; multiple responses possible)

Category	Count
Business and Employment	**34**
Job growth	29
New business growth	2
Job retention	1
Expand business capacity	1
Business attraction	1
Business retention	1
Community services	**11**
Health services	4
Education access	3
Job training	2
Child care	2
Homeless services	1
Hunger relief	1
Recreation facilities	1
Real estate improvements	**10**
Revitalization/blight	5
Affordable housing	2
Tax base growth	2
Commercial growth	1
Charter schools	1
Health care facilities	1
Enhance quality-of-life in low-income communities	2
Energy conservation	1
Asset growth	1
Poverty alleviation	1

Just as the targeted social return on investment varies among NMTC participants, so too do the measures of project outputs. As many participants attempt to address several social impacts at once, job growth may be a more prevalent response than it would have been in other years, owing to the current focus on job loss as a consequence of the recession. Table 11 presents a subjective sampling of metrics that NMTC participants employ to assess the impact of NMTC investments. As expected, there is considerable variation in the methods, use of subjective and objective measures, and level of post-project follow-up. In fact, several respondents explicitly noted that their measures were subjective.

Table 11. A Subjective Sampling of Metrics Used, drawn from 37 Respondents Only

"We measure by requiring QALICBs* to count and we observe and verify."
"[We] measure our project impacts by undertaking a detailed and comprehensive study to determine the true fiscal, economic, social/community and environmental impact."
"During construction, we seek to maximize and directly track construction jobs for all types of projects in which we invest (for-sale housing, commercial, mixed-use). After construction, we seek to maximize and directly track full-time retail and office jobs for the commercial and mixed-use projects in which we invest."

"We obtain jobs information on each project (existing and projected). Some impact is subjective (not measurable), such as evaluating the type of and strength of the business."

"We measure impacts using (i) staffing plans and projected operating budgets of specific projects; (ii) economic impact studies prepared for specific projects; (iii) formulas for estimating economic impact for specific industries found in national reports; for "spec" projects we use standard job creation measures used by our local redevelopment agency. To estimate indirect job creation from both permanent and construction jobs when there are no economic impact studies for specific projects, we use national studies and the BEA's RIMS II Input-Output Modeling System (RIMS II) which we obtain for each state in our service area. Where possible, detailed industry multipliers were used; if tenants were not yet identified, aggregate industry multipliers were used. (RIMS II is widely used to analyze economic impacts.) To estimate construction jobs, we used estimates provided by general contractors for specific projects."

"Do primarily charter school facilities and 330/Community Health Care facilities. Looking at number of new school seats added, low income patients served, construction jobs and permanent jobs increase."

*QALICB is an abbreviation used by the CDFI Fund for a Qualified Low-Income Community Business

Importantly, none of the respondents mentioned a "but-for" test, as described by GAO, to determine whether a project would have occurred without the use of NMTC, and no respondents noted a "no-action" alternative. As so many respondents focused on "job growth" and additional "growth," "attraction," and "retention" goals, the but-for test and no-action alternative should be a critical part of the methodology for determining the net gains in growth, attraction, and retention owing to NMTC-backed projects.

Analysis of Findings

New Markets Tax Credit Program in Action

Survey respondents are adhering to the legislative intent of the NMTC program, harnessing the capital markets to achieve community development in impoverished communities. The NMTC industry estimates the $26 billion in NMTC funding has leveraged an additional $1.12 in private investment for every NMTC dollar (NMTCC 2010: 17) and GAO has estimated a net present value of retained equity investment in low-income community entities of as much as 80 cents on each NMTC dollar (GAO 2010: 23). The real estate portfolio concentration of NMTC investments appears to be increasing, however, as 84 percent of respondents are involved in real estate activities, with more than half of those respondents said their real estate investments accounted for more than 75 percent of their portfolios.

Many of the respondents have participated in the NMTC program for multiple award years and have developed strong coalitions of investors, public agencies, nonprofits, and community-based organizations on projects, more than half of which are repeat projects. Community Development Entities are continuing to harness their social and community networks to source, develop, and implement deals, which matches the legislative intent for local control of capital investment. For every respondent, NMTCs accounted for more than 50 percent of the entity's revenues, assets, and human resources. Several noted that they would be hiring additional staff to address their NMTC projects.

NMTCs are being used as an investment tool, often pushing projects in low-income communities over the tipping point for financial feasibility. The credits are frequently twinned with other tax credits and subsidized with additional public and nonprofit funds to satisfy financing gaps, mitigate risk, and enhance investor returns so that the returns to investors are competitive with the capital markets. Most frequently, cost-of-capital advantages from NMTCs allow NMTC participants to offer lower developer or project financing costs (91.4 percent of the time).

Other important uses of the less expensive financing include capitalizing fees or predevelopment funding, covering operating expenses, using a pass-through to support a nonprofit end-user, capitalizing a separate loan fund, or providing additional project equity. Surprisingly, the equity-to-debt portfolio balance has risen slightly since the beginning of the recession, although the split between respondents was nearly equal between those seeking additional equity sources and those seeking additional debt sources.

NMTC participants promote community benefits, which are loosely defined by the legislative intent of NMTC and the CDFI Fund but are integral to the mission of CDEs that participate in the program. Again, the intention of the original legislation was that locally based CDEs would be in the best position to maximize community benefits given their neighborhood knowledge.

The community benefits that participants are seeking and the method used to measure project outputs vary greatly. Nine in ten respondents are focused on employment and business growth and retention strategies, 30 percent on community services, and 27 percent on real estate improvements such as revitalization, blight removal, and new school and health facilities. While 84 percent are participating in real estate activities, these investments seem to be a tool to achieve other community benefits.

Overcoming Funding Gaps and Market Volatility

Assembling deals, based on the survey responses, depends strongly on relationships, local knowledge, and participation with public agencies in larger initiatives and redevelopment efforts. This is also highlighted in the case studies included in appendix C. These multiphase projects, repeat clients, and internally sourced deals that do not meet traditional underwriting standards help to fill the NMTC pipeline.

Survey respondents use a variety of strategies to address funding gaps and fee-driven issues. Most rely on additional public or nonprofit sources of subsidy, including grants, credit twinning, bond financing, and loan products to fill financing gaps, provide credit enhancement, and preserve investor returns. Some respondents are also willing to relax underwriting standards, lower debt service coverage ratios, or contribute additional equity or subordinated debt, accepting a greater level of risk to support high-impact projects.

NMTC participants face extreme market volatility, as does the rest of the financial industry. However, participants characterize their NMTC recession pipeline as stronger than their non-NMTC recession pipeline. Respondents report an increase in the relative strength of their NMTC pipelines over the pre-recession period, which means they have performed better during the recession. With the opportunity to carry back corporate tax offsets by one year and forward by up to 20 years, NMTCs remains an attractive product for investors, although the cost of waiting for profit can lower the net present value of investor returns.

CDEs, along with rest of the marketplace, are experiencing difficulties accessing debt and leveraged lenders, and some are seeking project sponsors that bring lenders as part of the project package. Surprisingly, the same participants suffering from a lack of credit access have increased their average participation and average portfolio weight in real estate, which has substantially declined in value during the recession. That they are adding staff suggests a confidence in the ongoing performance of their NMTC investments, including their real estate portfolios.

Survey respondents, many of whom have participated in NMTC during multiple years, are expecting to pull back from the program during the 2010 round. At the same time, the CDFI Fund expects to award another $5 billion worth of credits–and the price investors pay for credits is falling, with the GAO estimating that the value could decline to as little as 50 cents on the dollar (GAO 2010: 23). As banks return to profitability, increasing demand may mitigate a surge in credit availability. More likely, however, a number of program reforms will be needed to preserve the value of the credits by feeding investor demand, expanding the categories of eligible investments, and lowering the costs associated with NMTCs.

Part III: Conclusions and Policy Recommendations

Introduction

NMTC continues to push the financing of high-impact projects over the tipping point, as well as shift private market investment interest to poorer communities. As the NMTC program grows and matures, the government and the NMTC industry have proposed a number of reforms that are primarily aimed at reassuring investors, boosting demand by increasing the number of qualifying investments and tax offsets, and ensuring a consistent supply. All of these changes would reinforce the pipeline.

Respondents prefer changes to the NMTC program that favor permanency, growth, and consistency. Seven in ten respondents want NMTCs to become a permanent program, 64 percent would like to increase demand by allowing NMTCs to offset the Alternative Minimum Tax (AMT), and 62 percent want the program to grow to $10 billion in annual allocation authority. From the outset of the program, investors have worried about the permanence of NMTCs and the potential implications (in legal and transaction costs) of rule changes.

Respondents also seek greater flexibility in using NMTCs. Three in ten support eliminating related-party rules that prevent a CDE from owning more than a 50 percent equity stake in a target investment. Three in ten also prefer an increase in the carryback potential for NMTC, allowing an investor to retroactively offset profits from past years. Currently, NMTC only allows an offset for one year prior. Approximately one-fourth of respondents prefer a shorter holding period for NMTC. A seven-year holding period represents a highly illiquid investment for a bank or financial institution. More investors would be attracted by a liquid investment product, and financial institutions would likely increase their initial value for the credit if they were better able to accurately forecast near-term market movements for the total holding period.

Several comments to open-ended survey questions indicated that NMTC participants would benefit from less complexity and fewer transaction costs associated with the program. Approximately one-fourth would like to reduce the fee structures associated with CDE participation, which have been driven up by legal costs associated with ensuring investment compliance with NMTC criteria. Due to transaction costs, the industry has adopted the practice of requiring a minimum scale for NMTC investments as a way to justify the legal and transaction costs, and this de facto $5 million threshold is most easily satisfied with real estate investments, undermining the other community development goals of the NMTC.

One of the largest challenges from a policy perspective is addressing supply and demand imbalances that have reduced the value of NMTCs. Several respondents are already forced to fill the widening gap between the expected price for the credits and the price that investors are willing to pay. There is the potential for a purely market action, perhaps by experimenting with new leveraged capital structures, reassessing risks associated with NMTC projects, or encouraging new entrants who can achieve economies of scale or innovation.

Without a market action to revive the value of NMTC, a government intervention may be necessary. A 50 percent gap in the value of the lost tax revenue and the community-level asset growth is politically difficult. The GAO has advanced a proposal to change the NMTC to a grant-based program, but only 2 of 13 open-ended responses favored this change (GAO 2010: 28-30). This alternative would entirely eliminate private investors from the NMTC program. Respondents also mentioned an interest in more lenient nonqualified financial property rules (in other words, raising the allowable maximum proportion of nonqualified financial property that is included in an NMTC investment). Respondents sought increased demographic eligibility, such as an expansion of qualified census tracts, for investments in Qualified Low Income Community Businesses. Both of these reforms would widen the NMTC pipeline and, as a result, could potentially increase demand, but have the potential to dilute the social impact of NMTC investments.

Strengths of the New Markets Tax Credit Program

Strong performance, long-term involvement, and continued demand demonstrate that CDEs have strong interest in NMTCs. NMTC participants are striving to achieve community benefit goals critical to their organizational mis-

sions. They are also striving to satisfy the requirements of the NMTC awards, and allow their investors to use their investments to satisfy Community Reinvestment Act requirements. NMTC participants are targeting net job growth and business development in low-income communities, which is consistent with the NMTC program's intentions, as stated by former CDFI Fund Director Tony Brown. At the same time, program participants are also developing alternative methods for determining and measuring the impacts of these investments. From the beginning, NMTC's community benefit goals–as legislated and implemented–have been open-ended (Armistead 2005; Brown 2002; GAO 2010: 32-35).

The GAO and NMTCC have both independently found that NMTCs channel private investment to low-income communities by pushing projects past the tipping point that will attract private investors and fill in financing gaps for individual projects. With project origination at the CDE level where NMTC are also allocated, local control of capital investment is much more possible. Survey respondents reinforced the point that deal-sourcing and pipeline development are based on these local community networks and social capital, and particularly within public-private partnerships that advance common goals and contribute diverse sources of funding. This is particularly important for mitigating additional financing gaps that may develop after the project has been initiated. The majority of respondents indicated that this was a common occurrence, and approximately two-thirds would choose to seek additional sources of public grant-based funding.

Challenges of the New Markets Tax Credit Program

The largest worry from the federal government's perspective is the falling value of NMTCs, which appears to stem from oversupply. However, for survey respondents, the greatest concern is that Congress has not permanently authorized the NMTC program. These two perspectives could be at loggerheads if the government were to choose to move from a private investor-backed program to a grant-based program administered at the federal or state level. Although the GAO has minimized the switching cost from one program to another in its evaluation, in reality it could be quite significant and would leave current participants in the program with several more years to finish out the seven-year holding periods for ongoing investments. Furthermore, the CDFI Fund noted in a letter to the GAO that private investors provide the discipline necessary to ensure that CDE investments qualify for NMTCs. In fact, investors push CDEs to assemble projects that exceed NMTC's poverty-based statutory requirements to ensure their investments are not placed at risk by a finding of noncompliance later, which would invalidate the NMTC credits that they had already claimed and trigger a tax bill with penalties for those claimed credits (GAO 2007: 51-52).

Supply and demand imbalances and, possibly, saturation of the existing market with NMTCs could complicate ongoing expansion of the program. The majority of the survey respondents favored allowing NMTCs to offset the AMT, which would attract a new category of investors. Survey respondents were also interested in simplifying a number of requirements, which could have the same effect. As noted above, these included eliminating the seven-year holding period and the related-party rule, increasing the businesses that are eligible for NMTC investments, and finding other ways to reduce the legal and financial costs of NMTC transactions.

There are some market reactions that could have negative consequences for the NMTC program. From the survey results it is clear that real estate investments have increased despite the dramatic declines in real estate values and commercial real estate performance during the recession. NMTC participants are taking on a higher risk level by relaxing some underwriting standards, on average, and increasing their equity exposure. When NMTC-backed projects run into additional financing gaps, survey respondents turn to additional sources of public subsidy. In the current economic context, these additional sources of public subsidy may become much scarcer.

Finally, although local control of the definition of "community benefits" allows maximum flexibility within a community context, a lack of standardization prevents rigorous cross-sectional analysis of outcomes or the development of any kind of effectiveness ranking. As a result, it is easy to question the net growth in job creation, business capacity, assets, or other measures that NMTC participants claim because very few, if any, subject their analysis to the "but for" test or compare their projects with a "no action" alternative (GAO 2010: 8-9). Survey respondents reported community benefits other than real estate, but the majority of their investment activity has been real estate related. This disconnect potentially undermines the original intent of NMTCs to encourage investment in business growth and development, social service delivery, and community facilities.

Responses to Extreme Market Volatility

Extreme market volatility and the recession appear to have dampened 2010 demand for NMTCs, which could lead to a sharp decline in the investor purchase price of NMTCs, a decline already noted by industry sources, survey respondents, and the GAO. NMTC value may fall to as little as 50 cents on the dollar, from a historic high of 80 cents on the dollar in 2004, representing a potential community impact loss of $1.5 billion on the 2010 $5 billion allocation (GAO 2010: 23).

NMTC-backed projects already in the pipeline, however, are outperforming non-NMTC backed projects. Several survey respondents are increasing their NMTC portfolio weight and hiring additional staff to support these projects, which suggests that NMTC-backed projects are performing counter-cyclically and survey respondents are expecting them to continue to outperform other investment opportunities.

Surprisingly, in addition to a growing real estate bias of NMTC investments in 2010, survey respondents are increasing their equity-to-debt ratio slightly, on average, and relaxing underwriting standards, which would increase their risk exposure.

The declining demand for NMTCs may arise for a number of reasons. Fewer banks and financial institutions had profits to offset during the past two recessionary years. Investor uncertainty about the long-term prospects and potential rule changes may be holding investors back.

NMTC participants' real estate pipelines, which lag the market due to the time involved in developing an asset, may be approaching exhaustion. Without a recovery in the real estate market, or a strategy shift to distressed debt, foreclosures, and workouts, NMTC participants may not have any viable real estate investments on the horizon.

Finally, the market may be suffering from sheer saturation as the volume of NMTC credits available has dramatically increased over the past three years. Although demand for NMTC has always exceeded supply, there may be a shortfall of quality deals in the 2010 marketplace.

There are a number of possible responses to a continued decline in the value of NMTC. The Obama administration, Congress, and the CDFI Fund are investigating a number of interventions to increase the demand and relax the rules for NMTCs at the behest of industry groups, including the New Markets Tax Credit Coalition and the American Banking Association (NMTCC 2008; ABA 2009; Gambrell 2009). At the same time, market conditions are rapidly changing, which may lead to an organic increase in demand, new entrants, and new financing strategies for using NMTC.

Congress, the U.S. Treasury Department, the CDFI Fund, and the Internal Revenue Service are actively pursuing changes that would boost demand for the credits. In particular, they are increasing the possibilities for tax offsets and simplifying the program to lower costs associated with legal and transaction costs. There is also a remote possibility that the very nature of the program would be changed from a tax credit to a grant-based program. Less optimistically, the quality threshold for NMTC allocations at the CDFI Fund may decline, as well as for target projects at the CDE level. Such a decline would impair the strength of the NMTC pipeline, however, and result in less satisfactory outputs and community benefits at the project level.

The market may develop its own response to the falling purchase price of NMTC. A rebound in financial institution profitability may drive up demand. Some survey respondents are already experimenting with new capital structures that bring in leveraged lenders tied directly to project sponsors. Others are seeking additional public and nonprofit subsidies that will preserve investor returns and fill in growing financing gaps as credit values fall. Several respondents are accepting lower internal rates of return on NMTC projects, as these returns still compare favorably to greatly reduced returns from other investments. Ultimately, if the credits become undervalued enough, new entrants and opportunistic buys will increase, given that investors stand to gain substantially on the spread between the face value and the purchase price of the credits.

As participants seek additional public and nonprofit sources of capital for projects and participate in larger redevelopment or revitalization efforts (as several respondents noted), the need for and impact of public and nonprofit subsidy for NMTC-backed projects are likely to grow—and even more so if NMTC values continue to decline. However, with severe budget shortfalls at the state and municipal levels and falling nonprofit endowments, this strategy

may fall short and impair NMTC project pipelines. To make up the shortfall, NMTC participants may need additional federal support, new for-profit capital partners, or untapped nonprofit partners such as anchor institutions (i.e., medical centers) that have program revenue streams that have weathered the recession.

Despite the recession and NMTC value decline, NMTC participants have continued to use the cost-of-capital advantages of NMTCs to subsidize projects costs, allow unconventional underwriting, and facilitate greater social impact in poor communities. Specific strategies during the recession that raise the risk profile for NMTC participants have included injecting additional equity into a project, covering project funding gaps, lowering debt-service payments, and relaxing underwriting standards to allow a higher loan-to-value ratio. Additional strategies include forgiving debt at the end of the seven-year holding period and passing through cost-of-capital savings to a nonprofit end-user.

The additional equity investments and funding gap remedies noted by some survey respondents are consistent with the average slight increase in equity participation since the beginning of the recession. This is quite likely a necessary intervention as the value of NMTC, which are often used as gap financing, falls. Furthermore, equity contributions may be the only means to provide additional funding for some projects without violating debt service coverage ratio and loan-to-value ratio loan covenants.

Finally, despite the challenges of the NMTC program and the market environment, NMTC participants continue to seek investments with a high social impact and positive community benefits. Community benefits in the NMTC program are broadly defined, but are essential to winning NMTC allocations from the CDFI Fund and are integral to the mission of the CDEs that receive them. Furthermore, investors have a vested interest in ensuring that projects are realized in communities with the greatest need that qualify under NMTC rules.

Respondents Weigh in on Proposed Reforms

Survey respondents provided clear preferences for the proposed reforms to the NMTC program. As shown in Table 12, the weighted average responses based on a three-point scale and a sample size of 42 can be divided into three priority levels. The preferred actions represent a mix of program reforms and responses to supply and demand imbalances in the NMTC market.

The top priority level addresses investor risk, NMTC demand, and consistent supply. In line with earlier industry findings and reporting, the greatest preference for reform is to make NMTC a permanent program. Seven in ten respondents found this to be important, while 64 percent sought to increase investor demand by allowing NMTC investments to offset the AMT. Just over six in ten (62 percent) of respondents sought a dramatic increase in the available supply of NMTC to an annual allocation authority of $10 billion. This is surprising in light of the falling value of the credit, although demand has always greatly exceeded supply based on NMTC applications. Furthermore, this desired increase is supported by earlier survey responses that indicate that NMTC pipeline performance has been superior to the pipeline for other investments and that participants are deriving more value and increasing the staffing related to NMTC. The latter suggests that participants are optimistic about a rebound in the value of the credits.

The second priority level would directly address the falling value of NMTC. Just over one-third (36 percent) of respondents wanted to make NMTC a “deeper” tax credit similar to the Low Income Housing Tax Credit. Nearly three in ten (29 percent) would like to increase the carryback period for tax offsets from one to five years. This would allow banks and financial institutions that experienced losses during the recession to retroactively offset profits from more profitable years before the recession. In general, this reform would also smooth demand over the long-term, although it would also increase the risk of government tax revenue losses during recessions.

Approximately one-fourth (26 percent) of respondents sought shorter holding periods for NMTC. This would reduce illiquidity risks for investors due to the seven-year holding period that is currently required for NMTC. This would also eliminate the risk and uncertainty of qualifying investments that mature early, before the end of the seven-year holding period. If an investment matures before the end of the holding period, the NMTC legislation requires immediate redeployment of the tax credit capital. Investors and CDEs have shied away from these types of investments and with an elimination of the seven-year holding period these short-term investments would become attractive, potentially expanding demand for NMTC.

The last priority included potential changes to the types of projects that would be eligible for NMTC. Three respondents placed value in expanding NMTC to support equity investments in community venture funds. As noted previously, only three respondents participated in venture funds before and during the recession and, as a result of the recession, had scaled back that portfolio allocation. Only two respondents valued including home mortgages in the program, and one respondent in the open-ended response section stated that this "would be disaster" due to the overwhelming supply of mortgages.

Table 12. Respondents' Ranked Preferences for Proposed Reforms (N = 42)

Potential NMTC Program Reforms	Most Important (3)	Second Most Important (2)	Third Most Important (1)	Rating by Weighted Average	Response Count
Make the NMTC a permanent program	22	6	2	1.90	30
Allow NMTC investments to offset the Alternative Minimum Tax	6	11	10	1.19	27
Increase the annual NMTC allocation authority to $10 billion	5	12	9	1.14	26
Make NMTC a "deeper" tax credit similar to the Low Income Housing Tax Credit	4	3	8	0.62	15
Carryback period of up to five years for NMTC tax offset	2	6	4	0.52	12
Shorter holding period for NMTC	3	4	4	0.50	11
Expand NMTC to support equity investments in community development venture funds	0	0	3	0.07	3
Pursue statutory changes that would enable NMTC investments to be used for home mortgages	0	0	2	0.05	2

There were 13 open-ended responses regarding the opportunity for program reforms. As shown in Table 13, 31 percent favored eliminating related-party rules that require a CDE to maintain less than a 50 percent equity stake in any investment in a Qualified Low-Income Community Business to avoid classification as a related-party. Respondents also noted that this is a policy position that NMTCC is advancing, which reinforces the interconnectedness and network-learning model of the NMTC community (Erickson 2009). Likewise, two respondents supported the GAO's suggestion that NMTC change from an investor-based program to a government grant-based program (GAO 2010: 28-30). The GAO believes this would reduce the loss of social impact value to communities at the investor

level when the credits sell for less than face value.

Approximately one-fourth (23 percent) favored reducing the fee structure, and 15 percent wanted to make the program more consistent. Two respondents perceived that transferring the NMTC program to the states for reallocation, following the Low Income Housing Tax Credit (LIHTC) precedent, would support increased consistency and reduce the fee structure associated with NMTC.

Table 13. Open-Ended Responses to Potential Program Reforms (N = 13)

Response	N	Response	N
Eliminate related-party rules*	4	NMTC changed to a debt grant for CDEs**	2
Reduce fee structure	3	Reduce risk to investor return	1
Limit CDE fees (direct and indirect)	1	Federal guarantee for equity investment in non-leveraged structures	1
Tax revisions for simpler structures, resulting in reduced legal, transaction, and exit costs	1		
States administer and allocate NMTC, which would eliminate sponsor fees and standardize the program (reducing legal and transaction costs)	1	Program Scope and Applicability	1
		A strong NO to making home mortgages eligible	1
		More lenient Non-Qualified Financial Property rules	1
Consistency	2		
Sponsors can expect regular allocation	1	Program Implementation	1
Shift to states for reallocation, as in LIHTC	1	Improved demographic eligibility determination for Qualified Low-Income Community Businesses	1

*Policy position advanced by NMTCC, as noted by respondent
**Policy position suggested by GAO (U.S. GAO 2010), as noted by respondent

Policy Recommendations

Congress should permanently authorize the NMTC program, but allow the year-to-year allocation to fluctuate as a monetary policy tool.

- The investor risk associated with ongoing uncertainty about the program is the largest obstacle to its ongoing success and is also a contributing factor in the decline in the purchase price of NMTCs. When the NMTC program was enacted, previous federal grants-based programs had a mixed track record and, even with the current decline in value, the NMTC program is redirecting investment to low-income communities and building assets that remain in low-income businesses after the 7-year holding period for the investment ends.
- Permanently authorizing the NMTC program would allow CDEs and other NMTC participants to engage in long-term planning based on reasonable expectations. This would allow them to develop a much stronger deal pipeline and better weather market volatility.
- The switching costs, investment in learning a new program, and uncertain status for past NMTC participants would be extremely challenging if the program were to fundamentally change.
- In addition, the CDFI Fund has noted that private investors are aligned with the program's community benefits and low-income community investment intentions because they do not want their investments to be placed at risk by a finding of noncompliance after the fact. The current administration of the program aligns all parties' interests in balancing community benefits and investor returns.
- NMTC has already been used as a monetary policy tool, as part of the federal government's response to the devastation caused by Hurricane Katrina and as part of the American Recovery and Reinvestment Act. Formalizing NMTC as a monetary policy tool could allow for more rapid deployment of NMTC in times of need.

Congress should seek to boost demand for NMTC, particularly with the increase in year-to-year supply of the credits.

- Increased demand would strengthen the NMTC deal pipeline, reduce the likelihood of new funding gaps owing to the decline in the purchase price of NMTC, and smooth volatility stemming from supply and demand imbalances for NMTCs.
- One area that has been overlooked in discussions is reevaluating the definition of poverty and, as a result, enlarging the number and size of low-income communities eligible for NMTC investment. Currently, 39 percent of US census tracts, home to 36 percent of the population, qualify for NMTCs (GAO 2010). There is growing agreement that the definition of poverty may be outdated and that under new "living wage" regimes, the number and spatial coverage of the poor would significantly increase.
- As intended, the allowance of NMTCs to offset the AMT will encourage a new group of investors to bid for NMTCs. High net worth investors may see NMTC as a stable fixed-income (through income tax offsets) addition to a balanced long-term portfolio.
- Congress should also strongly consider shortening the holding period for NMTCs to three to five years, or create two tiers of NMTC products with different tax offset allowances that would reward the investor that chooses the longer holding period. The current seven-year holding period results in a highly illiquid investment for banks and financial institutions and, as a result, they are bidding less to hedge against the possibility of underperformance against other investments.
- Increasing the investor demand for NMTCs and the supply of potential projects would also proactively address the potential for declining quality thresholds in NMTC award allocations or CDE project selection that could arise due to the need to deploy the current oversupply of credits.

Congress, the CDFI Fund, and the IRS should continue to seek ways to lessen the legal complexity and lower the transaction costs associated with the NMTC program.

- The evaluation and reform process is already underway, but the GAO, industry groups, and survey respondents continue to cite the legal complexity and transaction costs of the NMTC program. The GAO has noted that high transaction costs reduce the amount of investment in low-income communities, undermining one of the key goals of the NMTC program.

- If the legal complexity and transaction costs of NMTC can be mitigated, positive secondary effects could emerge that advance the original intentions of the legislation.
  - Currently, the high fixed legal and transaction costs are pushing NMTC participants toward real estate activities; these are one of the few ways that participants can distribute costs over a large project. If those costs decrease, non-real-estate projects would become more feasible.
  - In addition, the steep learning curve and high costs of NMTC transactions favor incumbents in the NMTC allocation process and industry consolidation, which threatens smaller, locally controlled CDEs. A decline in costs would allow smaller CDEs to more successfully compete for NMTC allocations and execute NMTC deals.

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Interviewees:

Brophy, Paul. Principal, Brophy Reilly, LLC, Columbia, MD. Interviewed by telephone on Friday, March 5.

Bryan, Tracy. Public Affairs Officer, Jacobs Center for Neighborhood Innovation, San Diego, CA. Interviewed by telephone on Wednesday, February 24.

Buttner, Chip. CEO & President, Diamond Management, Inc., San Diego, CA. Interviewed by telephone on Tuesday, March 9.

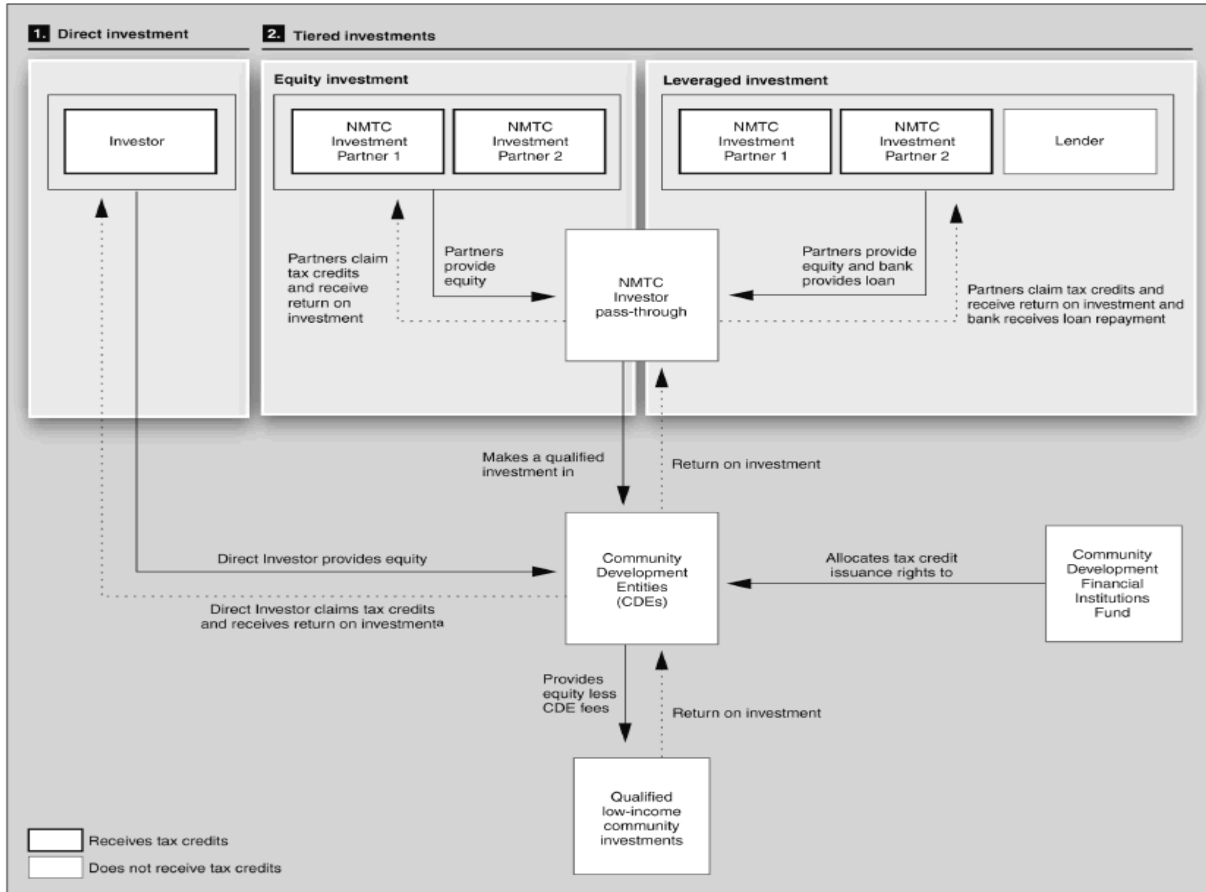
Ericson, Tracey. Senior Vice President, New Markets Tax Credit Investments, Wells Fargo Bank, San Francisco, CA. Telephone interview on Friday, February 12. In-person interview on Tuesday, March 9.

Hess, Mark. Senior Project Manager, HallKeen, LLC, Norwood, MA. Interviewed by telephone on Friday, February 12.

Sullivan, Patrick. Director of the Office of Housing and Community Development, City of New Bedford, MA. Interviewed by telephone on Friday, March 5.

Velazquez, Christa. Director of Social Investments, Annie E. Casey Foundation, Baltimore, MD. Interviewed by telephone on Monday, February 22.

Appendix A: Comparison of NMTC Investment Structures

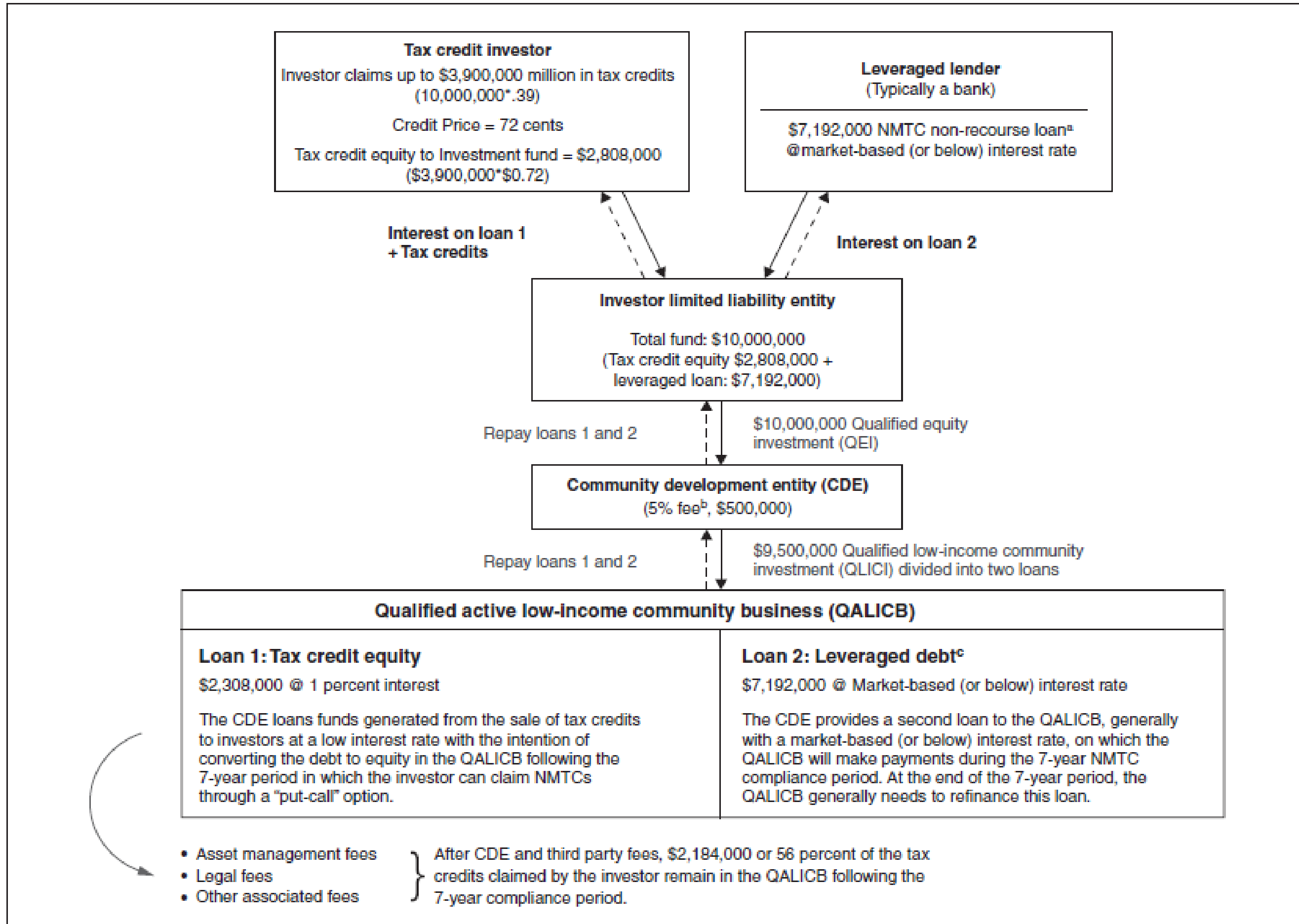


Source: GAO.

[a]Investors in a CDE cannot redeem any of the original QEI during the 7-year period while they are allowed to claim the credit. However, equity investors can receive a return on their investment in a CDE, in the form of dividends or partnership income, for example.

Source: U.S. GAO 2007

Appendix B: Example of a Leveraged NMTC Investment



Source: GAO.

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

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

[c]Due to the 7-year compliance period associated with the NMTC, most leveraged loans are interest-only for the 7-year period.

Source: U.S. GAO 2010

Appendix C: NMTC Case Studies

Case Study 1: Union Street Lofts

Financing Gap

In 2004, a joint-venture partnership between the Waterfront Historic Area League (WHALE) and HallKeen faced a critical $3.9 million equity financing gap for a $12-13 million redevelopment project. The project was converting five historic, 100-year-old structures into the Union Street Lofts in downtown New Bedford, Massachusetts. HallKeen, based in Norwood, Massachusetts, is a for-profit real estate investment, development, and management firm with nearly forty years of experience. The firm focuses on affordable housing development and has a mission that expressly directs the use of partnerships to develop projects. This financing gap developed as a result of cost overruns from weather delays and more substantial structural deterioration than had previously been identified in the buildings (NMTCC 2006: 124; FHLB Bank Boston 2005; Sovereign Bank 2006).

A sizable public-private coalition had assembled this project, which was anticipated to provide many community benefits to New Bedford, including affordable housing development, job creation, anchor institution engagement, retail diversification, around-the-clock attractions, historic stewardship, and downtown revitalization. Investor return to HallKeen would depend on the success of the mixed-use commercial and residential leasing for the Union Street Lofts. Nonprofit partners anticipated positive social impact returns based on the community benefits to be derived from the project. The returns for other private market financial partners were secured by a mix of public subsidies and guarantees. To fill the $3.9 million equity gap, however, any new investor would also need to earn a market competitive return.

Project Leadership

WHALE uses historic preservation as a means to further community, neighborhood, and economic development, affordable housing initiatives, and planning efforts (for more information on WHALE, see its website at www.waterfrontleague.org). It has also worked extensively with the City of New Bedford on the master plan for revitalizing downtown, which began to suffer rapid decline in the 1960s. WHALE played a leadership role in the enactment of the New Bedford National Historic District, which contains the Union Street Lofts, according to Patrick Sullivan, director of the Office of Housing and Community Development for the city of New Bedford, in a personal interview in 2010.

WHALE incorporated in 1962 as a 501(c)(3) membership-based nonprofit in New Bedford, where it has saved more than forty properties from demolition. WHALE was essential to gaining control of the site and obtaining Massachusetts Historic Tax Credits. According to interviews with Mark Hess, Senior Project Manager for HallKeen, a lead grant to WHALE from the Massachusetts Historical Commission supported the acquisition and predevelopment of the project.

Project Context

Prior to the start of the planning process, the City of New Bedford seized two of the properties, known as Lawton's Corner, due to tax delinquency. The owner of the other three properties, known as the Coffin Press Lofts, was willing to sell to WHALE because it was a mission-based nonprofit devoted to historic preservation. Together, these comprise the Union Street Lofts. New Bedford, in partnership with WHALE, had identified the group of properties as a high-priority catalyst for downtown revitalization. The deteriorated condition of these five buildings was a discouraging potential investors from redeveloping nearby properties.

The City of New Bedford's Office of Housing and Community Development, working with WHALE, crafted a Request for Proposals for the reuse of the buildings. The Department of City Planning changed the zoning to allow mixed-use commercial and residential structures, as well as an Artist Overlay District for artist live-work lofts, part of a new Arts and Cultural District intended to encourage new around-the-clock uses downtown. The District is anchored by two institutions, Bristol College and the University of Massachusetts Dartmouth College of Visual Arts, which had recently completed the conversion of a former department store that covered an entire city block.

The 70,000 square foot project refurbished approximately 16,000 square feet of ground floor retail and commercial space and created three ground floor artist live-work spaces, as well as 20 below-market very-low income and low-income apartments and 15 market-rate apartments (NMTCC, 2006: 124) at the "epicenter" of the business district.

Community Benefits Intentions

The Union Street Lofts were intended to generate a number of community benefits. This would be the first project in New Bedford to adaptively reuse historic commercial buildings for mixed-use, create affordable and market-rate housing to begin to attract residents and evening visitors to downtown, mitigate blight, support the development of the newly enacted Artist Overlay District, and catalyze additional revitalization. The partners anticipated that the redevelopment would create 100 Full Time Equivalent (FTE) construction jobs and 50 FTE long-term jobs (both estimates are based on direct and indirect job creation) (NMTCC, 2006: 124). Surprisingly, the subsidies for the below-market housing made the development of market-rate housing possible, as there are no subsidies for this product type. From HallKeen's perspective, according to Mark Hess, it would have been easier to finance and build only low-income housing on this site.

The Role of New Markets Tax Credits

The Massachusetts Housing Investment Corporation, LLC (MHIC) learned of the funding gap from HallKeen, WHALE, and the City of New Bedford's Office of Community and Housing Development, all of which had collaborated with MHIC on past Low-Income Housing Tax Credit-backed projects and regularly conversed with each other (NMTCC, 2006: 124). The partnership and, as a result, the project were relationship-driven, according to Mark Hess.

MHIC's mission is affordable housing creation, but it has also funded mixed-use and commercial development to support economic development goals (MHIC, 2006). MHIC is a nonprofit syndicator, but operates for-profit NMTC funds. MHIC had created two fully owned Community Development Entity (CDE) subsidiaries, each representing a closed-end investment fund, and won a $25 million New Markets Tax Credit (NMTC) allocation from the Treasury Department's Community Development Financial Institution (CDFI) fund in 2002, the program's first award year and 1 percent of that year's $2.5 billion in total CDFI Fund awards (MHIC, 2006). The Union Street Lofts were located in a census tract that met the CDFI Fund's poverty and economic development qualifications for eligibility and had the 20 percent commercial component that would qualify for NMTC (NMTCC, 2006: 124).

MHIC made a $3.9 million leveraged equity investment, filling the partnership's financing gap. MHIC committed $11.22 million in tax credits, nearly 40 percent of its 2002 NMTC allocation, to the Union Street Lofts. The deal timing suited MHIC, which needed to rapidly deploy its tax credits to satisfy the conditions of the CDFI Fund's NMTC award. To satisfy this rapid tax credit commitment, MHIC needed a project that was already in the development pipeline (MHIC, 2006; FHLB Boston, 2005). MHIC's equity investment covered approximately 35 percent of the total development costs. MHIC's use of NMTC for this project was also the first example in the country of "twinning", by combining NMTC with historic and affordable housing tax credits which would serve as a pilot financing structure for future NMTC-backed projects around the country (NMTCC, 2006: 124).

Capital Structure

MHIC's commitment was just one piece of a complicated capital stack that reflected the size and complexity of the public-private coalition backing the project [See Appendix Table 1]. The coalition developed because of compatible missions and shared project goals. HallKeen made a $2.4 million equity investment. MHIC was also able to arrange an additional NMTC-backed $300,000 direct subsidy by leveraging its NMTC credits through the Federal Home Loan Bank (FHLB) of Boston, with a mission of supporting housing and community economic growth and a focus on lower-income households (FHLB Boston, 2005). A combination of equity, subordinated debt, subsidies, and grants mitigated enough of the project risk and fulfilled loan-to-value requirements to allow the project to qualify for a $3.22 million long-term subsidized FHLB first mortgage through Compass Bank,[9] a community bank that reinvests in the communities where it operates (FHLB Boston, 2006). The corporate office for Compass Bank was just down the street from the Union Street Lofts, and the principals of the bank had been particularly interested in the success of the project (Hess, 2010)

In addition to the MHIC equity, the City of New Bedford and its Office of Housing and Community Develop-

9 Compass Bank was acquired by Sovereign Bank in 2004 (Massachusetts OCABR, 2004).

ment contributed $1.525 million in subordinated debt through the HOME program[10] and MassHousing contributed an additional $450,000 in subordinated debt through the Affordable Housing Trust Funds program. WHALE contributed $215,000 in historic preservation grant money to the project, thereby enhancing investor return on equity (NMTCC, 2006: 124).

The transaction closed in 2004, after a year of negotiations and project development. The closing was complicated and this was the first time any of the partners had used NMTC. Creating the CDE and LLC vehicles, as well as making the lenders comfortable with the collateral structure, took significant time. The City of New Bedford's $1.5 million HOME investment provided additional reassurance to the lenders (Sullivan, 2010), as did the city's letters of support (Hess, 2010). MHIC and MassHousing provided the financial and legal expertise necessary to structure the NMTC deal, allowing the partnership to avoid bringing in outside help and preserving more of the capital. NMTC filled a critical soft debt gap as the partners had desperately needed additional equity (Sullivan, 2010).

Appendix Table 1: Union Street Lofts Capital Structure

Partner Organization	Amount* (millions)	Capital Contribution	Capital Type	Program Type
Developer – WHALE and HallKeen (JV)	2.38	18.90%	Equity	
Massachusetts Housing Investment Corporation (MHIC)	3.89	30.95%	Leveraged equity gap financing (NMTC)	NMTC (Syndicated)
FHLB Boston (Sovereign)	3.22	25.59%	Long-term subsidized first mortgage	Affordable Housing Program
City of New Bedford	0.98	7.75%	Subordinated debt (HOME)	HOME
City of New Bedford, Office of Housing and Community Development	0.55	4.37%	Subordinated debt (HOME)	HOME
MassHousing	0.45	3.58%	Subordinated debt (HOME)	Affordable Housing Trust Funds
WHALE	0.22	1.71%	Grants for historic preservation	Massachusetts Preservation Projects Grants
FHLB Boston	0.30	2.38%	Direct subsidy through MHIC leveraged NMTC-financing program	NMTC pass-through
FHLB Boston (Compass)	0.60	4.77%	Credit advance for commercial space	Community Development
TOTAL	12.58	100.00%		

*Figures based on research and interviews are not entirely consistent, but the total project cost in the $12-13 million range

Sources: MHIC, 2006; interviews with Mark Hess, Hallkeen; Patrick Sullivan, City of New Bedford; NMTCC, 2006: 124; FHLB Boston, 2006

10 HOME is the HOME Investments Partnership Program, administered by the U.S. Department of Housing and Urban Development. It is the largest Federal block grant to States and local governments designed exclusively to create affordable housing for very low-income and low-income families, providing over $2 billion each year (HUD, 2010—ADD HUD 2010 to ref list. .

Project Outcomes

Public-Private Coalition

Both HallKeen and the City of New Bedford found the public-private coalition to be effective and successful. Every coalition participant shared the same goals, which can be challenging with that many interested parties in a redevelopment project, and all of them embraced the creation of a combination of affordable and market-rate housing creation in downtown. According to Patrick Sullivan in personal interviews, the City of New Bedford remains very open to working in the future with HallKeen and has ongoing work with WHALE and the other public agencies involved in the Union Street Lofts project. Likewise, HallKeen is interested in collaborating with WHALE again, and has ongoing projects with MHIC, according to Mark Hess. Currently, HallKeen is exploring the adaptive reuse of a historic mill in Vermont for affordable housing with MHIC, which would use NMTC-backed equity for this project.

Community Benefits

The Union Street Lofts opened for occupancy in 2006. The project achieved a number of community benefits. The completion of the project (1) advanced the redevelopment of downtown properties, including the immediate adaptive reuse of three nearby historic commercial structures as market-rate condominiums, (2) attracted new market-rate residents and provided affordable very low- and low-to-moderate-income housing, and (3) used Bristol Community College and the University of Massachusetts as anchors for the new downtown Arts and Cultural District and promoted linkages between the two institutions. The five vacant buildings that compose the Union Street Lofts were returned to the tax roll and are now fully occupied. Small business growth focused on night-time uses and serving new residents has continued, even during the recession (Sullivan, 2010). Some of the new renters work in the ground-floor retail (FHLB Boston, 2006).

Investor Returns

Investor returns to the project funders–the developer and the public agencies–could have been enhanced. The renovation of the retail portion of the project was expensive and required add-alternatives in the construction documents for the treatment of the retail façade. The resulting retail transformation was not as substantial as the city had hoped (Sullivan, 2010). At the same time, retail tenants throughout downtown have experienced sales growth. As Mark Hess told me in an interview, "It used to be, there was plenty of open parking and nothing to do after 5 pm. This project has been a big part of the downtown revitalization–of course, this is a small downtown."

The 120 feet of retail frontage of the Union Street Lofts has not attracted strong new tenants, and the existing tenants who were allowed to return after the renovation are unable to meet the project's rent projections, hurting HallKeen's return on equity. In retrospect, says Hess, HallKeen would have provided rent subsidies and left the spaces unimproved, shifting the capital cost of any improvements to the tenants. HallKeen still has loan reserves, but may need to renegotiate terms with the first mortgage lender if the commercial rent continues to fall short. According to Hess, "this underwriting problem has not been endemic to NMTC," but has been exacerbated by the recession. When the NMTC seven-year compliance period ends in 2011, HallKeen may be forced to sell some of its equity in order to refinance the Union Street Lofts.

Project Performance

Patrick Sullivan, as director of the Office of Housing and Economic Development, contrasted the successes of the Union Street Lofts with the failures of other redevelopment projects in New Bedford. From the marketing perspective, other projects have failed when the developer did not match the product to the market or erred in market timing. From the management perspective, sufficient developer follow-through has been a problem. From HallKeen's perspective, according to Hess, this is one of very few NMTC projects for which the financing actually closed; many others have not moved forward as a result of the recession.

The Impact of New Markets Tax Credits

Mark Hess calls the Union Street Lofts project, "a win for the City and a win for tax credit investors." So long as the project avoids foreclosure, there are no risks for NMTC, LIHTC, or HTC investors. Despite cash flow and investor return issues for HallKeen, the developer would still participate in this project, even with the benefit of hindsight, and retain the NMTC component. Mark Hess said, in describing NMTC, it "doesn't always pay to be first. It is a good program, but a little bit complicated and convoluted. It is an important program for a city like New Bedford that needs general economic assistance to bring in products and services, and not just help for low-income residents."

Case Study 2: East Baltimore Development Initiative[11]

Financing Gap

An enormous public-private coalition had formed around the 88-acre, $1.8 billion East Baltimore Development Initiative, formally launched in 2003. However, East Baltimore Development, Inc. (EBDI), the lead agency, faced an immediate construction financing and working capital shortfall (EBDI, 2010; NMTCC, 2006: 113-14). Due to the perceived investment risk in a troubled neighborhood for a speculative development, investor interest and traditional sources of capital were unavailable, according to Christa Velazquez, director of social investments for the Annie E. Casey Foundation, in a personal interview in 2010. Paul Brophy, of Brophy Reilly, LLC, a planning and economic development firm based in Columbia, Maryland, recalled in a personal interview that the coalition, which included the State of Maryland and the City of Baltimore, felt that the redevelopment was essential to rebuilding a troubled community and increasing the competitiveness of the state's already large bioscience cluster. The initiative was intended to spur job growth, local employment, workforce development, revitalize a blighted neighborhood, and provide a large number of economic and quality-of-life improvements, as recorded in a Community Benefits Agreement, for the people of East Baltimore.

Project Leadership

Master planning occurred between 2000 and 2003. Brophy conceived of the East Baltimore Revitalization Project in 2000. As an unpaid advisor to newly elected Baltimore Mayor Martin O'Malley, Brophy convinced the mayor of the idea's merits.[12] Brophy, who characterizes himself as a "producer" and not a developer, also brought his experience working with land clearance and health sciences development in Pittsburgh and subsequent work at the Enterprise Foundation.

Negotiation began between Mayor O'Malley and Dr. Elias Zerhouni, who was an executive vice president at Johns Hopkins University and Medical Institutions and, subsequently, the director of the National Institutes of Health from 2002 to 2008.[13] The coalition supporting this project rapidly grew to more than one hundred stakeholders, including high-level elected federal, state, and local officials, dozens of investment partners, and grassroots neighborhood organizations (EBDI, 2010a).

Johns Hopkins University and Medical Institutions and the City of Baltimore shared the costs of developing the plan for the East Baltimore Development Initiative and, in 2003, EBDI incorporated as a single-purpose nonprofit 501(c)(3) to be the implementation agency. EBDI has a three-pronged mission to (1) attract economic development and population to East Baltimore, (2) support community development through workforce training, educational access, and affordable housing creation, and (3) support the neighborhood's anchor institutions and grow the health and life sciences cluster in East Baltimore (EBDI, 2010a).

Project Context

The Historic East Baltimore Community Development Corporation, which had been proceeding with a house-by-house renovation of the Middle East neighborhood, had concluded that it could not keep pace with the ongoing deterioration of the neighborhood. Middle East had been severely troubled since the 1970s and unresponsive to the city's previous attempts at intervention, with a housing vacancy rate above 25 percent and a concentration of violent crime, drug trafficking, and chronic unemployment (EBDI 2010a; NMTCC, 2006: 113-14). At the same time, there was substantial market demand for life science research space adjacent to Johns Hopkins' East Baltimore medical campus. Furthermore, the State of Maryland had adopted a strong policy and funding push to promote life science and biotechnology research and commercialization, as Maryland already had a strong and growing life sciences cluster.

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11 Maryland State Governor Martin O'Malley referred to this initiative as the "East Baltimore Development Initiative" in a 2008 speech. It has also been called the East Baltimore Revitalization Project (NMTCC, 2006: 113-14) and Baltimore's New Eastside Project (EBDI, 2010).

12 Mayor O'Malley is now Governor O'Malley.

13 As of 2008, Zerhouni was once again in a leadership position at Johns Hopkins University and Medical Institutions.

The fifteen-year revitalization plan for the "Middle East" neighborhood is anchored by a 31-acre, 2 million square foot Life Sciences Park that would benefit from close proximity to Johns Hopkins Hospital. This is at the heart of Phase I, which began in 2003 and will be completed in 2010. Phase II, which includes the remaining 57 acres, began in 2007 and will be completed in 2013.

Community Benefits Intentions

From the City of Baltimore's perspective, Middle East will once again become a functional neighborhood with a net tax revenue contribution and spillover benefits for adjacent neighborhoods in East Baltimore, home to about 30,000 individuals (Cromwell et al., 2005: 114; NMTCC, 2006: 113-14). The project also aligns with the City of Baltimore's "economic development approach: creating a clean and safe city, promoting workforce development and education, and implementing an economic growth strategy" (Cromwell et al., 2005: 115).[14]

Projected community benefits from the East Baltimore Development Initiative include 2,200 new and renovated mixed-income housing units; 500,000 square feet of commercial, office, and ground-floor retail space; and community and recreational facilities including a seven-acre neighborhood school, improved subway and bus transit access, and new public open space. Workforce development estimates projected the creation of 8,000 new permanent jobs, with at least one-third available to workers who hold only a high school diploma or equivalent (NMTCC, 2006: 113-14; EBDI, 2010a).[15]

The Role of New Markets Tax Credits

While EBDI had the authority to lead the East Baltimore Development Initiative, it still needed funding to support the land acquisition. The cultivation of funding sources had started in 2000, even before the agency was formed, but had not been successful, according to Christa Velazquez of the Annie E. Casey Foundation.

Brophy brought Enterprise Community Foundation into the coalition. Enterprise received a $90 million first-round New Markets Tax Credit (NMTC) allocation from the U.S. Treasury Department's Community Development Financial Institutions (CDFI) fund in 2002, representing 4 percent of the total credits awarded that year. To receive the NMTC award, Enterprise launched a special-purpose, wholly owned for-profit Community Development Entity (CDE), ESIC New Markets Partners, LP, based in Columbia, Maryland. ESIC also received a second award in 2003 for $140 million, again representing 4 percent of the total credits awarded that year (CDFI Fund 2010d).

Enterprise's ESIC Fund committed $15 million worth of NMTC, or 15 percent of its 2002 portfolio, followed by another $15 million commitment in 2003, which represented 11 percent of its 2003 portfolio (NMTC, 2006: 113-14 and CDFI Fund 2010d). All of the East Baltimore Development Initiative's census tracts were eligible for the NMTC program based on poverty and economic development indicators; furthermore, the entire project is contained within a Federal Empowerment Zone and a State Enterprise Zone (NMTCC, 2006: 113-14).

Potential NMTC investors continued to be wary of the risk involved in purchasing the tax credits for a speculative project, however, and feared the possibility of EBDI default, in which case the tax credits could potentially lose their value.[16] As a result, the coalition initiated dialogue with the Annie E. Casey Foundation (AECF) with the hope that AECF would provide a credit guarantee. AECF has a multi-faceted public service mission, but one core component focuses on quality-of-life improvements for the City of Baltimore, where it is headquartered, only about two miles from the project location. AECF agreed to participate and took on a much greater leadership role in developing the community engagement process and community benefits package, which was enshrined in a formal Community Benefits Agreement (CBA) in 2003. AECF also contributed a package of grants, loans, and guarantees, in addition to credit enhancement on NMTC, participating in multiple funding rounds.

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14 "This strategy calls for: building on the city's assets, particularly higher education institutions, industry clusters such as health care and life sciences, parks and other natural settings, architecture and historic structures, and neighborhoods…" (Cromwell et al, 2005: 115, citing *Baltimore City 2002*).

15 "Over 55 percent of the project's on-site jobs awarded to local residents (120 from project area, 317 from city proper, 437 from metro area). 35 percent of all project contracts awarded to minorities, women, and local firms" (EBDI, 2010b: p2).

16 This potential tax credit loss due to default is still being clarified by CDFI Fund and the IRS, to this day. The credit loss to the investor may not necessarily occur, there may be a possibility to cure the loss, and/or it may be possible to redeploy the credits. A potentially greater risk than developer default would be CDE default, but again there may be remedies (Novogradac, 2010). It is important to remember that this was still at the beginning of the NMTC program, when many of the program's intentions, and longevity, were unclear.

Capital Structure

AECF's prominent entry into the coalition and capital structure encouraged additional investors and grantees to join. AECF also actively sought out multiple new partners and investors to lend internal and external credibility to the initiative so that it was "not just AECF," in the words of AECF's Christa Velazquez. Velazquez characterized NMTC as "found money" that brought in the private market.

Once AECF's credit enhancement guarantee was secured by its $4 billion endowment portfolio, Bank of America purchased ESIC New Market Partners' tax credit allocation for the East Baltimore Development Initiative and later purchased the second allocation as well. The complexities of NMTC, which was a new product at the time, contributed to the length of the funding development period, the complexity of the closing, and the credit enhancement requirement for the private investor. In fact, the first closing took one year and the transaction cost, including legal fees, was around $1 million for AECF.

Through an RFP process that ended with an announcement in December 2004, EBDI selected Forest City Enterprises–New East Baltimore Partnership, LLC as the developer of Phase I. In fact, the capital stack is complex, as shown in Appendix Table 2, with EBDI anticipating that more than 83 percent of the initiative's $1.8 billion in funding for both phases will be from the private sector. The total NMTC portion of the project funding is projected to grow to approximately $47 million. The State of Maryland has also authorized a Tax Increment Financing District that will allow tax revenue resulting from the redevelopment's added value to be reinvested in the initiative.

Appendix Table 2. East Baltimore Development Initiative Capital Structure – Phases 1 and 2

Investor	Funding	Capital Contribution
Private Developer Investment	$ 1,467,350,000	83.1%
Tax Increment Bond Financing	$ 44,326,166	2.5%
NMTC Debt and Fees	$ 46,820,000	2.7%
Federal Funds	$ 37,735,100	2.1%
State of Maryland	$ 42,075,000	2.4%
Baltimore City	$ 62,601,000	3.5%
Other Foundations	$ 10,250,500	0.6%
The Annie E. Casey Foundation	$ 33,211,719	1.9%
Johns Hopkins	$ 21,551,168	1.2%
TOTAL	$ 1,765,920,653	100.0%

Source: EBDI, 2010

Project Outcomes

Public-Private Coalition

Brophy characterized the coalition as a "process success," particularly considering the size of the undertaking and the number and diversity of stakeholders. EBDI is governed by a board that reflects the composition of the coalition, with appointed members selected by the mayor of Baltimore, grassroots community organizations located in East Baltimore, the governor of Maryland, and the presidents of AECF and Johns Hopkins University and Medical Institutions. The appointed members, in turn, elect the remainder of the board members. This reflected an important compromise that Brophy brokered, as Mayor O'Malley initially wanted to retain complete control of the board. Brophy successfully argued that this would have undermined the coalition-building efforts and made the initiative appear to be much more top-down and "a city agency." Furthermore, when AECF was brought into the coalition, President Doug Wilson was "attracted by the size and consequence of the project" and directed his staff "to play a major role in shaping the neighborhood benefits," according to Brophy.

Brophy emphasized the importance of creating an institution – "a competent, well-trained land developer" – that could survive for the next thirty years, as it will face many internal changes as well as changes in the leadership and composition of the coalition partners. In particular, the East Baltimore Development Initiative will need to weather changing political will with successive mayoral and gubernatorial administrations.

There were some ways that the leadership of the initiative could have been strengthened. Brophy believes that additional Board training at the beginning would have helped the board to "congeal" more quickly. He also believed that there should have been core agreement on the boundaries of EBDI activities to counteract mission creep. He believes that EBDI was never meant to own and operate housing or other entities, particularly a new neighborhood school. These additional duties distract EBDI from its purpose and blunt its effectiveness, in Brophy's opinion.

Brophy believes that this project was "idiosyncratic" as Johns Hopkins had a vested interest in Middle East and might not be at the table again. The development of the project has helped the city and the state gain experience in coalition-building for projects that benefit Baltimore, as this is the single largest redevelopment in Baltimore since the revitalization of the Inner Harbor, about one mile from this project, in the late 1970s and early 1980s.

Community Benefits

Brophy described the long-term goals of the East Baltimore Development Initiative as: (1) transforming a neighborhood, (2) marketing an attractive "neighborhood of choice," (3) creating a successful set of life sciences companies with biotechnology-related jobs, and (4) providing a segment of jobs for low- to moderate-income workers in East Baltimore. AECF saw the opportunity to create a "thriving mixed-income mixed-use community, " according to Velazquez.

The immediate benefits to East Baltimore to date are less drug activity, repopulation, and a new neighborhood school. By now, the initiative has helped half of East Baltimore's residents either directly or indirectly, according to Brophy. Furthermore, EBDI launched the East Baltimore Workforce Alliance, which seeks to (a) link residents to educational opportunities and careers, particularly through the Baltimore Healthcare Coalition, (b) continually fill entry-level jobs with neighborhood residents, (c) integrate financial literacy and the practice of accumulating personal savings into workforce development, and (d) support at-risk populations, including ex-prisoners (Cromwell et al, 2005: 119).

Investor Returns

AECF's oversized role in the project has led to internal debate about the appropriateness of the financial role that the foundation played. In particular, the social investing arm of the foundation believes that it should have provided less than 100 percent of the credit enhancement and loan guarantees. According to Velazquez, "there is a tendency for people to think that foundations should pay all of the costs, but receive none of the returns--and clean up everything that is problematic about a project. They don't realize that there is a 9 percent opportunity cost for committing money from the endowment, and that the return has to be made up somewhere else." In fact, Velazquez said, AECF sacrificed this return to enhance Bank of America's return on its NMTC investment, allowing it to receive a guaranteed minimum return and partially fulfill its Credit Reinvestment Act obligations.

For AECF, the scale of the East Baltimore Development Initiative was unprecedented, and AECF's level of portfolio exposure to one project will not be repeated again. AECF has invested in many mixed-use projects, but typically by

lending to the nonprofit loan fund of a CDFI. Because Baltimore was AECF's hometown, however, it accepted a higher level of risk. AECF does not anticipate putting any major new money into the initiative, or any other revitalization projects in eastern Baltimore. AECF continues to seek new partners and investors and has had to contend with the "branding" that East Baltimore Development Initiative is an AECF project. Going forward, AECF will be more focused on co-investments with banks, program-related investments, and investments in community development financial institutions, according to Velazquez.[17]

Johns Hopkins is also making an additional substantial investment in its physical plant and other East Baltimore interests, with a projected investment between 2010 and 2015 of $1.2 billion in East Baltimore. Hopkins agreed to lease 100,000 square feet, or more than one-third, of the first Life Sciences building (Cromwell et al., 2005: 119). This leasing guarantee has attracted other biotechnology and life science tenants, helping to ensure an equity return for Forest City Enterprises on the construction and operation of the life sciences park.

Project Performance

The East Baltimore Development Initiative was the only intervention in Middle East that had the necessary scale, large investment, and community benefits expertise to reverse the ongoing decline of the neighborhood. According to Brophy, "once the process began, there was no going back," nor any additional evaluation of balancing community benefits and investor return. He went on to say that all of the sponsors believed there were community benefits, satisfactory investor return, and a high level of community engagement through an inclusive public process. There was also never a "no action" alternative that would "pull the plug." However, Brophy added, there were no "metrics." Decisions were based on "all judgment," a feeling that the project would accomplish good for the community. Velazquez similarly characterized the project.

The Impact of New Markets Tax Credits

AECF plans to use the NMTC knowledge that it gained from this project to share best practices with other foundations and other redevelopment coalitions. AECF will describe the ways in which "the intensive involvement of a single investor or funder with deep pockets learns to be more efficient" and benefit from gaining expertise and economies of scale. While the transaction costs on first-round NMTC were "staggering," at approximately $1 million, they were consistent with the costs paid by other first-round awardees. By the time of the second investment, the transaction process was much easier.

Brophy believed that NMTC had been helpful, but not crucial, to this project. To him, it was far more important that AECF served as the debt guarantor for Bank of America's tax credit purchase. NMTC was the "icing" that brought in additional capital and the involvement of Enterprise Community Partners and AECF. For the first $15 million allocation, NMTC's complexity added many process meetings to the land acquisition and development transactions. The process also required a steep learning curve to understand how the credits would work, and AECF was "very annoyed" with the legal bills that accompanied the NMTC transaction. For the second $15 million allocation, the process was much simpler, and faster, because the transaction was essentially the same.

The end of the seven-year NMTC holding period is approaching for the first-round NMTC award allocation, and new replacement equity has been sourced, some with follow-on NMTC awards. Although the value of NMTC has been declining recently, this has not affected the East Baltimore Development Initiative, given that the commitments have already been made and the transactions have closed, according to Velazquez. Furthermore, as shown in EBDI's capital funding projections, the project coalition is expecting to refinance existing NMTC loans with new NMTC loans and add on $15 million in NMTCs to the outstanding $30 million that have already been committed (EBDI, 2010a).

Importantly, the involvement of NMTC did guide some evaluation of the community benefits in the deal owing to rights and regulations attached to the NMTC approach. Despite NMTC serving as the "icing," an internal screen was in place at the beginning of the transaction owing to the NMTC, "and then the deal was done." In Brophy's opinion, the NMTC requirements for the East Baltimore Development Initiative resulted in a project that contrasted with other redevelopment deals in which "no one is looking at community benefits. It is essentially a real estate transaction."

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17 AECF will also continue to make grants, and, in fact, it made an important grant to support the Market Creek Project in San Diego, the subject of the third case study in this appendix.

Case Study 3: Market Creek Plaza and Market Creek Village

Financing Gap

In 2004, the developers of Market Creek Plaza, a ten-acre, community-driven retail shopping center in the Diamond Neighborhoods of southeastern San Diego, sought a permanent loan of $15 million for a $23.5 million project. The Jacobs Family Foundation (JFF) and Jacobs Center for Neighborhood Innovation (JCNI) had created the vision for Market Creek Plaza through an extensive community engagement process with more than 3,000 local residents. Market Creek Plaza was intended to capture the majority of the $60 million in local spending leakage (money that was spent by residents outside of the community, rather than locally) for groceries, household items, and services and serve as a welcoming new community space at the heart of the Diamond Neighborhoods, home to 88,000 residents.[18] Market Creek Plaza was also intended to be the gateway project to Market Creek Village, a 63-acre, $1 billion transit-oriented development that would be entirely owned by the community by 2030.

Project Leadership

In 1998, JFF and JCNI of San Diego initiated the Market Creek planning process for the reuse of an 18-acre block of land that had been home to an aerospace factory. JFF had purchased the land and transferred it to Market Creek Partners, LLC, a wholly owned subsidiary of JCNI, for redevelopment. According to Chip Buttner, all of the project's profits would be reinvested in the community.

Based in San Diego, JFF was founded by the Jacobs family in 1988 and began as a grant-making nonprofit foundation involved in issues of neighborhood change, but quickly added technical expertise and hands-on involvement to its capacity. The late Joe Jacobs, the patriarch of the family and a billionaire, was uncomfortable with pure philanthropy, however, and sought to develop a foundation that focused on sustainable community and economic development instead. JFF's mission is to strengthen impoverished neighborhoods in San Diego through strategic investment that supports "innovative, practical strategies for community change," with community engagement values of "relationship, respect, responsibility, and risk" (for more information on the foundation, see www.jacobsfamilyfoundation.org).

JCNI, an offshoot of JFF, is a 501(c)(3) nonprofit incorporated in 1995. JCNI operates with a mission of "resident ownership for neighborhood change" to help the residents of the Diamond Neighborhoods lead and own the change in their neighborhoods. JCNI shares the same planning process values of JFF, and the two organizations are tightly bound together. According to Chip Buttner, oth JFF and JCNI have a sunset year of 2030, at which time the community will have full ownership of all development at Market Creek.

Project Context

JFF and the vision for Market Creek Plaza followed an unusual trajectory to arrive at the critical financing juncture in 2004. In 1998, JFF had been searching for a location in a bank building or shopping center to house a new foundation headquarters. During the search, JFF's intent shifted to become a much more place-based foundation rooted in the Diamond Neighborhoods. During a JFF meeting with a grantee, Joe Jacobs saw the abandoned aerospace factory and determined that JFF would relocate there and develop its own community-based shopping center, which would become JFF's headquarters. JFF tried to pursue the typical developer escrow process and recruit tenants, but found no interested parties. As a result, JFF reformulated its approach. It began a community listening process and leakage analysis, a study of the amount of household and goods and services that were being purchased outside of the community but could be purchased within the community if there was a local retailer, to determine the optimal vision and tenancy for a future shopping center. JFF also purchased the factory outright, according to Chip Buttner, CEO and president of Diamond Management and the developer-operator of Market Creek.

With ownership of the land and a completed vision and strategy for implementing Market Creek Plaza, JFF and JCNI once again sought bank financing. There was still no interest, however. Buttner characterized the bank's resistance to funding as "redlining," or discriminatory lending practices that exclude communities–usually communities of color–from consideration for credit, lending, and mortgages. As a result, JFF borrowed against its stock portfolio

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18 JFF commissioned an economic analysis that determined this was the annual leakage of goods and services spending from the Diamond Neighborhoods.

for an all-cash funding of the equity portion of Market Creek Plaza at a higher than typical equity level for a comparable shopping center development. JFF and JCNI continued to be in the precarious position of needing a loan for $15 million of the total $23.5 to $25 million, for a debt:equity ratio of 65-70 percent. JFF and JCNI also needed a below-market rate, at a point above prime or less, for Market Creek Plaza to be financially sustainable and allow the use of more expensive local labor. The latter is an important mission-based requirement for JFF and JCNI.

At the same time, JFF and JCNI staff people had an ongoing dialogue with the California Southern Small Business Development Corporation (CSSBDC), a nonprofit public-benefit corporation. CSSBDC is a local small business lender focused on minority- and women-owned businesses. It makes "patient debt capital" subprime loans on favorable terms to borrowers–interest-only loans for the first two years and interest-plus-principal for the following seven. CSSBDC is backed by the State of California Office of Small Business' Loan Guarantee Program and subsidized with micro-grants from several foundations, according to Tracy Bryan, public affairs officer at JCNI. CSSBDC initiated a conversation between JFF-JCNI and Douglas Bystry, President of Clearinghouse, CDFI, which is based in southern California (NMTCC, 2006: 18-19).

CSSBDC also had an ongoing partnership with JCNI to incubate and expand minority-, women-, and locally owned businesses in the Diamond Neighborhoods. CSSBDC provided working capital and equipment loans and JCNI developed a special leasing program at Market Creek Plaza. Rather than paying a fixed rent amount, the entrepreneurs and small business owners paid a portion of residual income or monthly profits for their spaces in the shopping center (Bystry, 2005).

Community Benefits Intentions

Market Creek Plaza and the follow-on Market Creek Village have a strong community benefit vision, objectives, and process that are shared by all of the public-private partners, including the NMTC investor, Wells Fargo Bank. The overarching vision is to (1) unify residents, (2) strengthen the process of community change (including anti-gentrification measures), and (3) develop residents' leadership abilities and financial independence. The objectives, said Tracy Ericson, senior vice president at New Markets Tax Credit Investments, were (1) economic development and neighborhood redevelopment, (2) community pride and community investment, (3) job creation and workforce development, (4) wealth-building, and (5) grocery and bank access. To fully engage the community, Bryan said, JFF and JCNI implemented enormous direct community engagement strategies; an elaborate and self-sustaining structure of visioning, process, and feedback community-based teams; and a system of ensuring community representation in the governance structures of Market Creek Plaza and the follow-on projects (Market Creek Partners, 2007).

The Role of New Markets Tax Credits

Clearinghouse CDFI is a mission-driven, for-profit lender focused on economic development, community benefits, and investor returns. Specifically, it has a mission to "provide economic opportunities and improve the quality of life for lower-income individuals and communities through innovative and affordable financing that is unavailable in the conventional market while achieving shareholder objectives" (Clearinghouse CDFI, 2010).

Clearinghouse CDFI had recently received a $56 million first-round NMTC award allocation, or slightly more than 2 percent of the CDFI Fund's $2.5 billion in awards for 2002. Clearinghouse CDFI was able to arrange a $15 million loan, about 27 percent of its NMTC portfolio for that year, through Wells Fargo's Community Development Corporation. They lent to Market Creek Partners, LLC, at a 3 percent rate, instead of the market rate of 6.0 to 6.5 percent, with the explicit intention of supporting the community benefits in the Market Creek vision (NMTCC 2006: 18-19). Market Creek Partners met the Treasury Department's CDFI Fund's NMTC eligibility requirements for poverty and economic development. Market Creek Plaza is also located within a State Enterprise Zone.

Closing the NMTC transaction took several months. For all of the public-private partners, this was a new program that required considerable legal and accounting expertise to implement. Furthermore, several nontraditional aspects of Market Creek Plaza made underwriting more complicated. For example, the special residual leasing structure developed by JCNI for new entrepreneurs made it difficult for Clearinghouse CDFI to project Market Creek Plaza's net operating income, a key factor for determining valuation, debt service coverage ratio, and other important parts of the risk analysis (Bystry, 2005). JFF's financial position, backed by its multi-billion dollar endowment, was crucial to making the underwriting possible, according to Buttner.

The first four banks that Clearinghouse CDFI approached declined to invest. The Jacobs family and JFF already had a depository relationship with Wells Fargo Bank, so the partnership was able to leverage that into a commitment. Wells Fargo Bank was initially reluctant to pursue an NMTC investment due to the risk of being unable to recapture its investment and not knowing whether the NMTC program would last, according to Ericson. The bank needed an additional three months to complete due diligence, develop the tax credit investment strategy, and approve the underwriting. The process was also complicated by JCNI's residual leasing program for entrepreneurs at Market Creek Plaza. In fact, from a credit perspective, the bank completely wrote off the "nonprofit" tenants. Wells Fargo was able to approve the investment, however, at an advantageous 3 percent fixed-rate for the full seven years of the required NMTC holding period. The guaranteed minimum returns due to the use of NMTC, as well as Wells Fargo's decision not to leverage the loan, made this subsidized rate possible (Bystry, 2005). According to Tracy Ericson, internally, Wells Fargo Bank had a policy in place that it would accept a lower rate of return as a trade-off for higher-impact community benefit projects, resulting in a "bifurcated pricing structure." Wells Fargo also provided a $35 million construction line of credit.

Capital Structure

The advantageous NMTC-subsidized loan rate for Market Creek Plaza allowed Market Creek Partners, LLC, to meet the targets set by the community visioning and the metrics established by JFF and JCNI. The sheltered amortized principal repayments freed up working capital for the next part of the project, according to Bryan and Buttner. NMTC "has helped keep the cost of money for development low, keeping more money in the community and freeing foundation funds to support more community development work. The NMTC program has literally made community ownership of the plaza possible." Program-Related Investments (PRI) from other foundations provided additional subordinate debt and safeguarded investor returns on the CDFI Clearinghouse loan. According to Tracy Bryan, the Rockefeller, F.B. Heron, Annie E. Casey Foundation, and Legler Benbough foundations provided $2.5 million in PRI subordinate debt for Market Creek Plaza [See Appendix Table 3].

Appendix Table 3. Market Creek Plaza Capital Structure (as of 2008)

Partner Organization	Amount (millions)	Capital Contribution	Capital Type	Program Type
Diamond Community Investors	$0.5	2.1%	20% Preferred Equity	Community Investment
Neighborhood Unity Foundation	$0.5	2.1%	20% Preferred Equity	Community Investment
JCNI	$2.35	10.0%	Junior Equity	Permanent Financing
Jacobs Family Foundation	$2	8.5%	Junior Equity	Permanent Financing
CDFI Clearinghouse	$15	63.6%	Permanent Loan	NMTC - Wells Fargo
Rockefeller Foundation	$1	4.2%	Subordinated Debt	Program-Related Investment
Annie E. Casey Foundation	$1.25	5.3%	Subordinated Debt	Program-Related Investment
F.B. Heron Foundation	$0.5	2.1%	Program Support	Program-Related Investment
Legler Benbough Foundation	$0.5	2.1%	Program Support	Program-Related Investment
TOTAL	$23.6	100.0%		

Source: JFF-JCNI, 2008

Project Outcomes

Public-Private Coalition

The strengths of the public-private coalition played a strong role in making the Market Creek developments possible. Buttner had been a contractor, banker, and developer, so he contributed important interdisciplinary expertise. In addition, Buttner said, "it has helped the project tremendously to have foundation people and for-profit people. Discussions used to be contentious, but then the people pressing for social benefit versus financial returns switched roles."

JFF and JCNI initiated and have led the project as well as provided equity financing and credit enhancement that leveraged debt financing. JFF and JCNI have fulfilled their investor criteria of strategic investment and sustainable development, as well as the social return criteria of community visioning, a high and ongoing level of community engagement, and the first steps toward actual community ownership of the Market Creek developments. In fact, according to Tracy Bryan, JFF and JCNI hope to transfer complete ownership of Market Creek Partners, LLC, the owner of Market Creek Plaza, to the community by 2012.

The president of Clearinghouse CDFI, Doug Bystry, also became an important proponent for Market Creek. Wells Fargo Bank, the NMTC investor, was a key member of the public-private partnership and expressed interest in additional NMTC investments at Market Creek. NMTC continues to be an important means for Wells Fargo Bank to fulfill its Credit Reinvestment Act requirements and offset its federal taxes on profits. According to Tracy Ericson, the bank also actively markets its community benefit investment in Market Creek Plaza within the Diamond Neighborhoods.

Community Benefits

With financing complete and construction ongoing, the remainder of Market Creek Plaza opened for occupancy about 12 months after the transaction closed.[19] Diamond Management was the general contractor on the construction and, as a result, ensured that 75 percent of construction jobs were sourced from within the Diamond Neighborhoods. Market Creek Plaza sustains 206 full-time equivalent (FTE) jobs, although community hiring has fluctuated. The Joe & Vi Jacobs Center, an add-on development, provides an additional 100 FTE jobs and workforce development training, according to Tracy Bryan.

Tenancy in Market Creek Plaza met community visions, local ownership desires, and achieved a top ten tenant mix based on community meetings and surveys. The mix included a food store, drug store, and entertainment, according to Bryan. The Market Creek team attracted Food4Less as the 57,000 square foot anchor grocery tenant. Food4Less recruited 91 percent of its employees, all of whom completed a JCNI workforce development program, from the neighborhood. In addition, Market Creek Partners reserved 17,000 square feet for small tenants according to the formula of one-third locally owned, one-third newly incubated entrepreneurs, and one-third chain stores.

Wells Fargo further supported Market Creek Plaza by opening a bank branch, and Starbucks occupied a food pad. Starbucks is part of the Urban Coffee Opportunities licensed brand, a joint-venture 50/50 partnership between Starbucks Corporation and Magic Johnson's Johnson Development Corporation. Urban Coffee Opportunities is a mission-based for-profit that reinvests most of its returns in the community, guarantees a living wage and benefits, and has a target market of urban, ethnically diverse communities nationwide (Market Creek Plaza, 2006; Magic Johnson Enterprises, 2010). According to Bryan and Buttner, JFF and JCNI valued brand-name chain stores as an important component of the Market Creek Plaza tenancy, given that they would attract sufficient foot traffic–as does a San Diego Gas & Electric bill paying center–to support the locally owned tenants.

Three additional projects have added community benefits value to Market Creek. JCNI completed the $2.4 million Chollas Creek restoration in 2001, with significant community engagement in the wetlands restoration and installation of public art. JCNI completed the Elementary Institute of Science in 2003 for $5.4 million. According to Chip Buttner, the community and JCNI completed a follow-on habitat restoration project, the Chollas Creek Encanto Tributary Restoration Project in 2008, for $1.7 million with 2,250 linear feet of wetland reclaimed from a polluted channel of a creek. A local firm that the partnership incubated served as the prime contractor.

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19 Portions of Market Creek Plaza, such as the anchor grocery tenant, had opened as early as 2000.

Investor Returns

The community benefits from the Market Creek developments are sizable, and the community ownership intentions are unprecedented in scale, ambition, and implementation. In 2006, Market Creek Partners opened an Initial Public Offering (IPO) targeted to neighborhood residents who wanted to invest in the equity portion of Market Creek Plaza. The IPO would have occurred sooner, but Market Creek Partners waited until Market Creek Plaza had proven its viability and also had to obtain approval from the state's Department of Corporations for the right to sell to unqualified investors.[20] Approval took six years of negotiations. The department imposed a ceiling of $10,000 per investor, and investors had to understand that they were investing in a double-bottom line corporation; that is, community benefits objectives could potentially reduce investor returns, without being a breach of fiduciary duty on the part of Market Creek Partners. Preferred units in Diamond Community Investors (DCI) were priced at $10, with a minimum purchase of 20 units. Four-hundred and sixteen "investors" representing 600 local community residents purchased interests of between $200 and $10,000. Together they hold a 20 percent ownership stake. The average investment is $1,185 and investors can purchase their interests using a payment plan. Each resident, regardless of the size of the investment, has one shareholder vote. There is a nine-member DCI advisory council that represents the preferred investors, and one member of this board has a seat on the board of Market Creek Partners. Investors earned a 10 percent preferred return during the first year.

Residents have also created a separate 501(c)(3), the Unity Foundation, to determine how to use the profits from Market Creek Partners to continue to improve the neighborhood. The Unity Foundation owns an additional 20 percent of the Market Creek Plaza equity and also receives preferred dividends (JCNI, 2008).

The seven-year holding period for the NMTC that supported Market Creek Plaza is almost completed, but JFF and JCNI anticipate favorable NMTC refinancing of this loan, according to Buttner. In fact, it is possible that the commercial balloon loan could be refinanced as a new NMTC-backed loan if Market Creek Partners undertakes improvements such as environmental sustainability upgrades, public infrastructure improvements, or attracts a new tenant with significant community benefits (such as a nonprofit health provider, for example). The appraisal value of Market Creek Plaza has substantially increased since the development began, which would support a low interest rate, as the loan-to-value ratio and risk factors would be low.

Market Creek Plaza has captured $40 million of the estimated $60 million in leakage from the Diamond Neighborhoods. After one year, the Food4Less had 25 percent higher gross sales per square foot than comparable stores (NMTCC, 2006: 18-19). The local residents who invested in preferred shares in DCI have earned 10 percent preferred returns the first year. The two largest resident-owned businesses were current on loans and lease payments. Construction contracts of $27 million, representing 76 percent of work through 2007, were awarded to minority- and women-owned businesses, including a local company that took on the restoration of Chollas Creek (JFF & JCNI, 2008).

Subsequent Development

JFF and JCNI built the Joe and Vi Jacobs Center as part of the second phase of Market Creek Village. A $15 million NMTC-backed permanent loan was arranged through Clearinghouse CDFI, at a rate of 2.5 percent. U.S. Bank and Washington Mutual purchased the credits (JCNI, 2008). (See Appendix Table 4 for the complete capital stack). The three-story, 75,000-square-foot building includes a meeting and conference center with banquet service on the first floor, six to ten commercial offices on the second floor, and the headquarters of the Jacobs Family Foundation on the third floor. An economic analysis commissioned by JFF and JCNI determined there was significant economic leakage in the convention and tourism industry, valued at $8 billion per year in San Diego, from the Diamond Neighborhoods. Services targeting this leakage were viable for this location, five minutes by freeway from downtown. With a pro forma goal of $4 million in revenue per year, the meeting and conference center employs an additional 100 community residents and trains them in hospitality, is nearing the break-even point, and has a long-term community ownership strategy, according to Bryan. As both Buttner and Bryan point out, the advantageous NMTC finance rate for the Joe and Vi Jacobs Center once again allowed for much greater capacity building than would have normally been possible because less income had to be applied to interest payments.

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20 According to Tracy Bryan, the Department of Corporations requires private placement investors to be of high net worth, so that a total loss of an investment would not impair them financially. JCNI had to convince the Department of Corporations that the investments in DCI would be scaled to the means of the investor and that investors would be thoroughly screened and educated about the investment. The final agreement allowed investment of up to 10 percent of annual income or 10 percent of net worth, but below the $10,000 ceiling.

Appendix Table 4. Joe & Vi Jacobs Center Capital Structure (as of 2008)

Partner Organization	Amount (millions)	Capital Contribution	Capital Type	Program Type
Private Investors (Seeking)	$5	17.5%	Equity	*To Be Determined
CDFI Clearinghouse	$15	52.6%	Permanent Loan	NMTC - US Bank & WaMu
JCNI	$3.5	12.3%	Subordinated Debt	Permanent Financing
Jacobs Family Foundation Grant	$5	17.5%	Grant	Building Infrastructure
TOTAL	$28.5	100.0%		

Source: JFF & JCNI, 2008

JFF, JCNI, and the equity owners of Market Creek Plaza now control 45 acres and will add 9 more acres in the near future, with an ultimate goal of 63 to "achieve scale" for Market Creek Village (JCNI, 2008).

The Market Creek Village site includes 20 acres of brownfields and contaminated apartment buildings, and the coalition has completed site cleanup and preparation. At its maximum extent, the vision for the entire 15-year build-out of the site includes 800 new homes, 350,000 square feet of commercial and industrial development, and 500 additional jobs. Total investment could reach $1 billion, and NMTC-backed financing would play a key role (JCNI, 2008). An enlarged public-private coalition has emerged for this project, including the San Diego City Council, San Diego Redevelopment Agency, San Diego Association of Governments, Urban Land Institute, San Diego Funders Collaborative, Rockefeller Foundation, and McCormack Baron Salazar, a for-profit community developer that will be the master site developer.

Market Creek Village's residences were originally intended to be owner-occupied residences, but the recession has changed the plan to a mix of one-third rent-to-own and two-thirds rental. The rent-to-own residences are primarily targeted to moderate-income households earning $37,000 per year. The rent-to-own component is structured such that residents can purchase an ownership share in a single-purpose LLC cooperative and the rent pays the debt service and amortization of the construction and development loans. At a rent of one-third of gross income, or $850 to 1,150 per month, the households could have never afforded to pay more than 20 percent of the true rent-to-own value. NMTC allows a repayment of 61 percent of every dollar, with a 91 percent ownership subsidy.

Within the footprint of the Market Creek developments, JFF and JCNI, in collaboration with the community, are also developing the Market Street Industrial Park. JCNI is pursuing an expansion of the Empowerment Zone to include this area. A combination of adaptively reused and new structures will focus on green technology.

The Impact of New Markets Tax Credits

NMTC made the Market Creek developments feasible. The advantageous debt rates made the community benefits of Market Creek possible, according to Buttner. The low rates of the NMTC-backed loans also stemmed gentrification by allowing Market Creek Partners to subsidize leases. Without NMTC, Wells Fargo Bank would have been unable to partner in the redevelopment, according to Bryan.

The requirements of NMTC were aligned with the intentions of the public-private coalition for the Market Creek developments, but some of those goals affected the financial returns of Market Creek Plaza. If Market Creek Partners had been able to lease out all of the retail space to national tenants, the shopping center would have had higher foot traffic and stronger sales performance. As Buttner pointed out, 80 to 90 percent of small businesses go under, and it is difficult to scale up small businesses even if they succeed. During the recession, Food4Less managed a 12 percent sales growth, while the locally owned restaurants saw 30 percent sales declines. Stronger profits overall would have allowed the next phases of the Market Creek developments to proceed more quickly. However, if Market Creek Plaza had not included community benefits, such as promoting local entrepreneurship and ownership, it would not have qualified for NMTC.

Appendix D: Authorizing Legislation

Internal Revenue Code

§ 45D New markets tax credit

(a) Allowance of credit.

(1) In general. For purposes of, in the case of a taxpayer who holds a qualified equity investment on a credit allowance date of such investment which occurs during the taxable year, the new markets tax credit determined under this for such taxable year is an amount equal to the applicable percentage of the amount paid to the qualified community development entity for such investment at its original issue.

(2) Applicable percentage. For purposes of, the applicable percentage is—

(A) 5 percent with respect to the first 3 credit allowance dates, and

(B) 6 percent with respect to the remainder of the credit allowance dates.

(3) Credit allowance date. For purposes of, the term "credit allowance date" means, with respect to any qualified equity investment—

(A) the date on which such investment is initially made, and

(B) each of the 6 anniversary dates of such date thereafter.

(b) Qualified equity investment. For purposes of this —

(1) In general. The term "qualified equity investment" means any equity investment in a qualified community development entity if—

(A) such investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash,

(B) substantially all of such cash is used by the qualified community development entity to make qualified low-income community investments, and

(C) such investment is designated for purposes of this section by the qualified community development entity.

Such term shall not include any equity investment issued by a qualified community development entity more than 5 years after the date that such entity receives an allocation under. Any allocation not used within such 5-year period may be reallocated by the Secretary under.

(2) Limitation. The maximum amount of equity investments issued by a qualified community development entity which may be designated under by such entity shall not exceed the portion of the limitation amount allocated under to such entity.

(3) Safe harbor for determining use of cash. The requirement of shall be treated as met if at least 85 percent of the aggregate gross assets of the qualified community development entity are invested in qualified low-income community investments.

(4) Treatment of subsequent purchasers. The term "qualified equity investment" includes any equity investment which would (but for) be a qualified equity investment in the hands of the taxpayer if such investment was a qualified equity investment in the hands of a prior holder.

(5) Redemptions. A rule similar to the rule of shall apply for purposes of this.

(6) Equity investment. The term "equity investment" means—

(A) any stock (other than nonqualified preferred stock as defined in) in an entity which is a corporation, and

(B) any capital interest in an entity which is a partnership.

(c) Qualified community development entity. For purposes of this —

(1) In general. The term "qualified community development entity" means any domestic corporation or partnership if—

(A) the primary mission of the entity is serving, or providing investment capital for, low-income communities or low-income persons,

(B) the entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity, and

(C) the entity is certified by the Secretary for purposes of this as being a qualified community development entity.

(2) Special rules for certain organizations. The requirements of shall be treated as met by—

(A) any specialized small business investment company (as defined in), and

(B) any community development financial institution (as defined in section 103 of the Community Development Banking and Financial Institutions Act of 1994).

(d) Qualified low-income community investments. For purposes of this —

(1) In general. The term "qualified low-income community investment" means—

(A) any capital or equity investment in, or loan to, any qualified active low-income community business,

(B) the purchase from another community development entity of any loan made by such entity which is a qualified low-income community investment,

(C) financial counseling and other services specified in regulations prescribed by the Secretary to businesses located in, and residents of, low-income communities, and

(D) any equity investment in, or loan to, any qualified community development entity.

(2) Qualified active low-income community business.

(A) In general. For purposes of, the term "qualified active low-income community business" means, with respect to any taxable year, any corporation (including a non-profit corporation) or partnership if for such year—

(i) at least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within any low-income community,

(ii) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within any low-income community,

(iii) a substantial portion of the services performed for such entity by its employees are performed in any low-income community,

(iv) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in) other than collectibles that are held primarily for sale to customers in the ordinary course of such business, and

(v) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property (as defined in).

(B) Proprietorship. Such term shall include any business carried on by an individual as a proprietor if such business would meet the requirements of were it incorporated.

(C) Portions of business may be qualified active low-income community business. The term "qualified active low-income community business" includes any trades or businesses which would qualify as a qualified active low-income community business if such trades or businesses were separately incorporated.

(3) Qualified business. For purposes of this, the term "qualified business" has the meaning given to such term by ; except that—

(A) in lieu of applying thereof, the rental to others of real property located in any low-income community shall be treated as a qualified business if there are substantial improvements located on such property, and

(B) thereof shall not apply.

(e) Low-income community. For purposes of this —

(1) In general. The term "low-income community" means any population census tract if—

(A) the poverty rate for such tract is at least 20 percent, or

(B) (i) in the case of a tract not located within a metropolitan area, the median family income for such tract does not exceed 80 percent of statewide median family income, or

(ii) in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.

Subparagraph (B) shall be applied using possessionwide median family income in the case of census tracts located within a possession of the United States.

(2) Targeted populations. The Secretary shall prescribe regulations under which 1 or more targeted populations (within the meaning of section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994) may be treated as low-income communities. Such regulations shall include procedures for determining which entities are qualified active low-income community businesses with respect to such populations.

(3) Areas not within census tracts. In the case of an area which is not tracted for population census tracts, the equivalent county divisions (as defined by the Bureau of the Census for purposes of defining poverty areas) shall be used for purposes of determining poverty rates and median family income.

(4) Tracts with low population. A population census tract with a population of less than 2,000 shall be treated as a low-income community for purposes of if such tract—

(A) is within an empowerment zone the designation of which is in effect under, and

(B) is contiguous to 1 or more low-income communities (determined without regard to).

(5) Modification of income requirement for census tracts within high migration rural counties.

(A) In general. In the case of a population census tract located within a high migration rural county, shall be applied by substituting "85 percent" for "80 percent".

(B) High migration rural county. For purposes of, the term "high migration rural county" means any county which, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

(f) National limitation on amount of investments designated.

(1) In general. There is a new markets tax credit limitation for each calendar year. Such limitation is—

(A) $1,000,000,000 for 2001,

(B) $1,500,000,000 for 2002 and 2003,

(C) $2,000,000,000 for 2004 and 2005,

(D) $3,500,000,000 for 2006 and 2007,

(E) $5,000,000,000 for 2008, and

(F) $5,000,000,000 for 2009.

(2) Allocation of limitation. The limitation under shall be allocated by the Secretary among qualified community development entities selected by the Secretary. In making allocations under the preceding sentence, the Secretary shall give priority to any entity—

(A) with a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities, or

(B) which intends to satisfy the requirement under by making qualified low-income community investments in 1 or more businesses in which persons unrelated to such entity (within the meaning of or) hold the majority equity interest.

(3) Carryover of unused limitation. If the new markets tax credit limitation for any calendar year exceeds the aggregate amount allocated under for such year, such limitation for the succeeding calendar year shall be increased by the amount of such excess. No amount may be carried under the preceding sentence to any calendar year after 2014.

(g) Recapture of credit in certain cases.

(1) In general. If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a qualified community development entity, there is a recapture event with respect to such investment, then the tax imposed by this chapter for the taxable year in which such event occurs shall be increased by the credit recapture amount.

(2) Credit recapture amount. For purposes of, the credit recapture amount is an amount equal to the sum of—

(A) the aggregate decrease in the credits allowed to the taxpayer under for all prior taxable years which would have resulted if no credit had been determined under this with respect to such investment, plus

(B) interest at the underpayment rate established under on the amount determined under for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved.

No deduction shall be allowed under this chapter for interest described in.

(3) Recapture event. For purposes of, there is a recapture event with respect to an equity investment in a qualified community development entity if—

(A) such entity ceases to be a qualified community development entity,

(B) the proceeds of the investment cease to be used as required of, or

(C) such investment is redeemed by such entity.

(4) Special rules.

(A) Tax benefit rule. The tax for the taxable year shall be increased under only with respect to credits allowed by reason of this which were used to reduce tax liability. In the case of credits not so used to reduce tax liability, the carryforwards and carrybacks under shall be appropriately adjusted.

(B) No credits against tax. Any increase in tax under this subsection shall not be treated as a tax imposed by this chapter for purposes of determining the amount of any credit under this chapter or for purposes of.

(h) Basis reduction. The basis of any qualified equity investment shall be reduced by the amount of any credit determined under this with respect to such investment. This shall not apply for purposes of, and.

(i) Regulations. The Secretary shall prescribe such regulations as may be appropriate to carry out this, including regulations—

(1) which limit the credit for investments which are directly or indirectly subsidized by other Federal tax benefits (including the credit under and the exclusion from gross income under),

(2) which prevent the abuse of the purposes of this,

(3) which provide rules for determining whether the requirement of is treated as met,

(4) which impose appropriate reporting requirements,

(5) which apply the provisions of this to newly formed entities, and

(6) which ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments.

Appendix E: Survey Instrument

Enhancing New Markets Tax Credit Pipeline Flow - Survey

1. Welcome

Thank you for taking the time to respond to this New Markets Tax Credit survey, which will assist us in preparing a working paper for publication within the next three months.

The working paper will respond to the question, "How do NMTC participants use project pipeline development strategies to maintain a continuous flow, in spite of funding gaps and market volatility?"

There are several multiple choice questions followed by a few short-answer questions. At the end, there is also an opportunity to request a follow-up phone call within the next three weeks from the survey administrator.

All answers are confidential, and will not be directly attributed to you or your organization in the working paper.

Enhancing New Markets Tax Credit Pipeline Flow - Survey

2. NMTC Participation

How does your organization participate in the New Markets Tax Credit Program?

- ☐ CDE
- ☐ CDFI
- ☐ CDFI Intermediary
- ☐ Venture Fund
- ☐ Bank
- ☐ Mission-Based Depository Bank
- ☐ For-Profit Mission-Based Organization
- ☐ Non-Profit
- ☐ Industry Group
- ☐ QALICB

If you play an additional role that is not included above, please describe it:

____

Which years has your organization participated in the NMTC program?

☐ 2000 ☐ 2001 ☐ 2002 ☐ 2003 ☐ 2004 ☐ 2005 ☐ 2006 ☐ 2007 ☐ 2008 ☐ 2

Enhancing New Markets Tax Credit Pipeline Flow - Survey

3. Sourcing Deals

In which ways does your organization source deals?

- [ ] Internally - the loan or underwriting department passes deals to us that do not qualify for traditional financing
- [ ] Internally - deals are sourced based on Board members, executives, or internal cultivation strategies
- [ ] Repeat clients
- [ ] CDFI intermediaries
- [ ] Industry coalitions
- [ ] Community development membership organizations such as Business Improvement Districts
- [ ] Churches or other religious institutions
- [ ] Executives who serve on other Boards
- [ ] Grassroots organizations
- [ ] Elected officials
- [ ] Public agencies
- [ ] Larger revitalization or redevelopment efforts
- [ ] Our deal sourcing has become more internally-drive since the recession began in December 2007
- [ ] Our deal sourcing has become more externally-driven since the recession began in December 2007

Other (please specify)

Enhancing New Markets Tax Credit Pipeline Flow - Survey

4. Funding Gaps and Fee-Driven Issues

How often does your organization encounter funding gaps or fee-driven issues that challenge NMTC project viability?

	Very Rarely	Sometimes	Generally	Most of the Time	Every Project
Funding Gaps	○	○	○	○	○
Fee-Driven Issues	○	○	○	○	○

What is the single largest funding gap or fee-driven issue?

Which strategies has your organization used to overcome funding gaps or fee-driven issues for NMTC projects? Please select all of the following that apply.

- ☐ Waive standard fees
- ☐ Capitalize fees or additional costs into debt or equity
- ☐ Allow higher Loan-to-Value
- ☐ Reduce loan payback spread
- ☐ Find new debt lender
- ☐ Client pledges additional collateral
- ☐ Utilize mezzanine loan
- ☐ Utilize 3rd-party credit enhancement
- ☐ Find public grant-based source of funding
- ☐ Find private or foundation source of grant-based funding
- ☐ Bond financing
- ☐ Reduce the project ROI
- ☐ Refinance outstanding debt for our clients to free up their cash flow for new projects

Other (please specify)

Enhancing New Markets Tax Credit Pipeline Flow - Survey

5. NMTC Cost-of-Capital

Has the recession (from December 2007 to now) changed the amount that investors are willing to pay for NMTC?

	Significantly lower	Somewhat lower	Unchanged	Somewhat higher	Significantly higher
Please characterize the change in value	○	○	○	○	○

Have changes in value created new issues for NMTC-backed projects?

For your NMTC-supported projects prior to the recession (before December 2007), how did you use NMTC cost-of-capital advantages to make projects possible?

- ☐ Reduced developer or project financing costs
- ☐ Capitalized fees or pre-development funding
- ☐ Utilized pass-throughs to support non-profits
- ☐ Capitalized a separate loan fund
- ☐ Covered operating expenses
- ☐ Did not participate prior to December 2007

Other (please specify)

Enhancing New Markets Tax Credit Pipeline Flow - Survey

6. Balance of Debt and Equity Investments

For your NMTC-supported projects, what is the overall balance of debt and equity for entire projects?

	Primarily Debt	More Debt than Equity	Equal Amounts of Debt and Equity	More Equity than Debt	Primarily Equity
Before the recession (prior to December 2007)	○	○	○	○	○
During the recession (from December 2007 to now)	○	○	○	○	○

Enhancing New Markets Tax Credit Pipeline Flow - Survey

7. Portfolio Diversity

How would you characterize your NMTC portfolio prior to the recession (before December 2007)?

	Less than 25%	Between 25% and 50%	Between 50% and 75%	More than 75%	N/A
Real estate development	○	○	○	○	○
Venture funds	○	○	○	○	○
Entrepreneurial or business incubation	○	○	○	○	○
Pooled funds	○	○	○	○	○
Blended-value projects	○	○	○	○	○
Non-profit growth	○	○	○	○	○
Workforce development	○	○	○	○	○
Mixed-use development with inclusionary housing	○	○	○	○	○
Commercial development	○	○	○	○	○
Industrial or manufacturing expansion	○	○	○	○	○

Other (please specify)

Enhancing New Markets Tax Credit Pipeline Flow - Survey

How would you characterize your NMTC portfolio during the recession (from December 2007 to now)?

	Less than 25%	Between 25% and 50%	Between 50% and 75%	More than 75%	N/A
Real estate development	○	○	○	○	○
Venture funds	○	○	○	○	○
Entrepreneurial or business incubation	○	○	○	○	○
Pooled funds	○	○	○	○	○
Blended-value projects	○	○	○	○	○
Non-profit growth	○	○	○	○	○
Workforce development	○	○	○	○	○
Low-income housing mixed-use development	○	○	○	○	○
Commercial development	○	○	○	○	○
Industrial or manufacturing expansion	○	○	○	○	○

Other (please specify)

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