New Markets Tax Credit Coalition

NMTCC Policy Bulletin - Fiscal Cliff Edition

As this report goes to press, the White House and Congress continue in negotiations over the 'fiscal cliff' -- the combination of tax increases and spending reduction that totals over $600 billion and takes effect on January 1.

Table 1: Fiscal Cliff:

Taxes	
Expiration of the Bush Tax Cuts	$221 billion
Expiration of the payroll tax cut	$95 billion
Other expiring provisions	$65 billion
Taxes included in the Affordable Care Act	$18 billion
Total Taxes	**$399 billion**
Spending	
Across-the-board cut (Budget Control Act)	$65 billion
Expansion of long term unemployment	$26 billion
"Doc Fix"	$11 billion
Total Spending	**$102 billion**
Increased Revenue/Lower Spending	**$105 billion**
Total	**$606 billion**

While the election did add some measure of clarity about increasing tax revenue, there is little agreement over the size and the scope of tax increases or spending reductions that would be included in a package that goes before Congress before the end of the year.

Two proposals have been made public – one from the White House and the other from House Republicans. Both contain 10 year deficit reduction targets in the range of $4 billion, the amount recommended by the Bowles-Simpson Commission.

Table 2: Fiscal Cliff Proposals

	Administration	House Republicans
Taxes	**$1.4 trillion***	**$800 billion**
Spending		
Health Programs	$350 billion	
Mandatory	$250 billion	$300 billion
Discretionary	$0	$300 billion
Previous Savings		
Budget Control Act	$1 trillion	$1 trillion
War drawdown	$800 billion	$800 billion
Interest savings	$600 billion	$600 billion
T**otal**	**$4.4 trillion**	**$4.6 trillion**

**net; includes tax extenders*

The differences in tax revenue and spending are significant and predictable -- with the White House wanting more tax revenue and less spending reductions and the House Republicans proposing less revenue and less spending. Of note is that the Administration proposal includes tax extenders, including NMTC. The House offer does not include that level of detail. However, there are good indications from House Republicans of support for the Credit and their intention to include NMTC in the final fiscal cliff package, if there is one, which is of course the $600 billion question. Stay tuned.

Regardless of the outcome of this lame duck session of Congress, all sides have clear that 2013 will be the year of tax reform. It has been 25 years since the last major tax reform legislation was enacted and in that time the code has become far more complex. According to Senate Finance Committee Chairman Max Baucus (D-MT), when Congress considered the 1986 Tax Reform Act, there were only 14 expiring provisions. Today there are 132. Since the last tax reform law, Congress has enacted 15,000 changes to the Internal Revenue Code.

For reasons related to deficit reduction and promoting economic growth, there will be great pressure to move forward on tax overhaul legislation. For example, the National Commission on Fiscal Responsibility and Reform, commonly known as Bowles-Simpson, has recommended $4 trillion in deficit reduction over 10 years. The $4 trillion deficit reduction target has gained great currency in Washington. Bowles-Simpson recommends six steps to remedy the deficit situation, one of them is:

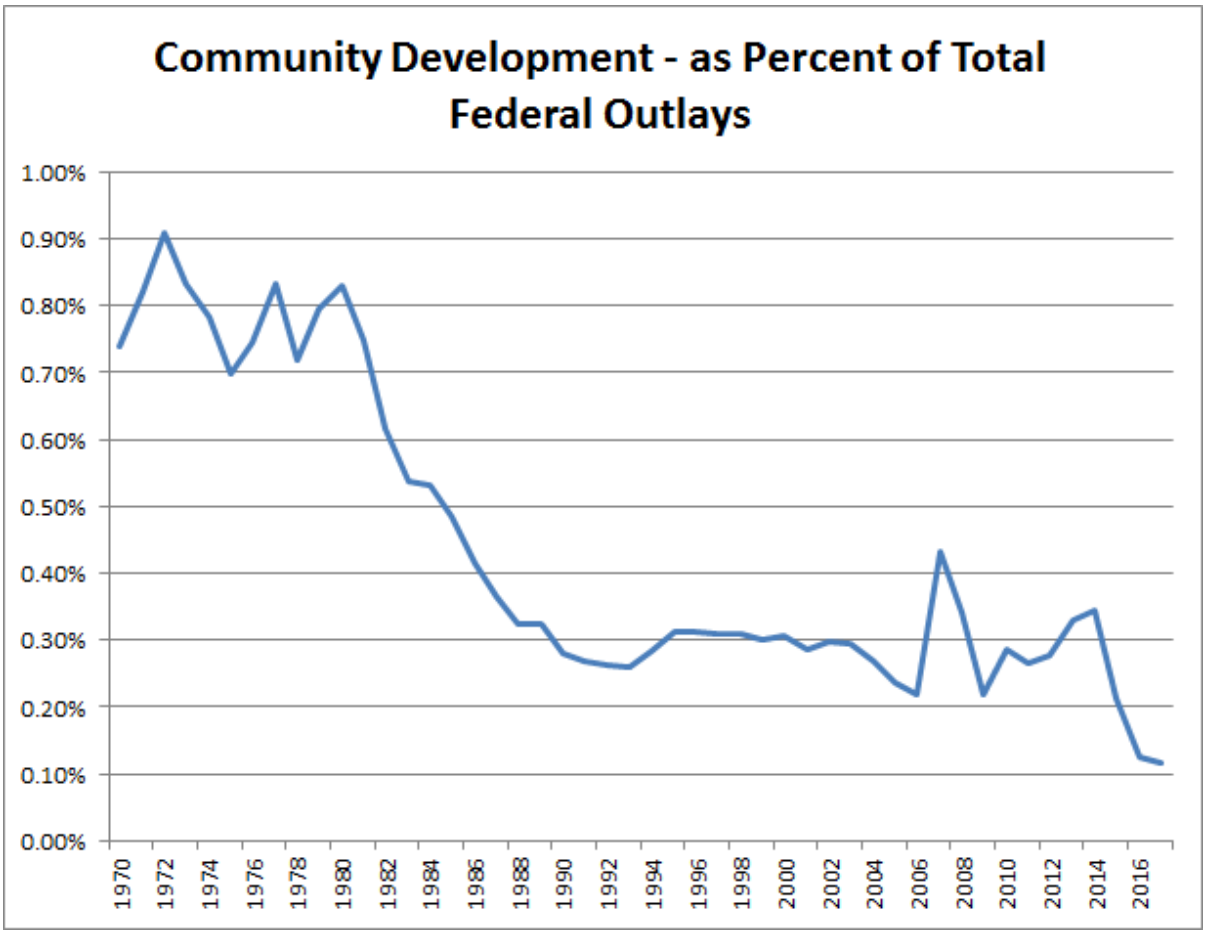
"Comprehensive Tax Reform: Sharply reduce rates, broaden the base, simplify the tax code, and reduce the deficit by reducing the many "tax expenditures"—another name for spending through the tax code. Reform corporate taxes to make America more competitive, and cap revenue to avoid excessive taxation … These tax earmarks – amounting to $1.1 trillion a year of spending in the tax code – not only increase the deficit, but cause tax rates to be too high."

Among the 132 expiring provisions cited by Senator Baucus is the New Markets Tax Credit (NMTC). The Credit is not expensive, at least compared to other similar provisions; it also does not add to the complexity of the code for the average taxpayer as most investors are corporations (*Source: New Markets Tax Credit Coalition, survey of NMTC allocatee activity covering January 1 – December 31, 2011. Survey respondents reported that 0.1% of NMTC investments came from individual investors*). There is a strong argument on the success of the Credit in incenting private sector capital to some of the poorest urban and rural communities in the America. Most recently, there is evidence that the

businesses receiving NMTC financing and the jobs created directly or indirectly by those businesses, generate enough federal tax revenue to offset the cost of the program (*Source: New Markets Tax Credit Economic Impact Report: Rapoza Associates*) and provide a return on investment to the federal government.

Over the last 30 years, there has been an important shift in the allocation of federal resources for community development. Beginning in 1980 and accelerating in the current Congress, direct federal spending for community development as measured by share of GDP has fallen by 75%. In the last two years alone, spending at a number of federal agencies --Housing and Urban Development, Commerce, Agriculture and Interior --on a range of housing, community and economic development programs was reduced by over 17%.

As federal community development spending has declined, Congress has added tax expenditures aimed at revitalizing communities, providing affordable housing and increasing economic opportunity. These included the Low Income Housing Tax Credit (LIHTC), Enterprise and Empowerment Zones and, most recently, New Markets Tax Credit. Successive administrations of both parties have viewed the tax code as their preferred vehicle for community development. Indeed during the Administration of George W. Bush, Low Income Housing and New Markets Tax Credits were identified as the pillars of his urban policy (*Source: New Markets Tax Credit – Tenth Anniversary Report. New Markets Tax Credit Coalition, 2011*).



The shift in allocation of resources from the spending to the tax side of the federal ledger has brought increased scrutiny. In March 2012, the Government Accountability Office (GAO) released a

report analyzing community development tax expenditures. The report Limited Information on the Use and Effectiveness of Tax Expenditures Could Be Mitigated through Congressional Attention *(GAO-12-262*) followed on the heels of a similar study analyzing the direct federal spending on loans grants authorized under some 80 programs.

Of the community development tax expenditures cited by the GAO, twelve support community development in low income communities, including tax expenditures for low income housing, enterprise zones, brownfields and private academy bonds, historic restoration, tribal economic development, and the new markets tax credit (See Table 3).

Table 3: Annual Federal Cost of Tax Incentives for Community Development (2011)

Program	**Annual amount**
*LIHTC	$5,650,000,000
*Exclusion of interest on rental housing bonds	$1,050,000,000
Empowerment zones	$730,000,000
HTC (20%) + 10% rehab credit	$410,000,000
NMTC	$720,000,000
Recovery zone bonds	$60,000,000
Tribal economic development bonds	$10,000,000
Brownfields redevelopment	$80,000,000
Credit for holders of qualified academy bonds	$200,000,000
Exclusion of interest for airport, dock, and similar bonds	$840,000,000
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	$460,000,000
Total	**$10,210,000,000**

**Primarily rental housing.*
***Source for table data**: A 2012 GAO report on incentives for community development.*

The challenge going forward for NMTC is to be sure that the unique nature of the Credit is recognized and understood by policymakers. At a moment in time in which every federal expenditure is closely examined, all sides – the Administration and Congress -- are on the lookout for programs that appear to overlap or duplicate others in hopes of reducing costs and improving efficiency.

As the debate on tax reform unfolds it is likely that the GAO report will be trotted as exhibit A in making the case that community development tax expenditures should and can be reduced because of duplication and overlap.

Key Points

New Markets Tax Credit makes up only about 7% of annual tax expenditures for community development. NMTC stands alone as the sole economic development incentive that is generally available, which transforms private sector capital into patient, flexible capital for credit-starved businesses in low income communities. NMTC is the only incentive that provides both (1) the flexibility to finance a variety of businesses and projects in these communities along with (2) an effective established system to deliver that financing.

Other credits in the same community development tax expenditure category, such as The Recovery Zone Bonds and Tribal Economic Development Bonds serve a similar purpose, but they both expired at the end of 2010 and both had a narrow list of targeted communities. The increased Section 179 deduction for businesses within Empowerment Zones (EZs) allows businesses located in one of less than 100 low income communities to claim a larger deduction for certain assets (accelerated depreciation for capital expenditures) but the Section 179 deduction does not directly incentivize outside financing like the NMTC*(Note: Businesses may claim an increased deduction of up to the smaller of $35,000 or the cost of eligible property purchases (including equipment and machinery) for businesses in an EZ)*. The only other incentive that drives capital to businesses in low income communities is the Brownfields redevelopment program, but this incentive is narrowly targeted to areas needing environmental remediation. See Table 4 for more information.

Table 4: Federal Tax Incentives Primarily Intended to Drive Capital to Businesses in Low Income Communities

Program	Amount
New Markets Tax Credit	$720,000,000.00
Recovery Zone Bonds	$60,000,000.00
Tribal economic development bonds	$10,000,000.00
Brownfields redevelopment	$80,000,000.00

Most of the $10 billion in federal tax expenditures cited by the 2012 GAO report target the construction of rental housing. By law, the NMTC cannot be used in combination with the LIHTC. While the NMTC is occasionally used to finance affordable owner occupied housing (6%) *(Source: 2012 NMTC Progress Report. The New Markets Tax Credit Coalition.)*, there are strict limitations on its use to create rental property *(Note: The NMTC statute, IRC Section 45D(e)3, prohibits using the NMTC to finance residential rental property and the statute references Section 168(e)2 of the IRS regulation where a residential rental property is defined as any building or structure if 80 percent or more of the gross rental income is derived from rental income from dwelling units. Therefore the NMTC can be used to finance mixed-use real estate projects where a portion of the development is dedicated to rental or for-sale housing and a portion dedicated to commercial or community uses as long as less than 80% of the development's gross rental income is derived from the dwelling units.)*

A closer look at the impact of the community development incentives identified in the GAO reveals that $4.9 billion ends up in low income communities targeted by NMTC (See Table 5). For example, while rental housing incentives can serve to revitalize communities, they are intended to target low income families and individuals rather low income communities. The LIHTC works well at directing private capital toward the creation of affordable housing; 31% of LIHTC projects are in low income communities that qualify for the NMTC.

Table 5: Adjusting GAO Cost Numbers Based on Capital Flow to Low Income Communities

Program	**Annual amount**	**Percent going to low income communities**	**Amount going to low income communities**
Empowerment zones	$730,000,000	100%	$730,000,000
HTC (20%) + 10% rehab credit	$410,000,000	77%*	$315,700,000
NMTC	$720,000,000	100%	$720,000,000

LIHTC	$5,650,000,000	31%**	$1,751,500,000
Recovery zone bonds	$60,000,000	100%	$60,000,000
Tribal economic development bonds	$10,000,000	100%	$10,000,000
Brownfields redevelopment	$80,000,000	100%	$80,000,000
Credit for holders of qualified academy bonds	$200,000,000	100%	$200,000,000
Exclusion of interest on rental housing bonds	$1,050,000,000	100%	$1,050,000,000
Total	**$8,910,000,000**		**$4,917,200,000**

**Source: An analysis of National Park Service HTC transaction-level data by the National Trust Community Investment Corporation*
***Source: An analysis of Housing and Urban Development LIHTC transaction-level data by the New Markets Tax Credit Coalition.*

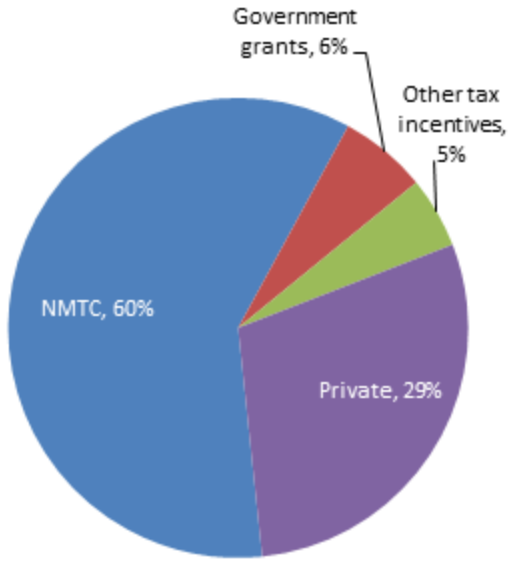
While Congress intended the NMTC to be paired with other federal incentives, this occurs infrequently. Some have criticized the NMTC for being used in concert with other federal incentives. However, both the statute and the rule governing NMTC explicitly authorize the use of NMTC with other tax incentives and preferences, excluding the Low Income Housing Tax Credit. *(See: Treasury Department regulation §1.45D-1(g)(3))*

The NMTC provides only a modest return as compared to the return on similar risk based investments, which provides a 6.5% to 13% annual return versus the 5.5 % return for NMTC investments. In addition, the preponderance of NMTC projects are in the poorest communities in the country– with poverty rates of more than 30% and unemployment rates exceeding 1.5 times the national average. Developing and financing projects in those high distress communities is challenging in terms of infrastructure, the availability of other sources of private sector financing and uncertain markets. For these very reasons, Congress authorized the Secretary of Treasury to issue guidance that facilitates the use of NMTC with other credits.

There is no data available on the use of NMTC with other federal tax credits. Only anecdotal information is available. For example, the NMTC Coalition reviewed forty NMTC projects financed over the last nine years. Our findings indicate that only 5% of financing on NMTC projects came from incentives other than the NMTC. In this sample, the NMTC financed 60% of total project costs and the private sector financed 29%, so a total of almost 90% of the cost of financing these businesses ultimately came from the private sector *(see chart below: Sources of Financing – Selected NMTC Projects)*

The historic tax credit has proven to be an effective incentive for putting vacant or underutilized historic buildings to use, and a substantial amount of HTC projects – nearly 77% of the over 8,000 projects between 2000 and 2011 - are in low income communities that qualify for the NMTC. When used together, Historic Tax Credit financing expenditures must still comply with the Secretary of Interior's Standards for Historic Rehabilitation.

Sources of Financing - Selected NMTC Projects



Source: Analysis of selected projects by the NMTC Coalition

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