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United States General Accounting Office
Washington, DC 20548

December 6, 2002

Congressional Committees

Subject: *New Markets Tax Credit: Status of Implementation and Issues Related to GAO's Mandated Reports*

The New Markets Tax Credit (NMTC) Program provides a credit against federal taxes for up to $15 billion of investments made in low-income communities. The NMTC Program is part of a federal initiative that includes such programs as the Renewal Communities Program that are designed to provide tax and regulatory relief to economically distressed communities. The Community Renewal Tax Relief Act of 2000 that authorized the tax credit also mandated that we audit and report on the NMTC Program in January 2004, 2007, and 2010.[1] This report describes the status of our work toward developing a methodology for evaluating the NMTC Program. Our objectives are to provide information about (1) the NMTC Program, including its goals, its design, and progress in implementing the program, and (2) our mandated review of the program, including the potential scope of the review and how the program may be evaluated for effectiveness and compliance.

To meet these objectives, we reviewed congressional and relevant executive branch documents to determine the goals and design of the NMTC Program and interviewed congressional staff to determine the scope of our legislatively mandated review. We also co-sponsored with the Treasury Department's Community Development Financial Institutions (CDFI) Fund a conference of experts to review methods for evaluating the program's effectiveness and compliance on the part of program participants. We conducted our work from January 2001 through July 2002 in accordance with generally accepted government auditing standards.

From August 29 through November 4, 2002 we briefed your offices on the results of our work. This report transmits the material from those briefings.[2]

Results

The goals of the NMTC Program are not stated explicitly in the legislation that authorizes the program. However, according to congressional supporters of the legislation, the program's goals are to direct new business capital to low-income communities, facilitate economic development in these communities, and encourage investment in high-risk areas. Although the legislation authorizing the NMTC Program requires that the investments be made in businesses and communities that meet certain eligibility standards, it does not specify that the investment be new capital, that performance measures be established to show that

[1]P. L. 106-554
[2]See the enclosure for details.

investment leads to economic development, or that the investment be in high-risk areas within eligible communities. Although not required by the legislation, the CDFI Fund includes some criteria, among those that it uses in its application process for allocating credits, which reflect these program goals.[3]

The NMTC Program is structured as follows. The CDFI Fund, which administers the application and allocation procedures of the NMTC Program under authority delegated by the Secretary of the Treasury, allocates shares of the total available tax credit to "community development entities" (CDEs) through a competitive application process.[4] In return for the tax credit, investors supply capital to the CDEs, which, in turn, invest the capital in qualified businesses operating in low-income communities. The tax credit, which may be claimed over 7 years, equals about 30 percent in present value terms of the amount invested.

The NMTC Program is in the initial stages of its implementation. The CDFI Fund has not yet made its first credit allocations, but it has provided guidance for CDEs applying for the credit allocations and set up a process for reviewing the applications. The $15 billion of investment qualifying for the credit will be made available over 7 years, in annual increments that range from $1.5 billion to $3.5 billion. Towards the end of 2002 or the beginning of 2003, the CDFI Fund plans to announce its decisions for the 2002 allocation round concerning which CDEs receive allocations and how much they receive. The CDFI Fund is also working on plans to monitor the CDEs' compliance with agreements that the CDEs reach with the CDFI Fund concerning how the allocations of qualified investment will be used and to evaluate the program's effectiveness in promoting investment and economic development.[5]

The legislation mandating that we audit and report on the NMTC program did not specify the scope of our review. After consulting with congressional staff, we concluded that potential topics for our review could include an evaluation of the program's effectiveness in promoting investment and economic development in low-income communities and an evaluation of compliance with the program's requirements in terms of its vulnerability to waste, fraud, and abuse.

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[3] The applicants, who receive scores based on information that they supply in a competitive application process, can score up to 25 points in a category called "community impact" where the reviewer considers, among other things, the extent to which the applicant (1) targets particularly economically distressed communities; (2) has the active participation of community representatives in designing and implementing its business plan; and (3) can show a demonstrable community development and economic impact. They can also score up to 25 points in the following categories: "business strategy" where the reviewer considers factors like prior performance providing similar kinds of products and services; "capitalization strategy" where the reviewer considers factors like whether the applicant has secured investor commitments; and "management capacity" where the reviewer considers factors like management's prior experience investing in low-income communities. Under the business strategy category, applicants may score an additional 5 points by demonstrating a record of successful investment in disadvantaged communities or businesses and an additional 5 points by intending to invest in businesses unrelated to the applicant.

[4] The CDEs, which must be certified by the CDFI Fund, are domestic corporations or partnerships with a primary mission of serving or providing capital to low-income communities or individuals. Eligible CDEs could include, for example, community development banks or venture funds, community development corporations, and New Markets Venture Capital companies among others.

[5] The NMTC allocation agreements, which contain the terms and conditions of the NMTC allocation, may specify the amount of the allocation, the approved uses of the allocation, the approved areas in which the proceeds of the investment may be used, the CDE's schedule for obtaining capital from investors, and the CDE's reporting requirements.

An evaluation of the program's effectiveness presents some significant difficulties. A criterion for judging the program's effectiveness is the extent to which NMTC investment and economic development in the communities receiving the investment would not have occurred if the tax credit program did not exist. The impact, if any, of the credit on investment and development is difficult to determine because it is difficult to know what program participants and others who invest in low-income communities would have done if the program did not exist. A further difficulty for an effectiveness evaluation is that the NMTC Program is very small relative to economic activity within the total geographic area eligible for the credit. The $15 billion of potential new investment – over 7 years – may be too small to have a measurable impact in a target area that the CDFI Fund estimates could include 35 percent of the U.S. population and 40 percent of the land area.

Several methods have been developed that address some of the difficulties present in effectiveness evaluations. For example, statistical methods use control or comparison groups in an effort to determine what program participants would have done if the program did not exist. However, all of these methods have significant limitations. Because of these limitations, definitive conclusions about the effectiveness of the NMTC Program may not be possible. Nevertheless, it may be possible to provide evidence that is consistent or inconsistent with the program's effectiveness, such as data on whether or not investors receiving the credit had made similar investments in low-income communities in the past. In our future reports on the NMTC program, we will provide detailed descriptions of the methodology, or combinations of methodologies, that we determine are most appropriate for our audit objectives.

The evaluation of program compliance requires determining the extent to which (1) the investors are claiming only the credits that they are entitled to, (2) the CDEs are conforming to statutory requirements relating to the timing of their investments, (3) the businesses receiving investment are qualified to participate in the program, and (4) the CDEs are conforming to the terms of the agreements reached with the CDFI Fund concerning how the allocations of qualified investment will be used. The evaluation of compliance will be complicated by the fact that different types of participants (investors, CDEs, and businesses) are involved at different levels of the program, and two agencies within Treasury (the Internal Revenue Service and the CDFI Fund) will have responsibility for administering, monitoring and enforcing compliance. Namely, the Internal Revenue Service is responsible for monitoring compliance with provisions of the tax code concerning the timing of investment and the businesses qualified to receive investment. The CDFI Fund is responsible for administering the application and allocation procedures of the NMTC Program (including both CDE certification and competitive NMTC allocations), and monitoring compliance with the terms of the NMTC allocation agreements.

Factors that affect the difficulty of evaluating compliance will include whether coordination between the Internal Revenue Service and the CDFI Fund is sufficient to detect ineligible credit claimants and whether sufficient data will be developed for the CDFI Fund to properly monitor the CDEs and for the CDEs to monitor the businesses that receive the investment. A further complication is that the requirement for compliance data from participants will need to be balanced with the possible disincentives for participation that might arise from increased record keeping. The CDFI Fund is currently working on plans to monitor compliance with allocation agreements and to evaluate the effectiveness of the program in promoting investment and economic development.

At this time, we expect our report in January 2004 likely will cover the status of the NMTC Program, but will not evaluate overall program effectiveness and compliance. At the time of this first mandated report, the NMTC Program will be only partially implemented and will not have been in operation long enough to permit such an evaluation. The report will likely provide descriptive information on the program's implementation, such as how much has been invested, where it has been invested, and the types of businesses that received the investment. The report will also likely identify any significant issues that have arisen concerning compliance, administration, or the design of the credit.

Agency Comments and Our Evaluation

In a memorandum dated December 2, 2002, the Director of the CDFI Fund provided comments on our draft correspondence. The Director suggested that we add certain additional details regarding how the NMTC program should be evaluated and regarding difficulties that may arise when applying the methodologies that we discussed in the correspondence. He also made suggestions for clarifying the respective roles and responsibilities of the CDFI Fund and the Internal Revenue Service in administering the program, and monitoring and enforcing compliance. We modified the correspondence as appropriate.

The Director also suggested that the NMTC Program should be evaluated in comparison with other federal programs with similar goals, such as the Empowerment Zone and Renewal Communities Programs. We expect that our future reports will deal chiefly with the NMTC Program because it is sufficiently different in structure and scope from these other programs to make comparison difficult. However, we are also mandated by the Community Renewal Tax Relief Act of 2000 to audit and report on the Empowerment Zone and Renewal Communities Programs in the same timeframes as our NMTC reports.

We are sending copies of this report to the Secretary of the Treasury; the Director, Community Development Financial Institutions Fund; and other interested parties. We will also make copies available to others on request. The report is also available on GAO's homepage at http//www.gao.gov.

This report was prepared under the direction of Jim Wozny. Other major contributors were Kevin Daly and Larry Korb. If you have any questions about this report, please contact Jim Wozny or me on (202) 512-9110.

Michael Brostek
Director, Tax Issues

Enclosure

Congressional Committees

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Minority Member
Senate Committee on Finance

The Honorable John F. Kerry
Chairman
The Honorable Christopher S. Bond
Ranking Minority Member
Senate Committee on Small Business and Entrepreneurship

The Honorable Paul S. Sarbanes
Chairman
The Honorable Phil Gramm
Ranking Minority Member
Senate Committee on Banking, Housing, and Urban Affairs

The Honorable William M. Thomas
Chairman
The Honorable Charles B. Rangel
Ranking Minority Member
House Committee on Ways and Means

The Honorable Donald A. Manzullo
Chairman
The Honorable Nydia M. Velázquez
Ranking Minority Member
House Committee on Small Business

The Honorable Michael G. Oxley
Chairman
The Honorable John J. LaFalce
Ranking Minority Member
House Committee on Financial Services

The Honorable Richard H. Baker
Chairman
The Honorable Paul E. Kanjorski
Ranking Minority Member
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
House Committee on Financial Services

Briefing to the Staff of the Committees of Jurisdiction August 29 through November 21, 2002

New Markets Tax Credit Status of Implementation and Issues Related to GAO's Mandated Reports

Objectives, Scope, and Methodology

Objectives

- To provide information on the New Markets Tax Credit (NMTC) Program, including
  - the goals and design of the program and
  - the progress in implementing the program.
- To provide information on our legislatively mandated review of the program, including
  - the potential scope of the review,
  - how the NMTC Program may be evaluated for effectiveness,
  - how the program may be evaluated for compliance,
  - the likely objectives of our report in 2004.

Objectives, Scope, and Methodology

Scope and Methodology

- We reviewed congressional and relevant executive branch documents to determine the goals and design of the NMTC Program.
- We interviewed congressional staff members to determine the scope of our legislatively mandated review of the program.
- We co-sponsored with the Treasury Department's Community Development Financial Institutions (CDFI) Fund a conference of experts to review methods for evaluating the program's effectiveness and for ensuring compliance on the part of program participants.

NMTC Program Goals

- According to congressional supporters of the NMTC, the program goals are to
  - direct new business capital to low-income communities,
  - encourage investment in high-risk areas, and
  - facilitate economic development in low-income communities.
- The NMTC requires that qualifying investments be stock or similar equity interest in, or loans to, businesses in low-income communities, or financial services provided to businesses and residents in low-income communities.
- The NMTC does not specifically require that the investment be new capital, that the investment be in high-risk areas within eligible communities, or that performance measures be established to show that the investment leads to economic development.

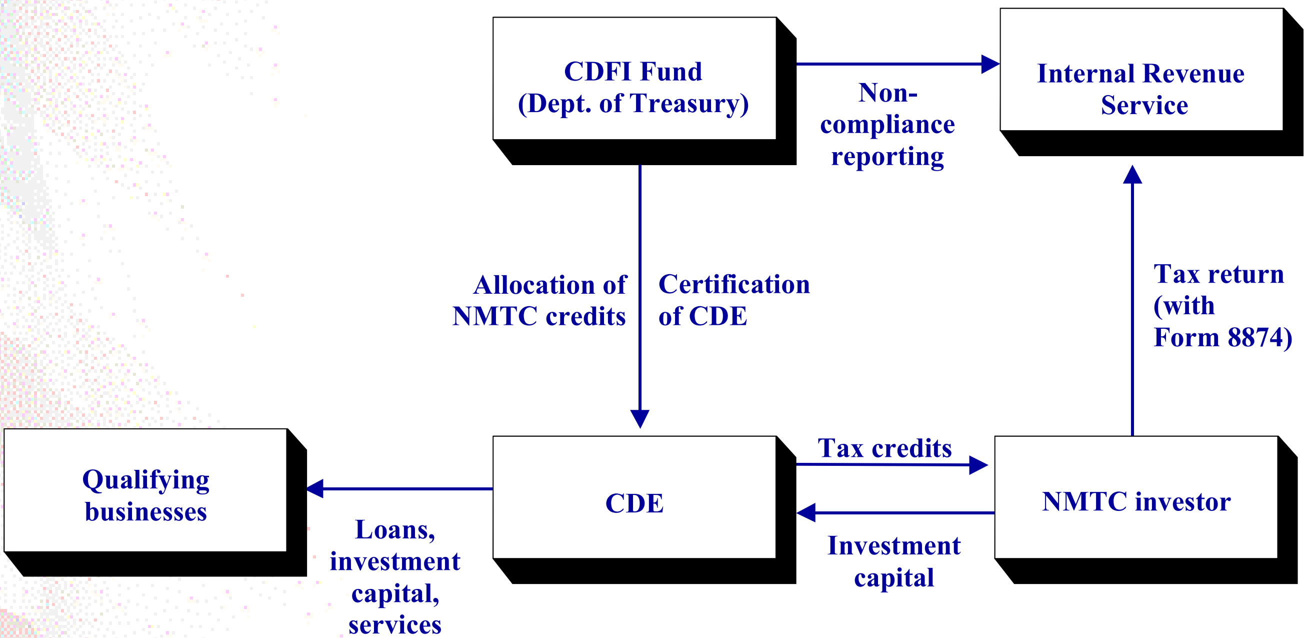
Design of the Credit

- The NMTC Program provides a credit against federal taxes for investments in low-income communities.
- The credit is taken over 7 years at the rate of 5 percent of the investment in each of the first 3 years and 6 percent of the investment in each of the final 4 years.
- The maximum amount of investment that qualifies for the credit is $15 billion, distributed over 7 years with annual caps that range from $1.5 billion to $3.5 billion.
  - According to administration projections made in 2000, the $15 billion in private investment will have a tax revenue cost of $4.5 billion over 10 years.

Design of the Credit

- Community development entities (CDEs) that have been certified by the Treasury Department's CDFI Fund compete to receive shares of the total amount of credit that the CDFI Fund has to distribute.
- The CDEs that succeed in gaining allocations of tax credits can offer them to the taxpayers who provide the CDEs with capital.
- The CDEs use the capital to make investments in businesses in low-income communities.
- The credit can be recaptured from the taxpayer by the Internal Revenue Service if
  - the CDE ceases to be certified,
  - the taxpayer's equity interest in the CDE is redeemed, or
  - substantially all of the funds received by the CDE for tax credits are not used to make qualified investments during the 7 year period.

Design of the Credit



Credit Program Implementation

- The CDFI Fund has provided guidance for CDEs applying for credit allocations and has set up a process for reviewing these applications.
- The Internal Revenue Service has also issued temporary regulations that include guidance on what investments qualify for the credit and what events will trigger a recapture of the credit.
- The $15 billion in investment that qualifies for the credit will be made available in the following increments:

Year	Amount
2001 – 02	$2.5 billion
2003	$1.5 billion
2004 – 05	$2.0 billion per year
2006 – 07	$3.5 billion per year

Credit Program Implementation

- The CDFI Fund plans to announce 2001-2002 allocation decisions towards the end of 2002 or the beginning of 2003.
- The CDFI Fund is working on plans to monitor compliance with agreements that the CDEs reach with the CDFI Fund concerning how the allocations will be used and to evaluate the effectiveness of the program in promoting investment and economic development.
- The Internal Revenue Service has responsibility for monitoring compliance with provisions of the tax code concerning the timing of investment and whether businesses that receive the investment are qualified.

Scope of the Mandated Study

- The legislative mandate for our periodic reviews of the NMTC Program did not specify the scope of the review.
  - The mandate requires that we audit and report on the NMTC program by January 2004, 2007, and 2010.
- According to the congressional staff that we consulted, potential topics for the review include an evaluation of
  - the effectiveness of the program in promoting new investment and economic development in low-income communities and
  - compliance with the program's requirements, that is, the extent to which the program may be subject to waste, fraud, and abuse.

Effectiveness Evaluation

Criteria for Determining Effectiveness

We found no guidance in the legislation for establishing criteria for evaluating the effectiveness of the credit. According to a conference of experts that we co-sponsored with the CDFI Fund, potential criteria could include:

- The extent to which investment in NMTC assets is new investment.
    - New investment means investment that would not have occurred in low-income communities without the tax credit and investment that is not simply shifted from other low-income communities.

Effectiveness Evaluation

Criteria for Determining Effectiveness (continued)

- The extent to which the investment produced economic development in the low-income communities.
  - Economic development includes the direct effect of growth in businesses receiving investment and indirect “multiplier” effects on economic growth in the low-income communities.

Effectiveness Evaluation

Factors Affecting the Evaluation

- The effectiveness of economic development programs is usually difficult to determine because it is difficult to know what program participants and others who invest in low-income communities would have done if the program did not exist.
    - In the case of the NMTC, it is difficult to determine:
        - What investors would have done with their capital if the program did not exist.
        - Whether NMTC investment recipients would have been able to obtain capital from other sources.
        - Whether the recipients' businesses would have grown more slowly if they had not been able to obtain capital from other sources.
        - Whether the communities would have had less economic development due to slower business growth.

Effectiveness Evaluation

Factors Affecting the Evaluation (continued)

- The effectiveness of economic development programs may also be difficult to measure when the program is small relative to total economic activity within the geographic area of interest.
  - The CDFI Fund estimates that eligible communities include 32 percent of the U.S. population and nearly 40 percent of the land area.
  - The $15 billion in potential new investment is likely to be too small relative to this target area to have an effect on economic development that is large enough to be measured accurately.

Effectiveness Evaluation

Factors Affecting the Evaluation (continued)

- Even if the evaluation is limited to low-income communities receiving NMTC investment, the amount of investment is likely to vary across these communities and may be too small to have a measurable effect.
- The program's effect on economic development may have to be evaluated through its effect on such factors as sales or employment growth in businesses receiving investment.

Effectiveness Evaluation

Methods for Determining Effectiveness

Methods for determining the effect of the tax credit on investment and economic growth include:

- Statistical methods that compare investors, businesses, and low-income communities that participate in the program with a comparison or “control” group of nonparticipants.
- Survey methods that directly question a sample of investors and businesses that participate in the program about the effect of the credit on their investment and business decisions.
- Case study methods that examine in detail information about a few investors and businesses that participate in the program.

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Effectiveness Evaluation

Statistical Methods

- The advantages of statistical methods are that
  - they can provide precise, quantifiable estimates of the credit's effect on the amount of new investment and the rate of economic growth of businesses and communities receiving the investment and
  - the estimates can be generalized to all program participants.

- The disadvantage of the statistical methods is that they may be difficult to apply because
  - randomly selecting control groups would require excluding investors, businesses,or communities from the credit program, and
  - identifying appropriate comparison groups would require a great deal of information about individual investors, businesses, and communities.

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Effectiveness Evaluation

Statistical Methods (continued)

Statistical methods may be difficult to apply because:

- There is likely to be little or no data available from standard research databases on
    - the investments and other characteristics of NMTC and non-NMTC investors;
    - employment, sales, and other economic characteristics of businesses that receive NMTC investment and those that do not;
    - total investment in low-income communities that receive the NMTC investment and those that do not.

Effectiveness Evaluation

Statistical Methods (continued)

Statistical methods may also be difficult to apply because:

- non-NMTC investors and businesses have little incentive to provide the information in response to surveys and reporting requirements, and
- record keeping requirements would reduce the incentive to participate in the program.

Effectiveness Evaluation

Survey Methods

- The advantages of survey methods are that
  - the survey responses can be generalized to the population of all program participants and
  - surveys require information from only a sample of program participants.
- The disadvantages of survey methods are that
  - the information from the survey may not be reliable because
    - survey respondents may have an incentive not to respond truthfully and
    - survey respondents may not be able to give accurate answers to all questions.
  - the method does not provide precise, quantifiable estimates of the credit's effect.

Effectiveness Evaluation

Case Study Methods

- The advantages of the case study methods are that
  - information is required from only a few program participants,
  - the information can be checked for its reliability, and
  - a considerable amount of detailed information could be collected.
- The disadvantages of the case study methods are that
  - findings cannot be generalized to the population of all program participants and
  - the method does not provide precise, quantifiable estimates of the credit's effect.

Effectiveness Evaluation

Limitations of an Effectiveness Evaluation

- Because each method for assessing effectiveness has significant disadvantages, definitive conclusions about the effectiveness of the NMTC program may not be possible.
  - The methods may not establish that the NMTC causes new investment or economic development.
- However, the methods may provide evidence that is consistent or inconsistent with the program being effective in attracting new capital or promoting economic growth. For example,
  - evidence consistent with attracting new capital would be finding that investors receiving tax credits had not made similar investments in low-income communities in the past, while
  - evidence inconsistent with attracting new capital would be finding that they had made such investments.

Compliance Evaluation

Criteria for Determining Compliance

According to the experts that we consulted, potential compliance criteria could include

- the extent to which the investors are claiming only the credits that they are entitled to;
- the extent to which the CDEs are conforming to the statutory requirements concerning the amount and timing of their investments in low-income communities;
  - the CDEs must invest substantially all of the funds in qualifying low-income community investments within 1 year.
- The extent to which businesses receiving investment from the CDEs qualify for the credit.
  - Qualifying businesses must have at least 50 percent of gross income, 40 percent of tangible property, and 40 percent of services in low-income communities.
- The extent to which the CDEs are conforming to allocation agreements reached with the CDFI Fund.

Compliance Evaluation

Factors Affecting the Evaluation

Factors that affect the difficulty of evaluating compliance include:

- Multiple responsible agencies:
  - Whether coordination between IRS and the CDFI Fund will be sufficient to detect ineligible claimants.
- Record keeping costs:
  - The need for compliance data will have to be balanced with the disincentives from increased record keeping burden.
- Multiple levels of monitoring:
  - Whether sufficient data will be collected, maintained, and reported by
    - the CDEs to the CDFI Fund to properly monitor the CDEs' compliance with investment requirements and
    - the businesses' to the CDEs for the CDEs to monitor businesses' compliance with eligibility standards.

Compliance Evaluation

Plans for Monitoring Compliance

The CDFI Fund's planned approach to monitoring compliance may include

- using electronic reporting tools,
- relying on self-certifications from CDEs with appropriate level of background documentation,
- providing CDEs guidance on monitoring compliance and developing standards for data collection and retention, and
- using some on-site auditing.

Likely Objectives of our 2004 Report

Because the NMTC Program will be only partially implemented in 2004, our report will not evaluate overall program effectiveness and compliance. The report likely will cover the status of the NMTC Program, including

- any significant issues that have arisen concerning compliance, administration, or the design of the credit and
- information on
  - who is investing in NMTC assets,
  - how much is invested,
  - where the investment occurs, and
  - what types of businesses receive the investment.

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