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NEW MARKETS TAX CREDIT

Minority Entities Are Less Successful in Obtaining Awards Than Non-Minority Entities

Statement of Michael Brostek,
Director, Strategic Issues





Highlights of [GAO-09-795T](#), a testimony before Subcommittees of Ways and Means and Financial Services, House of Representatives

Why GAO Did This Study

The Community Development Financial Institutions (CDFI) Fund in the Department of the Treasury has awarded \$21 billion of the \$26 billion in New Markets Tax Credits (NMTC) authorized to be awarded to Community Development Entities (CDE) between 2001 and 2009. CDEs use the NMTC to make qualified investments in low-income communities. Recent congressional interest has focused on participation by minority CDEs. This testimony is based on a recent GAO report (GAO-09-536).

As requested, the report (1) identified the number of minority and non-minority CDEs that applied to the CDFI Fund and received NMTC awards, (2) explained the process by which the CDFI Fund makes awards and summarized application scores, (3) described challenges minority and non-minority CDEs face in applying for and receiving awards and, (4) identified efforts the CDFI Fund and others have taken to assist minority CDEs in applying for awards. GAO analyzed CDFI Fund application data and interviewed officials from minority and non-minority CDEs, the CDFI Fund, and industry groups.

What GAO Recommends

GAO makes no recommendations, but summarizes options Congress could consider, such as providing certain preferences or technical assistance to minority CDEs. The CDFI Fund did not comment on GAO's options, but agreed with GAO's key conclusion.

[View GAO-09-795T](#) or [key components](#). For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

NEW MARKETS TAX CREDIT

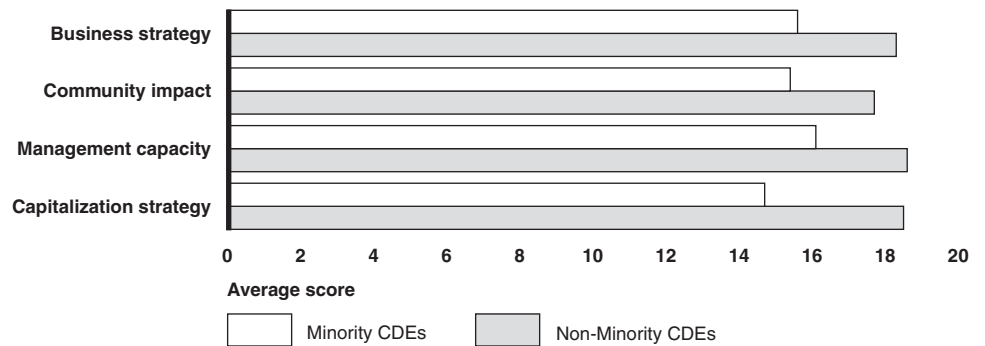
Minority Entities Are Less Successful in Obtaining Awards Than Non-Minority Entities

What GAO Found

From 2005 through 2008, minority-owned CDEs were successful with about 9 percent of the NMTC applications that they submitted to the CDFI Fund and received about \$354 million of the \$8.7 billion for which they applied, or about 4 percent. Non-minority CDEs were successful with about 27 percent of their applications and received \$13.2 billion of the \$89.7 billion for which they applied, or about 15 percent. Since GAO issued the report on which this statement is based, the CDFI Fund made 32 NMTC awards totaling \$1.5 billion under authority provided in the American Recovery and Reinvestment Act. Minority CDEs received 3 of those awards, totaling \$135 million.

The CDFI Fund relies primarily on its scoring of applications to determine which CDEs receive awards. As the figure shows, minority CDEs received lower scores than non-minority CDEs in each of the four application sections.

Minority and Non-Minority CDE Application Scores, 2005 through 2008
Application section



Source: GAO analysis of CDFI Fund data.

Although a CDE's resources and experience in applying are important factors in a CDE's success rate with the NMTC program, when controlling for factors that GAO could measure, minority status is associated with a lower probability of receiving an allocation. It is not clear from GAO's analysis why this relationship exists or whether any actions taken or not taken by the Department of the Treasury contributed to minority CDEs' lower probability of success. Characteristics associated with minority status of some CDEs for which data are unavailable may affect this relationship. If Congress views increased participation by minority CDEs as a goal for the NMTC program, options, such as providing certain preferences in the application process that may benefit minority CDEs, could be considered.

The CDFI Fund provides assistance that is available to all CDEs applying for awards, including a written debriefing to CDEs that do not receive awards detailing some of the weaknesses in the applications. Other stakeholders, including industry associations and consultants, hold conferences and offer services to help CDEs submit competitive applications. Should Congress view additional assistance to minority CDEs as important to increasing minority CDEs' participation in the NMTC program, it could consider requiring the CDFI Fund to provide assistance to minority CDEs.

Mister Chairmen, Ranking Members, and Other Subcommittee Members:

I am pleased to be here today to discuss minority Community Development Entities' (CDE) participation in the New Markets Tax Credit (NMTC) program. Congress created the NMTC through the Community Renewal Tax Relief Act of 2000¹ to encourage investors to make investments in low-income communities that traditionally lack access to capital. Conventional access to credit and investment capital for developing small businesses, retaining jobs, and revitalizing neighborhoods is often limited in economically distressed communities or in communities with large low-income populations. The Community Development Financial Institutions (CDFI) Fund in the Department of the Treasury administers the NMTC program and allocates tax credit authority—the amount of investment for which investors can claim a tax credit—to CDEs that apply for and obtain allocations. CDEs are domestic partnerships or corporations with a primary purpose of serving or providing investment capital to low-income communities or low-income persons.²

Our prior mandated work on the NMTC has focused on the implementation of the program, the effect of the credit on the behavior of individual and corporate investors, and efforts by the CDFI Fund and Internal Revenue Service (IRS) to ensure that CDEs and investors are in compliance with NMTC program requirements.³ Recent congressional interest has focused on minority CDEs' participation in the program. My statement is based on our recently released report that you requested, titled *New Markets Tax Credit: Minority Entities Are Less Successful in Obtaining Awards than Non-Minority Entities*.⁴ As agreed, the report (1) identified how many minority-owned or controlled and non-minority-

¹Pub. L. No. 106-554 (2000).

²CDEs are required to maintain accountability to residents of low-income communities by filling at least 20 percent of the organization's governing or advisory board positions with low-income community residents.

³GAO, *New Markets Tax Credit Program: Progress Made in Implementation, but Further Actions Needed to Monitor Compliance*, [GAO-04-326](#) (Washington, D.C.: Jan. 30, 2004) and *Tax Policy: New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance*, [GAO-07-296](#) (Washington, D.C.: Jan. 31, 2007).

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

owned or controlled CDEs have applied for and received allocations and how much they have applied for and received from 2005 through 2008; (2) explained the NMTC application process and summarized NMTC application scores for minority and non-minority-owned or controlled CDEs by CDE type from 2005 through 2008; (3) described the challenges minority-owned or controlled and non-minority-owned or controlled CDEs have faced in applying for and receiving NMTC allocations; and (4) identified efforts the CDFI Fund and others are taking to assist minority-owned or controlled CDEs in applying for NMTC allocations. As requested, we identified potential policy options that Congress may wish to consider based on its interpretation of our results.

To prepare the report, we analyzed CDFI Fund NMTC application data from 2005 through 2008. The CDFI Fund did not collect data on program participation by minority CDEs before the 2005 allocation round. We also interviewed officials from a variety of similarly sized minority and non-minority CDEs that received NMTC awards and applied for but did not receive NMTC awards from 2005 through 2008, and we interviewed industry experts with knowledge of the NMTC program. The report includes a detailed description of our scope and methodology. We conducted our work in accordance with generally accepted government auditing standards.

Background

As of the time of this hearing, the CDFI Fund in the Department of the Treasury has authorized \$21 billion of the \$26 billion⁵ in tax credit authority to be awarded between 2001 and 2009 to CDEs that manage

⁵The original legislation that authorized the program allowed for \$15 billion in tax credit authority for the NMTC program through 2007. However, the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135 (Dec. 21, 2005), authorized an additional \$1 billion of NMTC equity for qualified areas affected by Hurricane Katrina over a period of 3 years: \$300 million in 2005, \$300 million in 2006, and \$400 million in 2007. Pub. L. No. 109-432 (Dec. 20, 2006) and Pub. L. No. 110-343 (Oct. 3, 2008) extended the amount of NMTC authority available by \$3.5 billion for 2008 and 2009, respectively. The American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. No. 111-5 (Feb. 17, 2009), added an additional \$3 billion of NMTC allocation authority to be split equally between the 2008 (retroactively) and 2009 allocation rounds. Since we issued our report on minority CDEs' participation in the NMTC program in April 2009, the CDFI Fund has awarded \$1.5 billion of the \$3 billion authorized under ARRA.

NMTC investments in low-income community development projects.⁶ Eligible organizations may apply for and receive NMTC allocations once they have been certified as a CDE by the CDFI Fund (a CDE that receives an allocation is often referred to as an allocatee).⁷ After the CDFI Fund makes allocations to CDEs, investors make equity investments by acquiring stock or a capital interest in the CDEs, called qualified equity investments (QEI), in exchange for the right to claim tax credits that total 39 percent of their original investment over 7 years.⁸ The CDEs, in turn, are required to invest “substantially all” of the proceeds they receive into qualified low-income community investments (QLICI).⁹ Qualified low-income community investments include (but are not limited to) investments in businesses, referred to as qualified active low-income community businesses (QALICB), to be used for residential, commercial and industrial projects, and other types of investments, such as purchasing loans from other CDEs.

The CDFI Fund directs CDEs to classify themselves as minority if more than 50 percent of the CDE is owned or controlled by members of a minority ethnic group. In the case of a for-profit CDE, more than 50

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

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

⁸Beginning in the year in which the investment is made, investors are entitled to claim the credit for a 7-year period with 5 percent of the investment claimed in each of the first 3 years and 6 percent in each of the last 4 years. Investors are allowed to carry the credit back 1 year and carry the credits forward for a 20-year period.

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

percent of the CDE's owners must be minorities; if the entity applying is a nonprofit organization, more than 50 percent of its board of directors must be minorities (or its Chief Executive Officer, Executive Director, General Partner, or Managing Member must be a minority).¹⁰ Representatives from several minority-owned entities and industry associations that we interviewed indicated that minority CDEs and other locally-based community lending organizations may have a better understanding of the economic conditions and availability of capital in the communities they serve than other investment organizations serving those same communities. However, in addition to minority CDEs obtaining NMTC authority and making investments in low-income communities, minority populations may benefit from the NMTC in other ways. For example, non-minority CDEs have also made investments in minority businesses that serve residents in low-income communities. Minority-owned businesses located in eligible NMTC census tracts may hire or provide services to minority residents in low-income communities. According to CDFI Fund officials, it is frequently the case that non-minority-owned businesses located in NMTC-eligible census tracts with highly concentrated minority populations could provide economic benefits to minority residents.

Since we issued the report on which this statement is based, the CDFI Fund announced on May 27, 2009 an additional 32 NMTC awards to 2008 applicants totaling \$1.5 billion under authority granted by the American Recovery and Reinvestment Act of 2009 (ARRA).¹¹ According to our analysis, minority CDEs received three of these awards totaling \$135 million. Non-minority CDEs received the other 29 of these awards totaling about \$1.4 billion. The analysis presented in our report was limited to NMTC awards made from 2005 through the original 2008 awards; our analysis did not include the NMTC awards made in accordance with ARRA.

¹⁰For the purposes of the remainder of this statement, we generally refer to minority-owned or controlled CDEs as "minority CDEs" and non-minority owned or controlled CDEs as "non-minority CDEs."

¹¹Pub. L. No. 111-5 (2009). The CDFI Fund revisited the 2008 NMTC applications and made awards to the CDEs that would have been the next CDEs to receive awards had more allocation authority originally been available. After accounting for the additional awards, minority CDEs maintained lower success rates than non-minority CDEs in obtaining NMTC awards for the 2008 allocation round.

Minority Entities Have Received Proportionately Fewer Awards Than Non-Minority Entities

From 2005 through 2008, minority-owned CDEs were successful with about 9 percent of the NMTC applications that they submitted to the CDFI Fund and received about \$354 million of the \$8.7 billion for which they applied, or about 4 percent. By comparison, non-minority CDEs were successful with about 27 percent of their applications and received \$13.2 billion of the \$89.7 billion for which they applied, or about 15 percent. Since 2005, the first year in which the CDFI Fund collected data on minority CDEs, CDFI Fund application data indicate that 68 minority CDEs have applied for NMTC allocations from the CDFI Fund for a total of 88 applications. Fifteen minority CDEs applied for NMTC allocations in multiple years. From 2005 through 2008, the CDFI Fund received 934 NMTC applications from 566 different CDEs. Of the 68 minority CDEs that applied, 6 CDEs received a total of eight NMTC allocations (2 minority CDEs each received two separate allocations).¹² Minority applicants received about 2.6 percent of the \$13.5 billion in total NMTC allocation authority that the CDFI Fund awarded from 2005 through 2008.

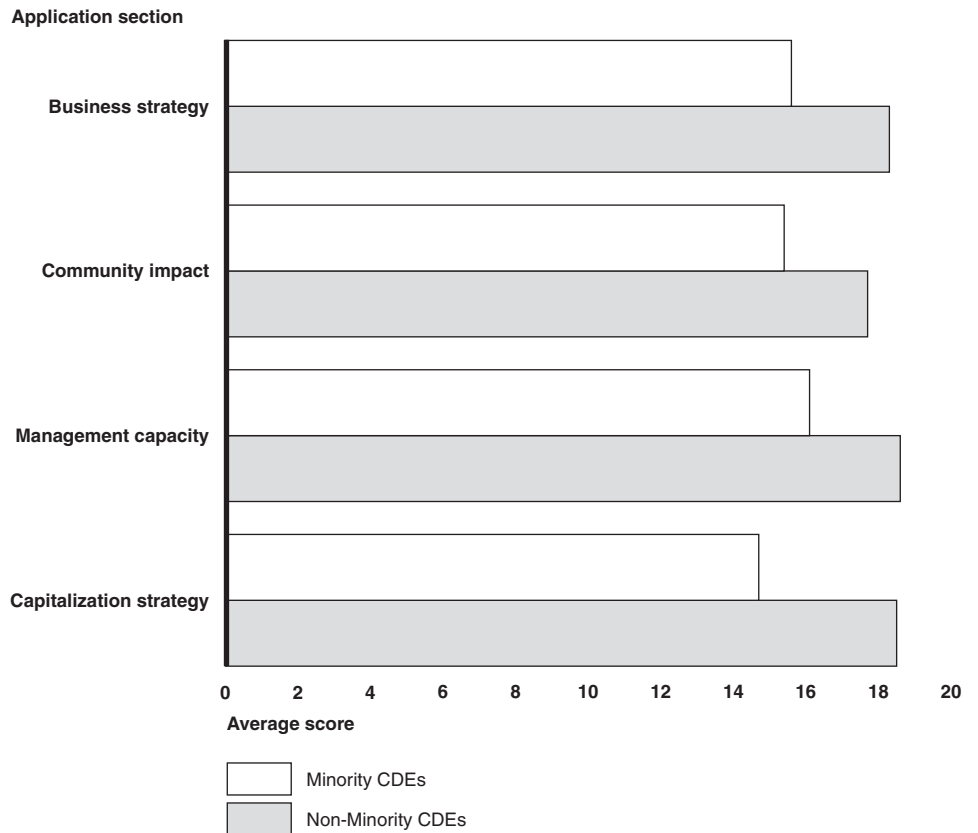
The CDFI Fund's process for making NMTC awards takes place in two phases. NMTC applications are first reviewed and scored by a group of external reviewers selected by the CDFI Fund who have demonstrated experience in business, real estate, or community development finance.¹³ CDEs that meet or exceed minimum thresholds in each of the four main application sections (business strategy, community impact, management capacity, and capitalization strategy) and an overall scoring threshold (out of a total of 25 points in each application section) advance to the second phase where they are re-ranked based on their scores in the business strategy and community impact sections of the application and half of the priority points awarded to CDEs that demonstrate a track record of investing in low-income communities and investing in unrelated entities. CDFI Fund staff review the amount of allocation authority that the CDE requested and, based on the information in the application materials, award allocation amounts in the descending order of CDEs' final ranking based on their re-ranked scores.

¹²Analysis of minority CDE participation in the NMTC program is limited to reviewing information about CDEs that applied for NMTC allocations and identified themselves as minority-owned or controlled CDEs. Other investment organizations would potentially be able to obtain certified CDE status and apply for NMTC allocations. This could include minority-owned banks and other minority organizations with the primary mission of serving low-income communities.

¹³The CDFI Fund requires reviewers to disclose any conflicts of interest related to applicants with whom they have or had a relationship.

According to our analysis of NMTC application data, of the 88 applications submitted by minority CDEs, 31 applications met the minimum threshold scores to advance to the second phase of the NTMC review process from 2005 to 2008. By comparison, during this same time period 518 of the 846 applications submitted by non-minority CDEs met the minimum thresholds to advance to the second phase of the review process. Overall, non-minority CDEs scored about 11 points higher than minority CDEs on NMTC applications from 2005 through 2008. As figure 1 shows, minority CDEs' scores differed the most from non-minority CDEs' scores in the capitalization strategy section of the application, where non-minority CDEs scored 25 percent higher than minority CDEs. Non-minority CDEs scored between 15 percent and 17 percent higher than minority CDEs in the business strategy, community impact, and management capacity sections of the application.

Figure 1: Minority and Non-Minority CDE Application Scores, 2005 through 2008



Source: GAO analysis of CDFI Fund data.
Note: The average scores presented above reflect the average aggregate application scores for each section divided by three—the number of reviewers scoring the applications.

To identify challenges minority and non-minority CDEs face in obtaining NMTC allocations, we interviewed representatives from minority and non-minority CDEs, and we analyzed CDFI Fund application data. While both our testimonial evidence and statistical analysis have limitations, they generally show that a CDE’s capacity, measured by asset size in this case, is associated with an increased probability of obtaining an award. CDEs we interviewed generally said it can be difficult on the NMTC application to demonstrate the capacity to effectively use the NMTC and the experience in investing in low-income communities necessary to obtain allocations. According to officials from several CDEs we interviewed, demonstrating the relative impact of NMTC projects through the NMTC application may be particularly difficult when smaller, community-based CDEs compete for allocations against large banks and financial

institutions that may have the capacity to undertake larger projects with more easily identifiable economic impacts.

Our statistical analysis of all CDEs that applied from 2005 through 2008 demonstrates that the probability that a NMTC applicant will receive an award is associated with certain factors. For example, after controlling for other characteristics, larger CDEs, as measured by asset size, appear to be more likely to receive NMTC awards, while smaller CDEs are less likely to receive awards. When controlling for factors we could, our analysis also shows that minority status is associated with a lower probability of receiving an allocation.¹⁴ It is not clear from our analysis why minority status is associated with a lower probability of obtaining an allocation or whether any actions taken or not taken by the Department of the Treasury or the CDFI Fund contributed to this statistical relationship. Other factors for which our statistical analysis is unable to account, such as experience with the application process, may also be reasons why minority CDEs have not been as successful in obtaining NMTC allocations as non-minority CDEs.

For example, according to our 2006 report, certain minority-owned banks have higher loan loss reserves and operating costs than non-minority owned peers.¹⁵ These types of characteristics could potentially affect the competitiveness of minority CDE NMTC applications, particularly in the business strategy and management capacity sections of the applications. Also, according to industry association representatives, minority-owned banks have traditionally had a more difficult time accessing capital markets than their non-minority peers, and our analysis of the CDFI Fund application data show that minority CDEs score lowest in the capitalization strategy section of the application. Our analysis indicates that these differences are not explained by the size of the CDE—that is, they are not problems shared, on average, by other small, non-minority CDEs that applied for NMTC allocations. However, these differences could

¹⁴CDE characteristics for which we could control included the CDE's asset size and whether the CDE was minority-owned or controlled, a certified Community Development Financial Institution, a nonprofit organization, a bank, or a publicly traded corporation. We also controlled for certain proposed project characteristics, including whether projects were to be non-real estate property investments or investments in severely distressed areas or urban areas.

¹⁵GAO, *Minority Banks: Regulators Need to Better Assess Effectiveness of Support Efforts*. GAO-07-6 (Washington, D.C.: Oct. 4, 2006).

be associated with some other feature that minority CDEs share with non-minority CDEs for which we do not have data to include in our analysis.

According to CDFI Fund officials, the CDFI Fund has conducted outreach intended to reach all CDEs that may have an interest in applying for NMTCs and CDFI Fund staff have given presentations to industry associations, such as the New Markets Tax Credit Coalition; the National Bankers Association (NBA), an industry organization that represents minority-owned banks; and at FDIC conferences targeted to minority-owned institutions. According to CDFI Fund officials, they have more recently developed a relationship with the Department of Commerce's Minority Business Development Agency that they hope will lead to additional applications by minority CDEs. The CDFI Fund also provides a written debriefing to each CDE that does not receive an allocation to assist the CDE in future application rounds. This debriefing provides the unsuccessful CDE with information about its scores in each of the application sections and written comments on areas of weakness within each of the four main application sections. Officials from some CDEs we interviewed noted that the debriefing document helped them submit more competitive application materials in future rounds. Officials from a few CDEs noted that the debriefing comments were not consistent from one year to another.

External stakeholders, including representatives from industry associations we identified, hold conferences and offer varying degrees of assistance to CDEs submitting competitive NMTC applications. In addition, CDEs often hire consultants to assist them with completing their NMTC applications. Consultants offer a range of services to CDEs, including reviewing NMTC applications for completeness and depth of responses to completing the entire NMTC application for an applicant. According to CDEs we interviewed, fees charged by consultants cover a broad range based on the services that the consultant provides. For example, officials from several CDEs indicated that they paid consultants less than \$5,000 to review their NMTC applications while others paid consultants as much as \$50,000 for a more complete set of services.

Potential Options

The legislative history for the NMTC does not address whether Congress intended for minority CDEs to benefit directly from the NMTC program. However, if Congress intends for minority CDEs' participation in the NMTC program to exceed the current levels and Congress believes that minority CDEs have unique characteristics that position them to target the NMTC to its most effective use, Congress may want to consider legislative

changes to the program should the New Markets Tax Credit be extended beyond 2009. Potential changes that could be considered include, but would not be limited to the following: (1) similar to provisions for certain federal grant programs, requiring that a certain portion of the overall amount of allocation authority be designated for minority CDEs; (2) in accordance with information we obtained in discussions with several experts in economic development, exploring the potential for creating a pool of NMTC allocation authority to be dedicated specifically for community banks (minority banks that are certified CDEs, in most cases, would likely compete with non-minority community banks with similar characteristics for NMTC allocations); or (3) similar to other federal programs where preferences are given to targeted populations, offering priority points to minority CDEs that apply for NMTC allocations. In addition, a fourth option would be for Congress to direct the Department of the Treasury and the CDFI Fund to explore options for providing technical assistance in applying for and using NMTC allocations to minority CDEs.

Although these options could increase the amount of NMTC authority awarded to minority CDEs, in part because we could not definitively identify the reasons why minority CDEs have scored lower on the NMTC application than non-minority CDEs, the options may not address the underlying reasons for lower minority CDE success. In addition, implementing these changes would require addressing a number of issues, including legal and administrative concerns, associated with such changes in the NMTC application process.

The CDFI Fund reviewed a draft of our report and agreed with our key conclusion that minority CDEs have not received awards in proportion to their representation in the application pool, but did not comment on our options. The CDFI Fund's response letter is reprinted in appendix VII of our report. The CDFI Fund also provided several technical comments on our report, which we incorporated as appropriate.

Chairmen, this concludes my remarks. As I noted earlier, the more detailed findings and conclusions of our review of minority CDEs' participation in the New Markets Tax Credit program can be found in our recently issued report ([GAO-09-536](#)). I would be happy to answer any questions you or other members of the subcommittees may have.

Contacts and Acknowledgments

For further information on this testimony, please contact Michael Brostek at (202) 512-9110 or brostkem@gao.gov. In addition, contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. In addition to the individual named above, Kevin Daly, Assistant Director; LaKeshia Allen; Don Brown; Thomas Gilbert; Cristian Ion; Jean McSween; Ed Nannenhorn; and Cheryl Peterson made key contributions to this testimony.

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