Q. What is the New Markets Tax Credit and how does it work?

A. The credit provides an incentive for investment in low-income communities. The US Department of the Treasury competitively allocates tax credit authority to intermediaries that select investment projects. Investors receive a tax credit against their federal income tax.

The New Markets Tax Credit (NMTC) was established in 2000. Congress authorizes the amount of credit, which the Treasury then allocates to qualified applicants. Since 2003, the program has parceled out credits worth nearly $23 billion. The NMTC has supported more than 4,800 projects in all 50 states, the District of Columbia, and Puerto Rico. Some 43 percent of the US's roughly 73,000 census tracts qualify for NMTC investments; by 2015, approximately 3,300 had received NMTC projects. In recent years, all applicants have pledged to place at least 75 percent of their NMTC projects in "severely distressed" census tracts. The credit is currently set to expire at the end of 2019, but Congress has extended it several times.

HOW DOES THE CREDIT WORK?

NMTC investors provide capital to community development entities (CDEs), and in exchange are awarded credits against their federal tax obligations. Investors can claim their allotted tax credits in as little as seven years—5 percent of the investment for each of the first three years and 6 percent of the project for the remaining four years—for a total of 39 percent of the NMTC project. A CDE can be its own investor or find an outside investor. Investors are primarily corporate entities—often large international banks or other regulated financial institutions—but any entity or person is eligible to claim NMTCs.

HOW HAS NMTC SPENDING CHANGED OVER TIME?

The cost of the program has fluctuated over time, including bump-ups in response to Hurricane Katrina and again as a part of the American Recovery and Reinvestment Act (figure 1). Of late, the NMTC has held steady at around $1.3 billion per year.

WHO INITIATES NMTC PROJECTS?

Community development entities are intermediaries that make loans or investments. They apply to the Treasury Department's Community Development Financial Institutions (CDFI) Fund to receive tax credit authority. CDEs sell these tax credits to investors and use the funds to make debt or equity investments in entities located in qualified low-income communities. CDEs are encouraged to make deals and offer preferential rates and terms. CDEs frequently leverage the NMTC by using other public subsidies and private-sector funds to invest in projects.

Key Elements of the U.S. Tax System

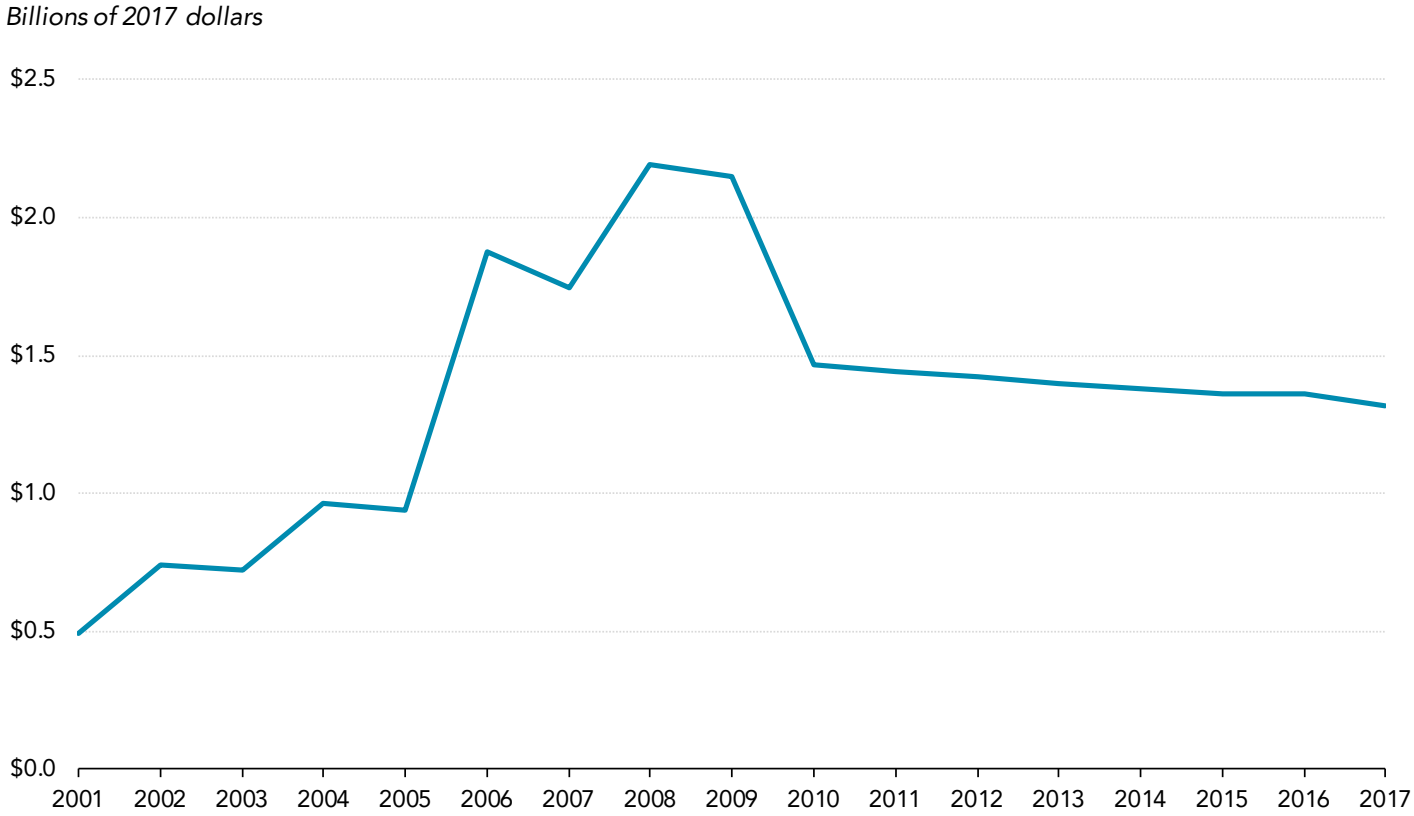
What is the New Markets Tax Credit and how does it work?

Many enterprises, including banks, developers, and local governments, can qualify to become CDEs. Our analysis of the most recent three rounds of NMTC allocations shows that CDFIs and other mission lenders were awarded the highest share of NMTCs, followed by mainstream financial institutions. The third-highest share went to government and quasi-government CDEs, followed by operating nonprofits and for-profits (table 1).

FIGURE 1

New Markets Tax Credit

Estimated present value of tax expenditures by approval year, 2001–17



Source: Urban Institute calculations based on allocation award information provided by the CDFI Fund.
Notes: The CDFI Fund publishes the amount of "allocation awards" under the program for each allocation round. This allocation authority is not the actual cost to the federal government, but the amount against which 39 percent can be claimed as credits, which we deflate in cost since not all credits are claimed in the year they are awarded. We adjust spending figures for inflation following the CPI-U. Calendar year of approval does not always align with year that credits were awarded and we use award dates for cost estimation.

Key Elements of the U.S. Tax System

What is the New Markets Tax Credit and how does it work?

TABLE 1

New Markets Tax Credit

Allocations by Type of Community Development Entity, 2015 - 2017

Type of CDE	Share of Number of Allocations	Share of Dollars Allocated	Median Allocation Amount
CDFIs and other mission lenders	50%	53%	$60,000,000
Mainstream financial institution	23%	23%	$55,000,000
Government/quasi-government	16%	15%	$50,000,000
Nonprofit (non-financial)	7%	5%	$40,000,000
For profit (non-financial)	5%	5%	$45,000,000

Source: Urban Institute calculations based on CDE application data from the CDFI Fund.

CDFI = community development financial institutions

WHO RECEIVES NMTC INVESTMENTS?

"Qualified active low-income community businesses" (QALICBs) receive NMTC investments. While called "businesses," QALICBs can be for-profit or nonprofit enterprises. Urban Institute calculations based on data from the CDFI Fund found that for NMTC projects reporting from 2003 to 2015, 61 percent went to for-profit QALICBs and 31 percent to nonprofits. (Tribal entities received 0.3 percent of investments, with the remaining projects missing or described as "other.")

The Urban Institute found in its evaluation of the 2002–07 New Markets rounds that QALICBs ranged in size—as measured by annual gross revenues or operating budgets at the start of their NMTC projects—from $0 for start-ups to $7 billion for a large for-profit parent entity in the natural resources business, with a median of $740,000.

WHAT PROJECTS DOES THE PROGRAM FUND?

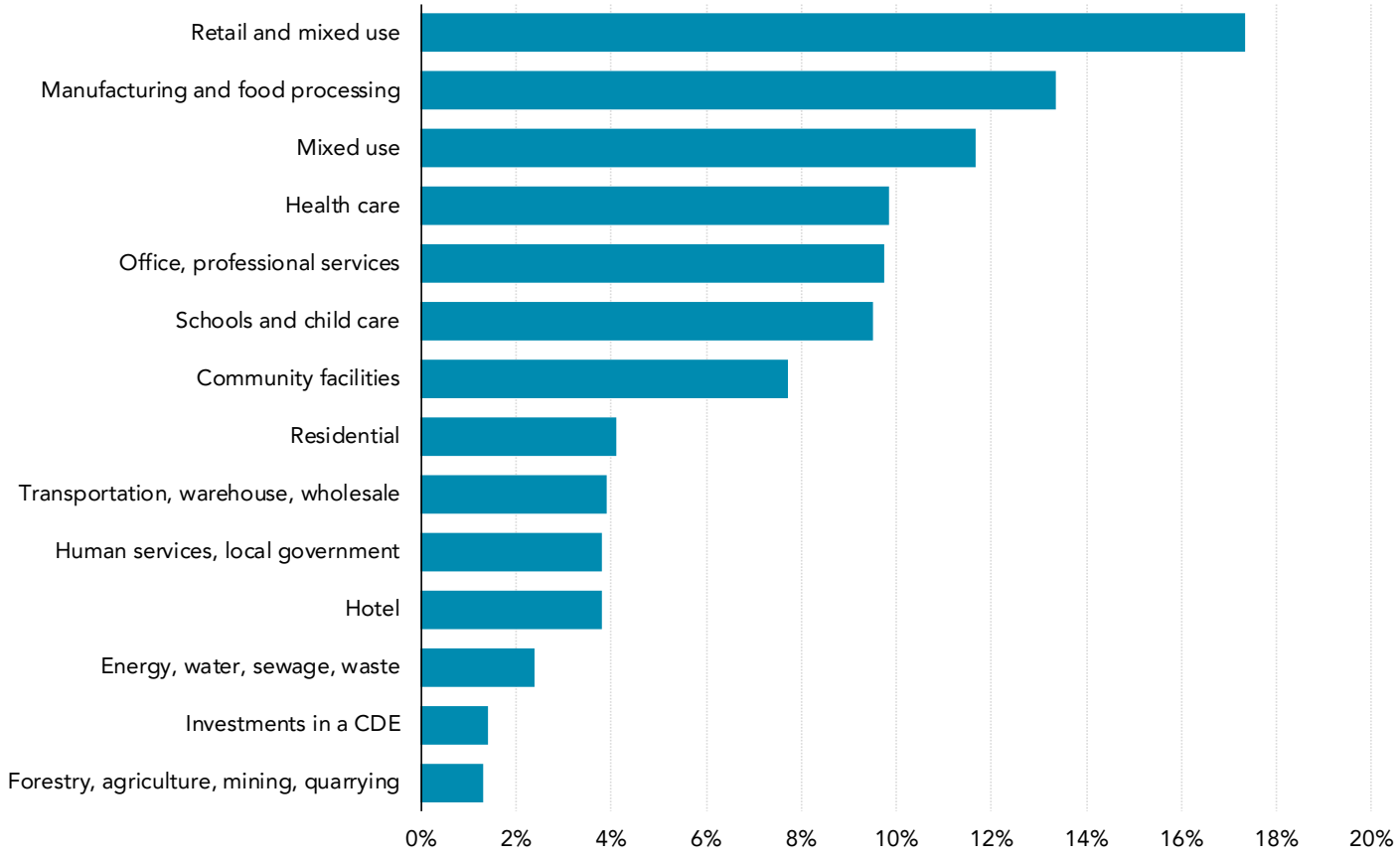
The NMTC program is flexible with regard to project type and purpose. QALICBs can be used to finance equipment, operations, or real estate. Real estate financing can purchase or rehabilitate retail, manufacturing, agriculture, community facilities (e.g., health services, museums, or charter schools), rental or for-sale housing, or combinations of these.

The Urban Institute categorized NMTC project types (figure 2). Although no type dominated, the most prevalent were retail, manufacturing/industrial, mixed use, health care, office buildings, and schools.

FIGURE 2

New Markets Tax Credit

Share of projects by industry, 2003–15



Source: Urban Institute calculations based on project reporting data from the CDFI Fund
Note: Projects with "other" industries comprising 0.1 percent of all projects not displayed.
CDE = community development entity

Further Reading

Abravanel, Martin D., Nancy M. Pindus, Brett Theodos, Kassie Dumlao Bertumen, Rachel Brash, and Zachary J. McDade. 2013. "New Markets Tax Credit Program Evaluation." Washington, DC: Urban Institute.

Q. What is the low-income housing credit and how does it work?

A. The credit provides an incentive for investment in low-income communities. The US Treasury competitively allocates tax credit authority to intermediaries that select investment projects. Investors receive a tax credit against their federal income tax.

The Low-Income Housing Tax Credit (LIHTC) subsidizes the acquisition, construction, and rehabilitation of affordable rental housing for low- and moderate-income tenants. The LIHTC was enacted as part of the 1986 Tax Reform Act and has been modified numerous times. Since the mid-1990s, the LIHTC program has supported the construction or rehabilitation of about 110,000 affordable rental units each year (though there was a steep drop-off after the Great Recession of 2008–09)—about 2 million units in all since its inception.

The federal government issues tax credits to state and territorial governments. State housing agencies then award the credits to private developers of affordable rental housing projects through a competitive process. Developers generally sell the credits to private investors to obtain funding. Once the housing project is placed in service (essentially, made available to tenants), investors can claim the LIHTC over a 10-year period.

QUALIFYING FOR THE CREDIT

Many types of rental properties are LIHTC eligible, including apartment buildings, single-family dwellings, townhouses, and duplexes.

Owners or developers of projects receiving the LIHTC agree to meet an income test for tenants and a gross rent test. There are three ways to meet the income test:

1. At least 20 percent of the project's units are occupied by tenants with an income of 50 percent or less of area median income adjusted for family size (AMI).
2. At least 40 percent of the units are occupied by tenants with an income of 60 percent or less of AMI.
3. At least 40 percent of the units are occupied by tenants with income averaging no more than 60 percent of AMI, and no units are occupied by tenants with income greater than 80 percent of AMI.

The gross rent test requires that rents do not exceed 30 percent of either 50 or 60 percent of AMI, depending upon the share of tax credit rental units in the project. All LIHTC projects must comply with the income and rent tests for 15 years or credits are recaptured. In addition, an extended compliance period (30 years in total) is generally imposed.

Key Elements of the U.S. Tax System

What is the low-income housing credit and how does it work?

COMPUTING THE CREDIT

The credit claimed by a taxpayer equals a credit percentage multiplied by the project's qualified basis. The percentage is larger for new construction or substantial rehabilitation (roughly 9 percent but specified in the law as a 70 percent present value credit) than for properties acquired for rehabilitation or for projects funded using tax-exempt bonds (roughly 4 percent but specified as a 30 percent present value credit). The qualified basis equals the fraction of the cost of the housing project rented to tenants meeting the income tests. For many LIHTC projects, the owners or developers aim to rent 100 percent of the units to qualifying tenants. State housing finance agencies may allocate enhanced tax credits to qualified projects in areas where the need is greatest for affordable rental housing.

The LIHTC statute originally specified that the IRS would periodically reset the specified credit percentages to maintain the present value of the 10-year stream of tax credits at 70 percent or 30 percent of the qualified basis. However, since 2008, Congress has specified that the minimum credit rate for the 70 percent present value credit should be at least 9 percent, regardless of prevailing interest rates. Thus, in a low interest rate environment, the present value of the credits claimed over 10 years will exceed 70 percent of the qualified basis.

ALLOCATING THE CREDIT

Congress sets a limit on the amount of LIHTC that can be allocated in any year. For 2018, each state was originally allocated $2.765 million or $2.40 per capita, whichever was larger. But Congress provided a 12.5 percent boost through 2021, so these figures were increased to $3.1 million and $2.70, respectively. Both dollar amounts are adjusted for inflation.

This structure guarantees that states with low populations get a somewhat larger award when calculated on a per capita basis. States then allocate these credits (generally through state housing finance agencies) to developers, based on state-created qualified allocation plans. These plans are required to give priority to projects that serve very low income households and that provide affordable housing for longer time periods. Projects financed by private activity tax-exempt bonds do not need to obtain a separate credit allocation from the state housing finance authority. The state, however, must approve the use of these bonds, which checks developers' ability to access 30 percent present value LIHTCs.

Developers generally sell the tax credits to investors, who may be better able to use the tax credits and other tax benefits of the housing project (e.g., depreciation, interest paid, net operating losses). Investors also contribute equity, often through a syndication or a partnership. The investors or limited partners usually play a passive role, receiving the tax benefits associated with the project but not participating in day-to-day management and oversight.

Most investors in LIHTC projects are corporations that have sufficient income tax liability to fully use nonrefundable tax credits. Financial institutions traditionally have been major investors, because they have substantial income tax liabilities, have a long planning horizon, and often receive Community Reinvestment Act credit from their regulators for such investments. Taxpaying investors cannot claim credits until the project is placed into service.

CALCULATING COSTS AND BENEFITS

The LIHTC is estimated to cost around $9 billion per year. It is by far the largest federal program encouraging the creation of affordable rental housing for low-income households. Supporters see it as an effective program that has substantially increased the affordable housing stock for more than 30 years. LIHTC addresses a major market failure—the lack of quality affordable housing in low-income communities. Efficiencies arise from harnessing private-sector business incentives to develop, manage, and maintain affordable housing for lower-income tenants.

Critics of the LIHTC argue that the federal subsidy per unit of new construction is higher than it needs to be because of the various intermediaries involved in its financing—organizers, syndicators, general partners, managers, and investors—each of whom are compensated for their efforts. As a result, a significant part of the federal tax subsidy does not go directly into the creation of new rental housing stock. Critics also identify the complexity of the statute and regulations as another potential shortcoming. Another downside is that some state housing finance authorities tend to approve LIHTC projects in ways that concentrate low-income communities where they have historically been segregated and where economic opportunities may be limited. Finally, while the LIHTC may help construct new affordable housing, maintaining that affordability is challenging once the required compliance periods are over.

Further Reading

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Q. What are opportunity zones and how do they work?

A. Opportunity Zones are tax incentives to encourage those with capital gains to invest in low-income and undercapitalized communities.

HOW DO OPPORTUNITY ZONES WORK, WHO CAN CLAIM THE INCENTIVES, AND WHAT PROJECTS CAN THEY SUPPORT?

The Tax Cuts and Jobs Act included a new federal incentive—Opportunity Zones—meant to spur investment in undercapitalized communities. Any corporation or individual with capital gains can qualify. The program provides three tax benefits for investing unrealized capital gains in Opportunity Zones:

1. Temporary deferral of taxes on previously earned capital gains. Investors can place existing assets with accumulated capital gains into Opportunity Funds. Those existing capital gains are not taxed until the end of 2026 or when the asset is disposed of.
2. Basis step-up of previously earned capital gains invested. For capital gains placed in Opportunity Funds for at least 5 years, investors' basis on the original investment increases by 10 percent. If invested for at least 7 years, investors' basis on the original investment increases by 15 percent.
3. Permanent exclusion of taxable income on new gains. For investments held for at least 10 years, investors pay no taxes on any capital gains produced through their investment in Opportunity Funds (the investment vehicle that invests in Opportunity Zones).

Investors can take advantage of one or more of the benefits.

Apart from a few "sin" businesses, Opportunity Funds can finance a broad variety of activities and projects. Funds can finance commercial and industrial real estate, housing, infrastructure, and existing or start-up businesses. For real estate projects to qualify for Opportunity Fund financing, the investment must result in the properties being "substantially improved."

WHICH COMMUNITIES ARE ZONES AND WHAT ARE THEIR ATTRIBUTES?

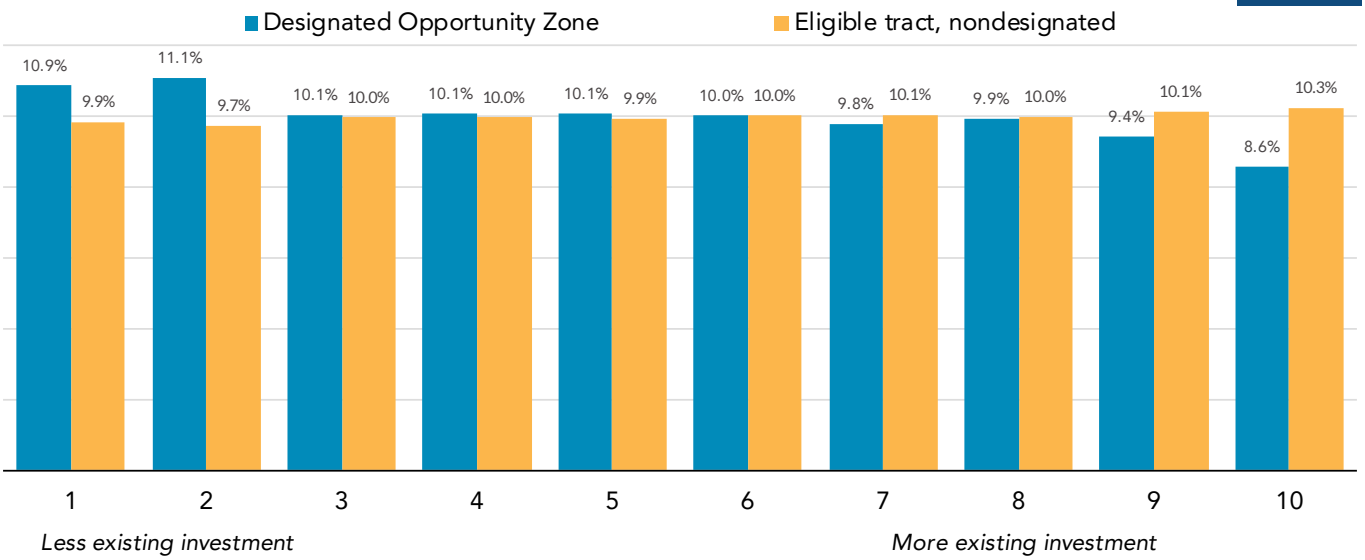
Twelve percent of US census tracts are Opportunity Zones (8,762 tracts). Governors of the 50 states and 4 territories and the mayor of Washington, DC, nominated the zones, which were officially designated by the US Department of the Treasury. The statute contains no provision to change which communities are classified as Opportunity Zones.

Urban Institute research finds that the designated zones have lower incomes, higher poverty rates, and higher unemployment rates than eligible nondesignated tracts. However, analysis shows minimal targeting of the program toward disinvested communities.

Urban ranked Opportunity Zone investment on a 1 to 10 scale, standardized across eligible tracts state by state, with 10 being the highest score. Just under one-third of Opportunity Zones are located in the three tracts that have the least investment, while 28 percent are in the three tracts attracting the most investment. This pattern is roughly similar to nondesignated tracts, with only very slight targeting toward lower-investment areas (figure 1).

FIGURE 1

Investment Score Distribution of Opportunity Zones



Sources: Urban Institute analysis of 2011–15 CoreLogic, 2015 Longitudinal Employer Household Dynamics Origin-Destination Employment Statistics Workplace Area Characteristics, 2011–15 US Census Bureau American Community Survey, 2000 US Census Decennial Census, 2011–15 Home Mortgage Disclosure Act, and 2011–15 Community Reinvestment Act data.
Note: This figure excludes US territories.

Opportunity Zones seem better targeted when measured by socioeconomic standards. Designated tracts have lower incomes, more poverty, and higher unemployment than eligible nondesignated tracts. Home values, rents, and homeownership rates also are lower. The designated tracts are less white and more Hispanic and black. Ages are similar while education levels are somewhat lower. The mix of urban and rural Opportunity Zones closely tracks community patterns (table 1).

Finally, we looked how designated tracts changed from 2000 to 2016. Where communities are already experiencing high levels of socioeconomic change, further investment may displace low- and moderate-income residents. Thus, Opportunity Zones in these areas may be less likely to benefit needy residents. We measured socioeconomic change by tracking changes in the share of residents with a bachelor's degree or higher, median family income, share of non-Hispanic white residents, and average housing costs as a share of income.

We found that tracts experiencing socioeconomic change were more represented among designated tracts (3.2 percent) than among eligible nondesignated tracts (2.4 percent).

TABLE 1

Tract Characteristics by Opportunity Zone Designation Status

Characteristics	Designated	Eligible, nondesignated
Economic (average $ or average %)		
Median household income	$33,345	$44,446
Poverty rate	32%	21%
Unemployment rate	13%	9%
Housing (average $ or average %)		
Median home value	$145,187	$170,919
Median rent/month	$768	$885
Homeownership	45%	57%
Severe rent burden	26%	24%
Vacancy rate	16%	14%
Demographic (average %)		
White alone	40%	55%
Black alone	24%	17%
Hispanic	30%	20%
Asian American and Pacific Islander alone	3%	4%
Younger than 18	24%	23%
Older than 64	14%	15%
Education (average %)		
Age 25+ with high school diploma or less	55%	50%
Age 25+ with bachelor's degree or higher	38%	43%
Geography (%)		
In a metro area	78%	79%
In a micro area	11%	11%
Not in core-based statistical area	10%	10%

Source: CDFI Fund, Urban Institute analysis of 2012–16 US Census Bureau American Community Survey.
Note: This table includes all 50 states, the District of Columbia, and Puerto Rico. It does not include American Samoa, Guam, Northern Mariana Islands, and the Virgin Islands due to data limitations.

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Further Reading

Theodos, Brett, Brady Meixell, and Carl Hedman. 2018. "Did States Maximize Their Opportunity Zone Selections?" Washington DC: Urban Institute.