Community Development Financial Institution (CDFI) Tax Credit

Chapter 436 of 2011 (AB 624, J. Pérez), extended until January 1, 2017, provisions of the state's personal income tax, corporation tax, and insurance tax laws that provide certain credits to individuals and businesses that make qualified investments in CDFIs. According to prior floor analyses, the CDFI tax credits originally were created in 1996 "as an alternative to state legislation that would have required insurance companies to invest in low-income urban and rural communities" (just as the Federal Community Reinvestment Act requires for most banks). Chapter 608 of 2013 (AB 32, J. Pérez), increased the amount of tax credits available from $2 million to $10 million per year, added new reporting requirements, and modified the process for allocating credits. Pursuant to Chapter 608, our office is required to evaluate the effectiveness of the CDFI tax credits with a focus on employment in low-to-moderate income and rural areas. This report fulfills that reporting requirement. (Our office previously evaluated the CDFI tax credits in a similar report dated April 14, 2011.)

Background

What Are CDFIs? According to the California Department of Insurance (CDI), CDFIs are "mission-driven community organizations, separate from government control, dedicated to providing financial products and services to low-income communities underserved by traditional financial markets." This description covers a variety of private organizations that are certified as CDFIs by the California Organized Investment Network (COIN)—an office within CDI. The U.S. Treasury also certifies CDFIs, but COIN does not require that California CDFIs be federally certified—although many are. Most CDFIs are non-depository lenders and loan funds that lend money to affordable housing projects, businesses and non-profit organizations, and various other community development projects. Some CDFIs instead take equity positions in community development projects. Often, CDFIs are organized as nonprofits, but they may be a for-profit organization. Some CDFIs are depository institutions—such as a credit union.

CDFI Tax Credit Program. The goal of this tax credit program is to provide incentives—through credits against the personal income tax, the corporate income tax, and the insurance gross premiums tax—to attract private capital investments that otherwise would not be available to CDFIs. Qualified investments in state CDFIs eligible for the credits include (1) loans or deposits that do not earn interest, (2) equity investments, or (3) "equity-like debt instruments" meeting certain specifications. All qualified investments must be equal to or greater than $50,000 and for a minimum term of five years.

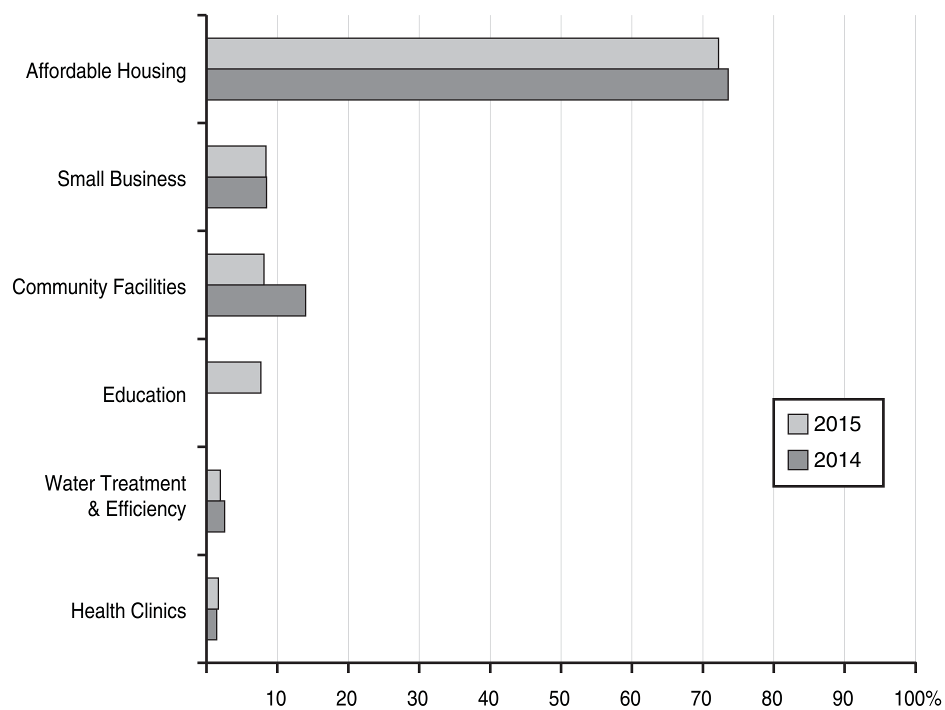
The credit is equal to 20 percent of the qualified amount invested in a state-certified CDFI. The total for all credits for all recipients is capped at $10 million per year for the three taxes combined. Accordingly, each year, up to $50 million in eligible investments in CDFIs may qualify for up to $10 million in tax credits. If the aggregate amount of eligible investments made in any calendar year is less than $50 million, state law provides that the difference between $10 million and the actual amount of allocated CDFI tax credits may be carried over to the next year. When the total amount of eligible investments exceeds available tax credits, the COIN program has the authority to qualify a smaller portion of the eligible state CDFI investments for a tax credit.

Tax Credit Investments. The CDFIs lend or invest their capital to various community development projects. It is as difficult to generalize the nature of these investments as it is to generalize the nature of the CDFIs. According to data provided by the COIN program, about three-fourths of eligible CDFI tax credit investments in 2014 and 2015 (by dollar amount) have been invested in affordable housing projects. As we show in Figure 1, state CDFI tax credit investments have also benefited other types of projects. We describe some examples of CDFIs and their investments in the box on the next page.

Figure 1

Use of State CDFI Tax Credit Investments

Percentage of Total Investments by Type of Use[a]



[a] Type of use classified by the California Organized Investment Network, California Department of Insurance.

CDFI = community development financial institution.

Program Has Significantly Expanded

Tax Credits Now Fully Utilized. We evaluated the CDFI tax credit program in 2011. At that time, we observed that the tax credit program had not been fully utilizing its capacity, and several million dollars in unclaimed CDFI tax credits had accumulated. In 2013, the Legislature expanded the program from $2 million to $10 million—as we

Four Examples of State Certified Community Development Financial Institutions (CDFIs)

Self-Help. Self-Help is a family of five affiliated nonprofit organizations—including a charitable nonprofit, two credit unions, a loan fund, and a research and policy center. Self-Help's stated mission is "to expand opportunities for underserved communities." In addition to doing business in California, the Self-Help organization is active in North Carolina, Illinois, and Florida. Between 2011 and 2015, Self-Help received 48 state CDFI tax credit investments totaling $6 million for small business loans. Most of these investments were made by private individuals. Two insurance companies invested a total of $500,000 in Self-Help Federal Credit Union in 2012.

Clearinghouse CDFI. Clearinghouse is a nonprofit corporation that makes a wide range of housing and community development project loans. Its stated mission is "financial lending for projects with measurable impacts." Between 2011 and 2015, a number of banks made 20 state CDFI tax credit investments in Clearinghouse CDFI totaling $7 million. This capital allowed Clearinghouse to invest in projects such as a biomass electric facility in Madera County and a community center building in Vallejo.

Genesis LA. This CDFI makes direct loans and investments to community and economic development projects in underserved areas of Los Angeles. Genesis LA received five investments totaling $5.25 million in 2014 and 2015 from four banks and one insurance company. Some of the investments made by Genesis LA include loans to build an after school program for low-income students in Watts and an early child development center for low-income families in need of childcare in the Koreatown neighborhood of Los Angeles.

Enterprise Community Partners. Enterprise Community Partners is a nationwide organization that lends funds, finances development, and manages and builds affordable housing. Its stated mission "is to create opportunity for low- and moderate-income people through affordable housing in diverse, thriving communities." Two subsidiaries have received state CDFI tax credit investments. The Enterprise Community Loan Fund received five investments totaling $10.5 million in 2015 from two insurance companies—MetLife and UnitedHealthcare. Some of these investments helped fund the purchase of a one-acre site in the Koreatown neighborhood of Los Angeles that will be the site of a five story mixed-use multifamily building. Enterprise Community Investment received 24 investments from banks and insurance companies between 2012 and 2015 totaling $63.9 million. A project funded by some of these investments was the rehabilitation of a building in Oakland to create 137 units of affordable rental housing.

show in Figure 2, the $8 million increase in tax credit capacity was rolled over to 2014. The COIN program awarded $13.8 million in tax credits in 2014 and rolled over $4.2 million in tax credits to 2015. In 2015, as we show in Figure 2, taxpayers invested $89.6 million in CDFIs (eligible investments). Given that the credit is capped at only $10 million of new incentives each year, COIN could qualify only $71 million of the total amount of eligible investments. No credits were rolled over to 2016. A preliminary survey of CDFIs suggests that tax credit eligible investments in 2016 could exceed $150 million—up substantially from prior years.

Figure 2

Annual Utilization of CDFI Tax Credit Program

(In Millions)

Year	Eligible Investments In CDFIs	Qualified Investments In CDFIs	CDFI Tax Credits Available	CDFI Tax Credits Awarded	Tax Credits Available Next Year
2011[a]	$23.6	$23.6	$4.7	$4.7	—
2012	10.0	10.0	2.0	2.0	—
2013[b]	10.0	10.0	10.0	2.0	$8.0
2014	69.0	69.0	18.0	13.8	4.2
2015	89.6	71.0	14.2	14.2	—

[a] $2.7 million in tax credits were carried over to 2011 from 2010.
[b] CDFI tax credit program increased from $2 million to $10 million in 2013.
CDFI = community development financial institution.

Credits Awarded Competitively. Until recently, the COIN program awarded state CDFI tax credits on a first-come, first-served basis. As we noted in 2011, this did not allow the state to prioritize CDFI investments to fit desired policy objectives. Now that the demand for credits somewhat exceeds capacity, however, the COIN program has implemented an application scoring and weighting methodology to competitively award CDFI tax credits. This process aims to give priority to (1) investments that may generate higher economic, social, and environmental benefits; (2) CDFIs with the greatest financial and operational capacity to deliver those benefits; and (3) investors that are insurance companies. Figure 3 shows the scoring questions used by COIN to evaluate and weigh the tax credit applications. In 2015, the COIN program qualified for a tax credit only about one-fourth of the eligible CDFI investments made by the lowest-scoring investors. (All other eligible investments in 2015 were fully qualified for the tax credit.)

Figure 3

Tax Credit Application Scoring Questions

- Direct benefit to low-to-moderate income households?
- Direct benefit to rural areas?
- Green investment?
- Affordable rental housing?
- Community-based residential programs?
- Self-help housing?
- Veteran housing?
- Single-family owned housing?
- Is the investor an insurance company?
- Estimated number of temporary jobs created?
- Estimated number of permanent jobs created?
- Estimated number of jobs in high unemployment areas?
- Is there any other statistical information that addresses the previous factors?

Technical Assistance and Underwriting. The COIN program works with CDFIs on an on-going basis to evaluate their financial and organizational capacity. For example, the program works with CDFIs before they submit tax credit applications to provide advice on their investment capacity and funding needs. Participating CDFIs provide COIN with quarterly updates on tax credit investments. In addition, the COIN program educates insurance companies about CDFIs. It is our understanding that many insurance companies may be unfamiliar with CDFIs and the types of investments they require. Moreover, many large institutional investors—such as insurance companies—typically prefer to make larger investments than most state-certified CDFIs have the financial capacity to use. To address these concerns, the COIN program reportedly helps to connect insurance companies with CDFIs that are seeking new investments. The program staff review eligible investments in CDFIs and may work with both parties to help structure the investment agreements.

Tax Credit Effectiveness

Appears to Have Increased CDFIs' Access to Capital. Interest in the state CDFI tax credit program appears to have significantly increased. According to preliminary estimates provided by the COIN program, tax credit eligible CDFI investments could exceed $150 million in 2016—more than double the $69 million in 2014. While this appears to be a significant increase in investments in state-certified CDFIs, it is also worth noting that CDFIs are capitalized in many ways and not only through investments facilitated by the COIN program. Our earlier comments regarding the wide variety of CDFIs are also relevant here. While this tax credit program has likely increased the amount of capital available to some small- and medium-sized state CDFIs, we think it has had a much less significant effect on the largest CDFIs.

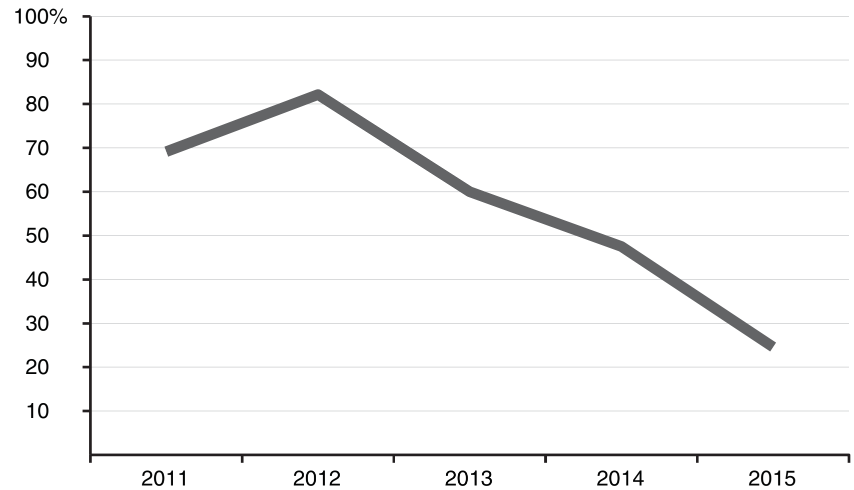
Insurance Company Participation Has Declined. The legislative history of the CDFI credits—and the placement of its administration within CDI—suggest that a key goal of the program has been to encourage insurance company investments in CDFIs. In our earlier report, we observed that only a small number of insurance companies were participating in the program. By 2011, however, their participation increased significantly, with eight insurance companies investing a total of $16.3 million in CDFIs—about 70 percent of the total eligible investments in state CDFIs that year. However, as shown in Figure 4 (see next page), the relative participation of insurance companies has been declining in recent years. In 2015, three insurance companies invested a total of $22.3 million in CDFIs—about a quarter of the eligible investments. Preliminary estimates provided by the COIN program suggest that insurance companies will make about one-third of all tax credit eligible CDFI investments in 2016. (The final level of participation in the program could increase, however, because we understand that insurance companies tend to invest later in the year than other CDFI investors.) The COIN program gives insurers' tax credit applications priority under existing regulations, so it is also possible that insurers may receive more than a third of the tax credits in 2016.

COIN Estimates Some Economic Effects of Each Investment. The tax credit application requires that CDFIs provide various information and "impact" metrics about the investment—such as the percentage of the investment that will provide a direct benefit to low-to-moderate income households and estimates of the number of jobs created. In addition, the COIN program estimates the total final economic output and employment of each eligible investment using commonly accepted economic multipliers from the U.S. Bureau of Economic Analysis (RIMS II).

Figure 4

Participation by Insurance Companies

Insurance Company Investments in CDFIs as Percentage of All Investments



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Using this methodology, COIN estimates that a $1 million affordable housing investment, for example, would generate 16.8 direct, indirect, and induced jobs and $2.29 million in final economic output. In comparison, COIN estimates that $1 million in loans to small businesses would generate 14 jobs and $2.28 million in final economic output. While there are limitations to this methodology, the use of RIMS II multipliers allows for a consistent comparison of projects within a program such as this one.

Tax Credits May Increase Employment in Low-to-Moderate Income Areas. Consistent with legislative intent, the tax credit appears to result in more resources to CDFIs, which invest that capital in low-to-moderate income areas of the state that may not have otherwise received those investments. All of the eligible CDFI tax credit investments are in low-to-moderate income areas of California. Based on the information provided to us by COIN, the CDFI tax credit investments made between 2011 and 2015 could directly result in (the full-time equivalent of) roughly 1,400 jobs in low-to-moderate income areas. (We do not have any detailed information about these jobs. The estimate is based on the amounts of the investments in CDFIs and the types of projects identified at the time of the application for the tax credit. The investments made by the CDFIs may ultimately differ from the projects identified on the tax credit application.)

Overall Net Effects on State Economy. As we discuss in the box on the next page, we would expect the total statewide *net* increase in employment due to the credit to be significantly less than 1,400 jobs—and could be zero or even negative—because of other complex economic factors. While credits may benefit the specific segment of the economy at which they are targeted, overall net effects for the state's economy generally are much less positive.

Investments in Rural Areas Growing. In 2012, only two state CDFI tax credit investments were in rural areas, about 12 percent of the total dollar amount. Chapter 608 specifically prioritized investments in rural areas and the number and dollar amounts of investments in rural areas increased considerably in 2014—to 26 investments and

Estimating the Economic Effects of Tax Credits

Our office is often asked to evaluate the economic and employment effects of tax credits. In doing so, it is helpful to try to distinguish between (1) "new spending" resulting from the tax credit and (2) spending that would have occurred in the economy regardless of whether or not the tax credit existed. In addition to any direct effects of the spending in isolation, this new spending in the economy causes various indirect and induced economic effects—some positive and some negative. It is difficult to identify and quantify all of these effects, which may include "opportunity costs" and "windfall benefits."

Opportunity Costs. There are two major types of opportunity costs of tax credits, including the community development financial institution (CDFI) tax credit:

- A tax credit directly and indirectly changes the behavior of some businesses and individuals. Those businesses that invest in a CDFI in order to receive a tax credit would have otherwise invested their money in some other way. That other investment may have had similar economic effects. The tax credit subsidized investment also may have indirectly "crowded out" an investment that would have otherwise been made by a different business or individual.

- A tax credit puts more money in the accounts of some businesses and individuals to spend and invest in the economy. However, it prevents the state government from using those funds for other public purposes—ranging from spending on other programs to broader tax reductions. Those alternative actions by government would have benefited a different set of businesses and individuals, potentially providing a similar benefit to other parts of the economy as the CDFI tax credit.

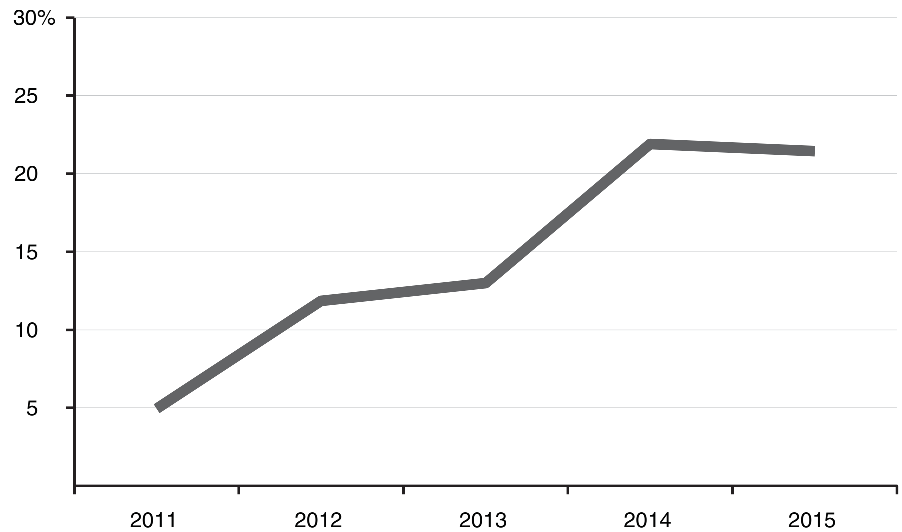
Windfall Benefits. Often, tax credits do not change the behavior of their recipients. In these cases, a tax credit is essentially a windfall benefit to the taxpayer for doing something they would have done even had they not received the tax credit. Windfall benefits occur with most, if not all, tax credit programs but it can be very difficult to determine whether or not a tax credit has changed the behavior of any specific business or individual.

22 percent of the total dollar amount. As we show in Figure 5, that trend has reversed somewhat in 2015, when 24 investments were made in CDFIs in rural areas representing 21 percent of the total dollar amount. Based on the information provided to us by COIN, the CDFI tax credit investments made between 2011 and 2015 could directly result in (the full-time equivalent of) roughly 250 jobs in rural low-to-moderate income areas of California. As noted in the discussion above and in the nearby box, the *net* effect on rural California's economy is likely much less than this.

Figure 5

Rural Investments

Percentage of All CDFI Tax Credit Investments



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Other Benefits. As CDFIs are community-development, mission-driven organizations, we understand that many of the projects they fund may likely achieve other policy objectives and benefits—beyond changes in employment and economic activity—that can be difficult to quantify. For example, some of the investments aim to improve energy efficiency and others provide affordable rental housing to the mentally ill. Investments in community facilities and health clinics may be delivering social benefits. Other means of promoting these goals may be more or less costly for taxpayers than this program.

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