At A Glance:

- Community Development Financial Institutions (CDFIs) are private government-certified financial institutions that serve individuals, businesses and communities that tend to be overlooked by the conventional financial system. There are currently more than 1,000 CDFIs operating in the U.S. as banks, credit unions, loan funds, microloan funds and venture capital funds.

- Today dozens of CDFIs raise capital from individual and institutional investors through community investment products, each of which delivers a financial return alongside intentional and measurable social benefits. For the most part, income earned on these investments is taxed at the same rate as income from traditional investments that have no clear obligation or intent to deliver social impact.

- We urge Congress to establish a new federal tax incentive for impact investments through CDFIs. That incentive could take several forms, including: (1) a tax exemption for all income earned through eligible investment products, similar to the treatment of municipal and other tax-exempt bonds; or (2) a tax credit worth a certain percentage of the principal invested through eligible products.

- This issue brief weighs the pros and cons of those two approaches, including their respective: (1) ability to leverage private investment; (2) simplicity and efficacy as viewed by mainstream investors; and (3) expected cost to taxpayers.

Introduction to CDFIs and Community Investing

Community investments deliver financial returns alongside intentional and measurable social benefits and are commonly referred to as impact investments. The U.S. market for community investments has grown in both scale and prominence over the past two decades, totaling more than $122 billion in 2016, according to the Forum for Sustainable and Responsible Investment. That’s roughly twice the amount invested in 2014 and six times the amount in 2005.\(^1\)

Community Development Financial Institutions (CDFIs) are crucial intermediaries for community investing. CDFIs are government-certified financial institutions focused on serving economically disadvantaged individuals, businesses and communities within the United States.\(^2\) The U.S. Department of Treasury certifies CDFIs to ensure that their investments produce certain social outcomes, such as job creation, the expansion of small businesses or the development of affordable homes.

Over the past three decades CDFIs have invested more than $42 billion to support 1.5 million homes and 143,000 small businesses or microenterprises.\(^3\)

CDFIs raise and manage capital from several sources, including banks, foundations, religious institutions, individuals and government agencies. Many CDFIs also offer private community investment products to individual and institutional investors. For example, the Enterprise Community Impact Note is a fixed-income security that provides a financial return to retail, accredited and institutional investors, with the requirement that all capital raised is invested in projects that deliver a public benefit.\(^4\) This year two other CDFIs – Local Initiatives Support Corporation and Reinvestment Fund – issued general obligation bonds totaling $150 million with similar investment requirements.\(^5\) According to research from ImpactUs, an online platform for community investment products, at the end of 2016 there were at least 28 CDFIs raising capital through community investment products totaling $2.4 billion in offerings.\(^6\)

Under current federal law, income earned on investments made through CDFIs is taxed at the same rate as income earned from a savings account, certificate of deposit or corporate bond, all of which typically have no obligation or intent to produce clear social or environmental benefits. The amount of investment capital flowing to support disadvantaged individuals, businesses and communities could be greatly increased if impact investments through CDFIs provided a tax benefit.
In October 2016, Enterprise Community Partners and the Accelerating Impact Investing Initiative (AI3) released "Tax Incentives for Impact Investments through CDFIs," which describes two state-level tax incentives that have proven to drive private investment to communities through CDFIs. This issue brief builds on that analysis, laying out two proposals for a similar tax incentive at the federal level: either a tax exemption on income earned or a tax credit worth a portion of the total amount invested.

These proposals are the product of independent research and a series of conversations with industry experts, including both CDFI representatives and impact investors. Notably, in October 2016 Enterprise and the AI3 hosted a roundtable of more than 30 CDFI stakeholders and experts at the Opportunity Finance Network Conference in Atlanta to discuss how a federal impact investing tax incentive could work. That group remained engaged as we developed the two options outlined in this issue brief.

**Two Options for a Community Investment Tax Incentive**

In general, tax incentives deliver a financial benefit to investors by increasing the effective rate of return on their investment. In many cases, this additional benefit could allow many community investing products offered by CDFIs to deliver annualized returns that are similar to or greater than traditional market-rate investments.

Regardless of the specific policy goal, any effective tax incentive must: (1) provide a valuable benefit to both the investor and the government; (2) engender certainty so that both the investor and qualified investment organization can reasonably assume that the benefit will be available for several years; (3) be simple and intuitive enough to encourage both sides to pursue the benefit; and (4) not carry excessive “costs” to the federal government through foregone tax revenues and administrative expenses associated with providing the tax benefit.

With those considerations in mind, below are two possible models for a new federal tax incentive to encourage impact investments through CDFIs.

**Option 1: Federal Tax Exemption on Interest Income**

Under this approach, eligible investors would generate tax-free income on eligible investments made through CDFIs. The tax exemption could be implemented quickly, so investors could realize the benefit almost immediately once enacted. We do not anticipate significant administrative expenses would be incurred to support the tax incentive.

This model is similar to the treatment of municipal and other tax-exempt bonds that governments issue to raise private financing for public infrastructure projects such as housing, schools and health facilities. Municipal bonds are not subject to federal income taxes and most state and local taxes. This tax benefit increases the effective rate of return on the investment, which has proven to meaningfully enhance investor interest despite the low interest rates offered. Lower interest rates equate to a lower cost of capital to the government entity issuing the bonds. Since investment products issued by CDFIs serve a similar public purpose – financing housing, schools, health facilities, etc. – it makes sense for these products to be treated similarly in the federal tax code.

Ideally this proposal would be adopted as a permanent part of the tax code; otherwise, it could be subject to annual reauthorization risks, which would create uncertainty that may dampen its efficacy. If a tax exemption is made permanent it could be subject to caps on annual issuances like the caps imposed on bonds. We understand the importance of limiting the costs to government – and mitigating fraud and abuse. We look forward to working with lawmakers to design rules that accomplish both goals.
Figure 1: How a federal tax exemption could flow to investors

**Option 2: Federal Tax Credit Worth a Percentage of the Investment**

Under this approach, Congress would authorize the amount of tax credits to be allocated annually. Eligible investors would receive a nonrefundable credit against their federal tax liability worth a certain percentage of the principal placed in community investment products offered by a CDFI. The credit would be nonrefundable, meaning the total credits claimed in a given year could not exceed the investor’s tax liability.

This model is similar to state-level tax credit programs that incent impact investing through CDFIs. Below is one possible way that a federal tax credit could be structured to flow to investors:

- Each year Treasury allocates the tax credits to certified CDFIs offering eligible investments – either through a competitive process, a needs-based formula or some combination of the two. The total amount of tax credits available to investors is limited by the amount allocated to the CDFI through which they want to make an eligible investment.

- Over the course of the year, each CDFI allocates the tax credits to eligible investors who have made eligible investments. The CDFI must allocate the majority of its tax credits within one year, and Treasury can reclaim and reassign all unallocated authority after two years.

- The investor claims the tax credit over the designated credit period, which aligns with the duration of the investment. For example, if the tax credit is worth 10 percent of the amount invested and the credit period is five years, the investor claims a tax credit valued at two percent of the investment for five years.

Again, ideally this credit would be a permanent part of the tax code to avoid the market uncertainty that is common with tax credit programs that rely on reauthorization. Investors and CDFIs must be able to rely on the ability to access and receive the credit from year-to-year. Uncertainty may delay or prohibit investment, which can negatively impact CDFIs’ capital aggregation and management strategies.

There is also value in testing this model at the small scale before making the tax credit permanent. Congress could adjust annual allocations based on the program’s efficacy in delivering the desired social outcomes.

More research is necessary to determine the appropriate value of the tax credit and the period over which the credits could be claimed, among other important details. For example, to encourage investors to hold the investment, the program could be structured so that the tax credit must be claimed over a period of several years. A longer credit period would benefit
CDFIs because of their need to access long-term capital. As a rule, the value of the credit should be set against some benchmark, with the goal of aligning the financial return of the eligible investment with that of traditional investment products.

Figure 2: How a nonrefundable tax credit could flow to investors

Weighing the Pros and Cons of Each Option

The options described above have distinct upsides and downsides. For example, a full tax exemption is a relatively simple program that would be easy to implement. However, tax exemptions tend to be poorly targeted – in part because the tax benefit depends on the investor’s marginal tax rate – and deliver a relatively small benefit to investors compared to a tax credit worth a portion of the total investment.11 Alternatively, the tax credit approach can deliver a more targeted and robust benefit to investors, but implementation is far more complicated, which could negatively affect uptake of the program. Below is a high-level summary of the pros and cons of each approach.

Table 1: Summary of the pros and cons of each proposal

<table>
<thead>
<tr>
<th>Option 1: Federal tax exemption on interest income</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Relatively simple and easy to implement</td>
<td></td>
<td>• Relatively modest benefit to the investor (see Table 2)</td>
</tr>
<tr>
<td>• Lower cost to government</td>
<td></td>
<td>• Benefit depends on the investor’s income tax rate</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Option 2: Federal tax credit worth a percentage of the investment</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• More robust benefit to the investor (see Table 2)</td>
<td></td>
<td>• Complex and difficult to implement</td>
</tr>
<tr>
<td>• Flat benefit to all investors regardless of income tax rate</td>
<td></td>
<td>• Higher cost to government</td>
</tr>
</tbody>
</table>
Below is a summary of the private investment capital that the federal government could leverage under each proposal, as well as a rough estimate of the benefit to investors under different tax scenarios. We have based our analysis on a hypothetical $10,000 investment that earns two percent annually and is held for five years. The estimated leverage ratios do not account for additional funding needed to implement or provide the tax incentives.

Table 2: Estimated leverage ratio and annual benefit to the taxpayer under each proposal

<table>
<thead>
<tr>
<th>Proposals</th>
<th>Estimated Leverage Ratio (Private Dollars Attracted per Public Dollar Invested)</th>
<th>Estimated Annual Benefit for Investor</th>
<th>Estimated Interest Rate Subsidy for Investor (Basis Points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option 1a: Tax exemption on interest earned</td>
<td>200:1</td>
<td>$50</td>
<td>50 bps</td>
</tr>
<tr>
<td>(25% individual tax rate)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 1b: Tax exemption on interest earned</td>
<td>143:1</td>
<td>$70</td>
<td>70 bps</td>
</tr>
<tr>
<td>(35% corporate or individual tax rate)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 2a: Tax credit worth 10% of principal</td>
<td>10:1</td>
<td>$200</td>
<td>200 bps</td>
</tr>
<tr>
<td>(claimed over 5 years)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 2b: Tax credit worth 20% of principal</td>
<td>5:1</td>
<td>$400</td>
<td>400 bps</td>
</tr>
<tr>
<td>(claimed over 5 years)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The government can quantify and control the cost of providing a tax credit program or a capped tax-exemption – i.e. forgone tax revenue and administrative expenses – through program rules.

It could be a lengthy process to implement and fund a new tax credit program, and ongoing operations would require additional funding. For a tax exemption, a layer of oversight would be needed to track the availability of the benefit if it is capped because multiple CDFIs would be able to issue multiple eligible investments.

**Next Steps**

In communities across the country, private investors are helping to address some of the most pressing issues facing our country – from a lack of good jobs to a shortage of affordable homes – often working with CDFIs as trusted intermediaries. To the extent possible, federal policy should encourage more of these public-private partnerships with CDFIs given their strong track record in furthering government priorities through market-based approaches.

As Congress and the administration consider comprehensive tax reform in the coming months, Enterprise and the AI3 encourage lawmakers to establish a new federal tax incentive for impact investments through CDFIs. Such a program could significantly expand the amount of private capital invested to strengthen our workforce, bolster economic growth, and support disadvantaged people, communities and small business across the United States.

This new federal tax incentive could take several forms, including a full exemption for earned income – like the benefit for investments in municipal bonds – or a tax credit valued at a portion of the total investment amount. More research and modeling is necessary to determine which option is optimal, accounting for the program’s: (1) ability to leverage private investment; (2) simplicity and efficacy to mainstream investors; and (3) expected cost to taxpayers. We look forward to working with policymakers, impact investors, CDFI representatives and other key stakeholders to further flesh out those proposals in the coming months.
REFERENCES


2. Learn more about CDFIs at: https://www.cdfifund.gov/Documents/CDFI_infographic_v08A.pdf.


4. Learn more about the Impact Note at: https://www.enterprisecommunity.org/invest/impact-note.

5. Learn more at: https://news.impactalpha.com/a-private-bond-market-emerges-for-low-income-community-development-fe90c4cc79a0.


8. Read more background on the issue brief and how it was discussed during the roundtable at: https://acceleratingimpactinvesting.org/2016/10/25/issue-brief-tax-incentives-for-impact-investments-through-cdfis.

9. To be sure, in today’s low-interest-rate environment many CDFIs already offer competitive interest rates on the securities they issue, but that may not always be the case as interest rates rise in the coming years.

10. Read more about similar state-level tax credits in South Carolina and California at: https://www.enterprisecommunity.org/resources/policy-focus-tax-incentives-impact-investments-through-cdfis-18588.

11. For example, assuming interest income of $1,000, an investor with a marginal income tax rate of 35 percent would receive a benefit of $350 from the tax exemption, while an investor with a marginal income tax rate of 25 percent would receive a benefit of $250.