



**ACCELERATING IMPACT
INVESTING INITIATIVE AI3**

Tax Incentives for Impact Investments through CDFIs

Lessons Learned from Tax Credit Programs in
South Carolina and California

By Rachel Reilly Carroll and John Griffith | October 2016

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 investment capital from individual and institutional investors through fixed-income securities and promissory notes, each of which delivers a financial return alongside intentional and measurable social benefits. There is currently no federal tax credit or deduction for these “impact investments” and, for the most part, income earned on these investments is taxed at the same rate as income from traditional investments with no clear obligation or intent to deliver social impact.
- Two states – South Carolina and California – have established tax-credit programs to encourage more investors to make impact investments through CDFIs. These tax incentives have proven effective in increasing the amount of private capital invested in underserved communities to develop affordable homes, support small businesses and create jobs.
- Enterprise Community Partners (Enterprise) encourages more states to establish tax-incentive programs for private investments through CDFIs. In the coming months, Enterprise and our partners will develop a proposal for a new federal tax incentive targeting impact investment products offered by CDFIs.

Introduction

In communities across the country, private investors are working with public and private partners to address some of the most pressing issues facing the most disadvantaged people, including poor health, lack of education and a shortage of quality, affordable homes. The demand for community investment products that deliver measurable societal benefits alongside financial returns has grown in scale and prominence over the past two decades. Community investments in the United States totaled \$64.4 billion in 2014, up from less than \$20 billion in 2005 and just \$4 billion in 1995, according to the Forum for Sustainable and Responsible Investment.¹

Community Development Financial Institutions (CDFIs) are financial intermediaries that make community investments to produce positive social outcomes, from expanding small businesses and creating jobs to developing affordable homes. The U.S. Department of Treasury certifies CDFIs, ensuring that they are achieving their primary mission of serving economically disadvantaged individuals, businesses and communities. Over the past three decades CDFIs have invested more than \$42 billion to support 1.5 million homes and 143,000 businesses or microenterprises.²

CDFIs raise and manage capital from several sources, including banks, foundations, religious institutions, individuals and government agencies. Many CDFIs also offer private investment products to individual and institutional investors. For example, the Enterprise Community Impact Note (Impact Note) is a fixed-income security that provides a financial return to retail, accredited and institutional investors. Capital raised through the Impact Note is invested in affordable homes and community development projects that deliver a public benefit. According to research from ImpactUs, a soon-to-be launched online platform for community investment products, at least 28 CDFIs are currently raising investment capital through note products or promissory notes, with a combined \$2.4 billion in offerings and \$688 million in debt outstanding.

Under current federal law, income earned on investments made through CDFIs is taxed at the same rate as income earned in 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 carried a tax benefit. This benefit

**STEP 1**

Investor advances funds or property to a certified eligible entity.

**STEP 2**

The investor and eligible entity sign a program-specific document attesting to the nature of the funds or property advanced. This includes the type of investment or donation, the amount of the investment or the value of the donation, and the date it was received by the eligible entity.

**STEP 3**

The eligible entity immediately submits this document to the administrator so that they can accurately monitor the amount of credits claimed to date that year.

**STEP 4**

The investor completes the proper tax forms to claim their credits, and submits that form when filing their taxes.

**STEP 5**

The administrator is responsible for reporting to eligible entities the amount of remaining credits available at some predetermined frequency, so that eligible entities can provide this information to potential investors. Certification and taxation forms are available on the administrator's website, in addition to annual reports outlining the program's impact in South Carolina communities.

could take several forms, such as a full exemption for earned income – similar to the benefit for investments in municipal bonds – or a tax credit valued at a portion of the total investment amount.

This issue brief – prepared by Enterprise and the Accelerating Impact Investing Initiative (AI3), a cross-sector coalition working to improve and expand the market for impact investments through public policy – takes a close look at two impact investing tax credit programs that can serve as a model for other programs: the South Carolina Community Development Tax Credit Program and the California Organized Investment Network's CDFI Tax Credit Program.

South Carolina Community Development Tax Credit Program

Program Overview:

The South Carolina Community Economic Development Act of 2000 created a tax incentive for investments and contributions to CDFIs and community development corporations operating in the state. The South Carolina Community Development Tax Credit program provides a credit against state tax liability worth 33 cents for each dollar invested or donated to eligible entities certified by the state's Department of Commerce. Eligible activities include the purchase of stock, advance of a loan and donation of cash or property. If the amount of the credit exceeds the investor's state tax liability for the year, the investor can carry over the excess credits for up to 10 years.³

The program authorized \$1 million of tax credits annually. In 2015, the South Carolina General Assembly reauthorized the program through 2020 due to its demonstrated success and the increased investor demand in recent years. The tax credit is available on a rolling basis until the \$1 million cap is reached and all tax credits available for that year have been claimed.

How It Works:

The enacting legislation allows a third party to administer the program on behalf of the state. In 2013, the South Carolina Association for Community Economic Development (SCACED) assumed this role. For the first 12 years, the program was administered by the Department of Commerce. SCACED is not compensated to administer the program; administration costs are covered by nominal fees paid by the eligible entities as part of the certification and recertification processes. Each year eligible entities must be certified by the administrator, and both parties sign a Memorandum of Understanding (MOU) outlining terms of participation.

The process and the responsibilities of all three parties (investor, eligible entity and administrator) are outlined on the left.

Impact:

Since the South Carolina Community Development Tax Credit program originally passed in 2000, \$2.8 million in tax credits have been claimed to leverage \$8.5 million of private investment in underserved communities throughout the state.⁴ For example, the South Carolina Community Loan Fund has leveraged investments made through the program to raise \$2.3 million in capital since 2011. That investment has attracted \$7.6 million in additional capital to support projects like DP Cooper Elementary, Harvest Food Hub and Madison Station Apartments.⁵

In 2014, the state allocated \$704,000 in tax credits, which incented \$2.1 million in private investment in nine CDFIs and community development corporations. The additional capital allowed these entities to create nearly 200 affordable homes in the state and connect more than 750 individuals and families to financial literacy, homebuyer education, workforce development and other support services. In 2015, the program was fully subscribed at \$1 million of tax credits, yielding an additional \$3 million in private investment for South Carolina's communities.³

Lessons Learned:

The administrator plays a crucial role in the program's success. Prior to SCACED assuming the role of administrator and marketer, most investors, donors and tax professionals were unaware of the program, meaning authorized tax credits for community investing were not being fully utilized. The use of these tax credits reached the annual cap of \$1 million for the first time in 2015; in 2016 investors claimed the full amount of available credits by June.

The increased demand is due to the administrator's success in both increasing the program's credibility as a viable option for reducing tax liability, as well as raising awareness of the tax incentive and the investments' impact. By continuously monitoring the amount of tax credits available throughout the year, the administrator has enhanced the program's credibility. Investors' confidence in the program has improved as increased transparency provided certainty that their investment or donation would be eligible to receive the tax benefit. Additionally, SCACED is actively marketing the program's benefits to potential investors and South Carolina's accounting and investment advisory professionals. SCACED's reporting allows investors to see the impact of their investment, and helps to demonstrate the program's effectiveness to state legislators and other key stakeholders.⁶

California Organized Investment Network CDFI Tax Credit Program

Program Overview:

The California Organized Investment Network (COIN), a government entity within the state's Department of Insurance, was established in 1996 to encourage insurance companies working in California to pursue investments that support rural, underserved and disadvantaged regions or yield environmental benefits within the state. Since its inception, COIN has played a critical role in channeling hundreds of millions of dollars of institutional and personal investment capital into community development projects and small or sustainable businesses across California.

COIN facilitates this investment through two primary ways: Investor Bulletins and the CDFI Tax Credit Program. The tax credit is worth 20 percent of the eligible investment, which includes interest-free loans, equity or equity-like debt. Investments must be made at a minimum value of \$50,000 and term of 60 months. The credit can be applied to the investor's state personal income tax, corporation tax or insurer premium tax liability.⁷

Due in part to COIN's successful track record and demonstrated investor demand, the total amount of tax credits available annually through the CDFI Tax Credit Program increased from \$2 million to \$10 million in 2013. This program requires reauthorization because it is not a permanent program in the California state tax code.⁸

How It Works:

Each year, the Department of Insurance is authorized to allocate up to \$10 million in state tax credits to support community investments by insurance companies and other entities through COIN-certified CDFIs.

The illustration below demonstrates the process and responsibilities of all three parties (investor, COIN-certified CDFI and COIN):



Impact:

Between 2011 and 2015, COIN facilitated \$237.5 million in investments into 34 COIN-certified CDFIs and mission-aligned funds. Those investments leveraged more than \$500 million in financing, which was used to support real estate and infrastructure projects and businesses that provide societal benefits. The capital was deployed across multiple sectors, with \$127.5 million structured as debt and \$110 million structured as equity. The investments have been placed in each of California's 40 State Senate districts, and in 74 of the 80 State Assembly districts. In addition, 76 percent of the capital was invested into low- and moderate-income communities, which are often bypassed by investors and lack access to capital.

CDFIs and fund managers have invested in more than 12,000 affordable homes and 212 small businesses, 68 percent of which are minority-owned or controlled. COIN investments have also supported schools in low-income communities, consumer financial services for disadvantaged households, public infrastructure projects and facilities that provide health care, child care and social services. In total, these investments have created 4,215 new jobs and supported existing jobs for 2,300 workers.⁹

Lessons Learned:

No investor has lost money on COIN-facilitated investments, and when accounting for net charge-off rates, the weighted average loan return is 4.9 percent.⁹

There remains a critical need for capital to support projects and businesses in California that yield social and environmental benefits. Insurers and CDFIs estimate they have the combined capacity to make or receive COIN CDFI tax-credit investments of \$490 million using \$98 million of tax credits annually. Currently the program is only authorized for \$10 million of tax credits annually, and the program lacks permanent status in the tax code, causing uncertainty for investors and CDFIs alike.⁹

Conclusion and Next Steps

Tax incentives for impact investments through CDFIs are yielding positive social and environmental benefits in South Carolina and California. Adopting similar programs in other states could significantly expand the amount of private capital invested to support disadvantaged people, communities and small business across the United States.

More states should build on proven models to establish programs that meet the needs and market conditions in their communities. Over time, as the market infrastructure for impact investments continues to evolve, these tax incentive programs could be expanded beyond CDFIs to include other impact investments, such as targeted impact funds and investments into B-Corps and Social Impact Bonds (SIBs).¹⁰

In addition, the federal government should consider establishing similar tax incentives for impact investments. In February 2016, Enterprise released *An Investment in Opportunity*, a long-term platform that identifies the policy changes necessary to address America's rental housing crisis and create communities of opportunity throughout the country. The policy platform includes a recommendation to "create a new federal tax credit for private investments into CDFIs and other community development entities," which is based largely on the South Carolina Community Development Tax Credit model.¹¹

In the coming months, Enterprise and our partners in the Accelerating Impact Investing Initiative (AI3) will work with industry stakeholders and thought leaders to examine the impact and design of such a federal tax incentive program. We expect to release that proposal in spring 2017.

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10. To learn more about SIBs see: <http://www.enterprisecommunity.com/resources/ResourceDetails?ID=0101026>.
11. See more at www.InvestmentInOpportunity.org.