



# buildinghope

## Charter School Infrastructure Tax Credit Program

*CREDITS: This paper has its basis on a working paper published in the Federal Reserve Bank of San Francisco's Community Development Investment Center in the summer of 2008, "Charter School Facilities Finance: How CDFIs Created the Market, and How to Stimulate Future Growth". This paper advances on earlier efforts and reflects a different approach and is updated to reflect changes in federal laws over the last decade.*

It is all but certain that the demand for affordable charter school facility financing will continue to rise in the near future. Witness the significant increase in recent years in the number of operating charter schools, along with the heightened focus President Trump and his administration are expected to place on promoting and supporting school choice—particularly the expansion of quality charter schools. Indeed, for many charters, owning their own school facility is a key priority as it is often fundamental to their long-term viability and success, offering certainty to their location and role as community anchor along with bringing stability to their annual budget and bolstering their overall long-term financial position.

Today, the need for affordable and accessible facility financing options continues to outpace the appetite from both traditional lenders as well as the tax-exempt bond market. In anticipation of a continued rising interest rate environment, we expect this need for financing to intensify. In order to address the charter school mismatch between the demand for affordable facility financing and its availability, we highly recommend that the Administration's policy initiatives for expanding school choice include new and innovative charter school facility financing solutions. This paper recommends the creation of the Charter School Infrastructure Tax Credit Program, composed of Charter School Infrastructure Tax Credits and corresponding Charter School Infrastructure Bonds.

### **A New Tool for Expanding Charter Schools**

The Charter School Infrastructure Tax Credit Program would offer charter school investors new federal Charter School Infrastructure Tax Credits (CSITCs). For investors, these credits would be in lieu of, or in addition to, collecting interest payments on debt issued by, or on behalf of, charter schools, thus making facility financing more accessible and debt service more affordable for borrowers. This new plan would provide public incentives to leverage private investment, which would in turn allow a greater number of charter schools to access the capital they need to operate in quality facilities.

As part of this program, this paper also recommends the creation of a new class of debt called Charter School Infrastructure Bonds (CSIBs) consisting of obligations issued to take advantage of the presence of either tax credits—or at the borrower's choice—a direct federal interest payment subsidy.

Figure 1

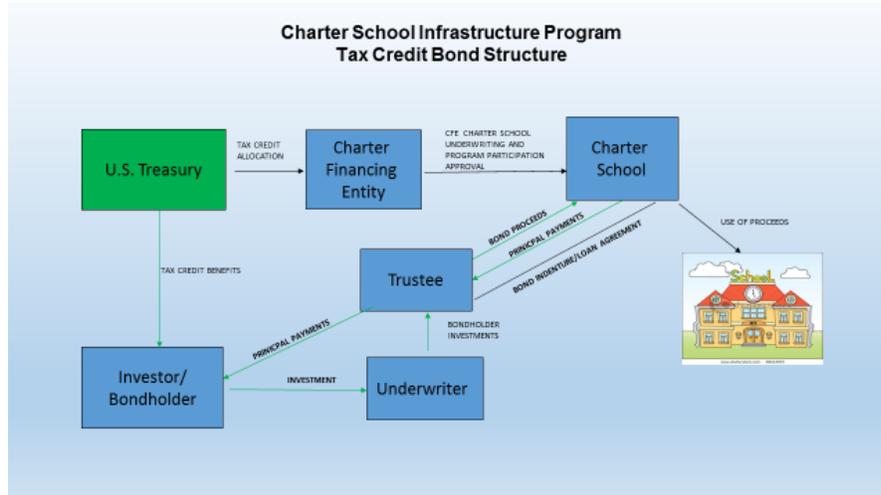
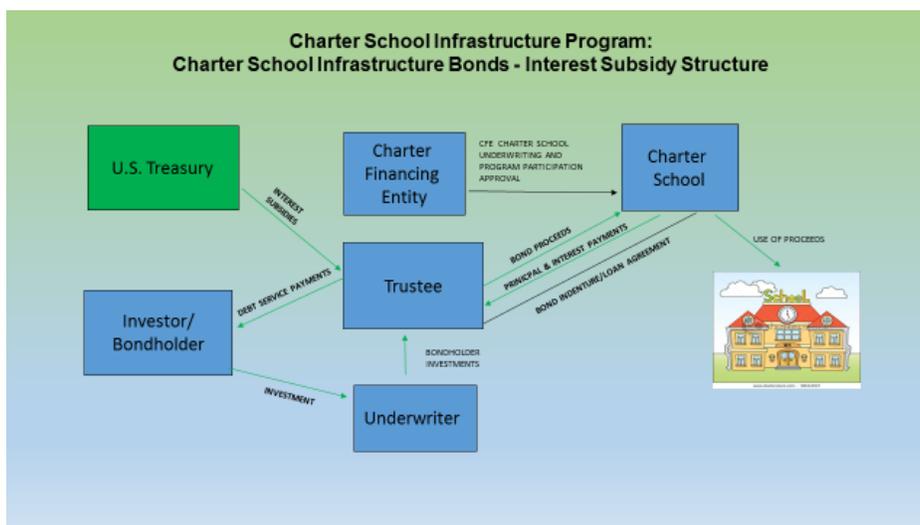


Figure 1 above shows the proposed design of the traditional tax credit option that draws from two existing federal programs. The subsidy mechanism of offering tax credits in lieu of interest is modeled after the original Qualified Zone Academy Bond (QZAB) Program. The distribution of tax credits through the Treasury Department to certified entities is borrowed from the New Markets Tax Credit (NMTC) program—a deployment channel that has proven to be highly efficient.

Alternatively, Figure 2 below shows the direct subsidy option that could be used in lieu of tax credits. This model is based on the updated structure for both Qualified Zone Academy Bonds and Qualified School Construction Bonds as authorized as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010. Rather than have investors take a tax credit against their federal income tax liability, this second option provides a U.S. Treasury direct payment or subsidy to borrowers—generally sized to allow the borrower to issue at zero interest cost. These periodic subsidies are then passed along to bondholders as part of regularly scheduled debt service payments. This direct payment model effectively eliminates or greatly reduces interest costs to borrowers, thereby lowering their overall debt costs. Borrowers would have the option to choose either the tax credit or the direct payment method based on market conditions and investor demand for the different structures.

Figure 2



Either of these options, i.e., the tax credit or the direct subsidy structure, would deliver three vital benefits:

- 1) encourages the expansion of high quality charter schools, thereby allowing the delivery of a considerably better education to many more students than is currently the case;
- 2) significantly reduces debt service for charter school borrowers, thereby permitting those dollars to be reinvested into instructional programs and enhancing education quality—including the hiring of more teachers and staff; and
- 3) infuses substantial dollars into construction and rehabilitation of school facilities, thereby creating thousands of jobs across the country. Indeed, based on the American Recovery and Reinvestment Act job creation formula, a \$1 billion investment of tax credits or direct subsidies would leverage approximately over \$2 billion of construction work resulting in almost 22,000 jobs.

Indeed, state tax credit programs have been highly successful in creating jobs and promoting investments in community projects, including the South Carolina Community Development Tax Credit Program and the California Organized Investment Network CDFI Tax Credit Program.

### **Program Structure**

Qualifying Charter School Infrastructure Bonds and Notes, or CSIBs, would be sold to investors in the capital markets in the same manner as other bonds and notes. If the tax credit option is chosen, investors would receive federal tax credits that would, in most cases, supplement the school's interest payments such that the combined total of interest payments and tax credits would equal the risk-adjusted rate of return on the debt. The tax credits would be allocated by the Treasury Department to qualified Charter Finance Entities (CFEs). The role of the CFEs would be to ensure that tax credits are only allocated to high quality transactions.

In making this determination, CFEs would be required to: 1) assess the borrower's credit quality in terms academic quality, financial position, governance, and other factors; and 2) analyze the proposed charter school bond transaction in terms of construction costs, affordability, key partners, etc.; and 3) either approve the proposed CSIBs for program participation by allocating tax credits to the transaction for use by investors, or decline to approve the transaction.

The Treasury Department would qualify CFEs based on their experience underwriting charter schools and their ability to efficiently deploy assets. CFEs would receive tax credit allocations, analyze transaction risk, structure deals, allocate tax credits to charter school transactions, and work with investment bankers to place the bonds/notes, and maintain an ongoing monitoring role. As part of their lending commitment to charter schools across the country, many Community Development Financial Institutions (CDFIs) perform this work already, and as such would be ideal CFEs.

Program implementation would require little by way of new complex mechanisms. QZABs and NMTCs are understood and accepted by investors and would provide a launching pad for CSITCs. Moreover, investors have accepted CDFIs as effective intermediaries for tax credits. With a deep understanding of the charter market and NMTCs, CDFIs are well positioned to deliver on the promise of CSITCs as a solution to the high cost of debt experienced by charter schools compared to traditional school districts.

## Leveling the Debt Affordability Playing Field for Charter Schools

A fundamental premise of the argument in favor of the creation of the Charter School Infrastructure Program is that as a matter of parity, charter schools, as public schools, should be able to access the debt market under the same, or nearly the same, conditions as school districts. Traditional district school buildings are most often financed with general obligation bonds secured by the full faith and credit of a local municipality, i.e., the school district. Because these general obligation bonds are typically backed by the district's unlimited taxing authority, they are considered low-risk investments and enjoy easy access to bond financing at low interest rates. Charter schools, in contrast, are stand-alone organizations generally without the advantages of any taxing authority.

Further, while charter school debt is perceived as significantly higher risk than school district obligations, various studies indicate the historic default rate of charter schools is low compared to other sectors. According to a comprehensive 2015 analysis published by Local Initiatives Support Corporation (LISC)—a federally designated CDFI—the historic monetary default rate for charter schools was 3.4% based on the \$10.4 billion of tax-exempt charter school bonds issued between 1998 and 2014. An updated 2017 analysis by NewOak Capital, an independent credit advisor, shows the default rate had declined to 3.2% as of December 31, 2016 due, in large part, to materially improved underwriting standards for the sector. Moreover, NewOak expects the sector's default rate to continue to improve citing the default rate figure over the past five years—the average time between issuance and default—had declined considerably to 1.3%—a figure that bodes well for the sector's future repayment performance.

### Why Existing Programs Don't Level the Playing Field

We believe CSITCs can be highly effective as well as administratively feasible. CSITCs can meet both tests, assuming a commitment is made to leveling the playing field for charter schools. The recommended incentive mechanism for CSITCs is modeled after the Qualified Zone Academy Bond (QZAB) program. QZABs were created by Congress in 1997 to address a growing need for modernization of school facilities in low-income areas. QZABs provide bondholders with federal tax credits or cash subsidy payments in lieu of cash interest payments from the school borrower. Some have called for the broader use of QZABs for charter schools as a solution to the facilities conundrum, but significant design obstacles make the existing QZAB program too fundamentally flawed to be effective for charter schools.

The first and most significant problem is the *distribution mechanism* for the tax credits. QZAB allocations are made by the Treasury Department to State Education Agencies (SEAs), which can choose to distribute the credits or sub-allocate them to Local Education Agencies (LEAs). To access QZABs, charter schools often need the cooperation of their local school districts or state education departments, but these entities may not have an interest in helping them—and inasmuch as they are often competing organizations, they may have the motivation to impede charter schools. In fact, because charter schools can operate outside the regulations that govern local school districts, it is not uncommon for charters to be treated with resistance at the local level.

Even when hostilities do not exist, QZABs get bogged down in bureaucracy and as a result have been undersubscribed. From 1998 to 2007, \$4 billion was authorized under the QZAB program, but only \$1.6 billion of bonds were issued, a cumulative deployment rate of only 40 percent. Recognizing some of the problems of the QZAB program, the Hiring Incentives to Restore Employment (HIRE) Act of 2010 was signed into law. Provisions of the HIRE Act included an option whereby the borrower may opt to issue these bonds as "direct payment bonds" in lieu of traditional tax credit bonds. Under this direct payment

bond structure, the borrower receives a direct cash subsidy from the U.S. Treasury to offset their interest payments to bondholders. Other limitations of the QZAB program still exist, however, including the prohibition from financing new construction and the threshold requirement that applicant schools enroll at least 35 percent low-income children.

	<b>New Market Tax Credits</b>	<b>Qualified Zone Academy Bonds</b>	<b>Charter School Infrastructure Tax Credits</b>
<b>Permitted Investments</b>	Wide range, e.g. housing, education, healthcare, food	All public schools - district and charter; Renovation - no new construction	Charter Schools; new construction, renovation, refinance
<b>Form of Subsidy</b>	Tax Credits to Investors	Tax Credits or Direct Subsidy Payments to Borrower	Tax Credits or Direct Subsidy Payments to Borrower via Trustee
<b>Level of Subsidy</b>	39%	100% of Treasury-determined credit rate	100% of Treasury-determined credit rate
<b>Term</b>	7 years	Varies - currently 31 years	up to 32 years
<b>Location Restrictions</b>	Must be in a Low Income Area	Must be in a Low Income Area	None
<b>Federal Administrator</b>	U.S. Treasury's CDFI Fund	U.S. Treasury	U.S. Treasury
<b>Local Administrators</b>	Community Development Entities - often CDFIs	State departments of education	CDFIs
<b>Enabling Legislation</b>	Community Renewal Tax Relief Act of 2000	Taxpayer Relief Act of 1997; ARRA; HIRE	TBD

A Charter School Infrastructure Program would provide the clean slate charters need to design a mechanism that is scalable and efficient. To address the problem of deploying CSITCs effectively, it is recommended that CSITCs mimic the distribution system of the New Markets Tax Credit (NMTC) program. The NMTC program was enacted in 2000 to create incentives for investors to provide capital to financially underserved, low-income markets. The program was the first tax credit to bypass the protocol of allocating tax credit authority to projects from the federal level through state and local government.

In programs such as QZABs and the Low Income Housing Tax Credit (LIHTC), allocations of tax credits are made to states based on population and poverty statistics. State governments then choose to allocate directly to projects or sub-allocate to local jurisdictions, which then make allocations to projects. In the NMTC program, by contrast, the Treasury Department certifies allocatees called Community Development Entities (CDEs). CDEs then allocate tax credits directly to projects. This approach has proven to be both effective and efficient.

As of February 2017, the Treasury's CDFI Fund reported that 84.8 percent of tax credit allocations made since the very first round in 2002, or \$42.8 billion of the \$50.5 billion allocated, had been converted into cash investments, including 85% of the \$3.5 billion allocated in the 2014 round, a rapid rate of deployment. It is not surprising, therefore, that CDE demand for the NMTC far exceeds its availability. According to the Treasury's CDFI Fund, CDEs requested \$319.2 billion in allocation authority between 2003 and 2016 while the CDFI Fund has awarded NMTC allocation authority totaling \$50.5 billion—demand that exceeds available allocation by more than six times.

Given the unquestionable success of the New Markets Program, a question may reasonably be asked: Why not just model a program for charter schools entirely after the New Markets Tax Credit program, or expand the existing program with special "carve-outs" for charter schools? In fact, experience shows that charter schools that have been able to access NMTCs report high degrees of satisfaction with the program.

There are three reasons, however, that such a "carve out" solution would be suboptimal: (1) advocacy groups who see themselves as the protectors of the NMTC program have worked diligently to prevent "carve-outs," fearing that once permitted, there would be an avalanche of worthy causes seeking the same treatment, (2) the NMTC program requires a complex structure to create the legal borrower and prescribes the method of the debt instrument, thereby creating significant fees for lawyers, and reducing the full financial benefit to the school, and (3) tax credits in the NMTC program are available only for seven

years, while credits in the QZAB program extend considerably longer—currently up to 31 years. The NMTC credit is a shallower subsidy, so while NMTC loan products beat out conventional financing for charter schools, they are not as favorable as the all-in subsidy of a QZAB.

### **Other Program Details**

To design the specific product features of CSITCs, a good starting place would be to follow the methodology established in the QZAB program for setting the rate and term of the product. Each business day, the Secretary of the Treasury determines and posts the credit rates and terms for QZABs based on a formula outlined in the program's regulations. As of March 31, 2017, the QZAB rate was 4.49 percent and the maximum term—which is also subject to change—was 31 years. The Treasury determines the rate based on yields on outstanding bonds with credit ratings between “A” and “BBB” for the business day prior to the sale of the tax credit bonds. The credit rate derived is intended to allow the borrower to issue the bonds without interest cost. The maximum term is calculated based on the time period the Secretary estimates will result in the borrower saving the present value of 50 percent of the par value of the bond.

For example, suppose “College Prep,” a fictitious charter school, wanted to finance the acquisition and rehabilitation of a school building that will cost \$5 million. Assume for the moment that the investor is willing to price the Charter School Infrastructure Bonds at 4.49 percent and to offer a 30 year amortization period. For the entire bond term, the investor would receive scheduled interest payments from Treasury subsidies via the bond trustee. The charter school would effectively make debt service payments to the investor as if the interest rate were zero. Annual debt service without the CSITCs credits or subsidies would be approximately \$304,000. With the federal credits or subsidies, annual debt service would be reduced by almost \$225,000, for a net annual debt service of \$80,000—composed entirely of principal amortization. Over the 30 year period, the school would save more than \$4 million in interest expense.

If the Treasury's credit rate is lower than the interest rate required by the investor to invest—as will likely be the case for most charter schools as their credit profile generally does not result in the “A” to “BBB” rated bonds used by the Treasury to set rates—then the school would have to supplement the interest rate in order for the investor to receive his or her total required rate. As the Treasury pays the lesser of the credit rate or the actual interest bond interest rate, borrowers whose credit profile are stronger than the Treasury benchmark would not be eligible for any excess payments above the actual interest rate.

If, however, the CFE uses the tax credits or direct subsidy to finance a school facility in a distressed census tract, or if the school serves more than 50 percent low-income students, the CFE would be eligible for a 10% supplemental offering of tax credits if the tax credit option is chosen or 10% supplemental subsidy if the borrower opts for the direct subsidy. The justification for granting greater subsidies to charter school borrowers located in low-income areas is similar to the justification for creating NMTCs or QZABs in the first place, i.e., in order to make these communities stronger, our public policy should promote and encourage the deployment of private investment to finance capital projects that create jobs, encourage further investment, and improve economic opportunities for area residents.

Moreover, school construction in low-income areas is just as costly as in other places, yet the risk is often higher because (a) the value of real estate in distressed communities is lower, which serves to constrain the flow of capital, and (b) student mobility in low income is higher which creates an added risk factor to schools whose finances are based on enrollment. The CSITC program should allow for the use of other credit enhancements such as the CECSF, USED CE program and state, local, and philanthropic

enhancements so that schools that are still too risky for market investors have additional tools at hand to make a transaction feasible.

Any investor with a federal tax obligation may be interested in purchasing CSIBs that offer CSITCs and any investor—even those without federal tax obligations—may want to purchase CSIBs with the direct subsidy. To issue CSIBs, a charter school would apply to a certified Charter Financing Entity (CFE), which would evaluate the risks of the transaction and help structure a bond/note to meet the needs of the school. Much like CDEs in the NMTC program, CFEs would work with investors and investment banks, to place the CSIBs appropriately and would be compensated through the proceeds of the transaction.

### **A Better Structure – the Charter School Infrastructure Tax Credit Program**

The combination of CSITCs and CSIBs present a better structure than any other financing option currently available to charter schools, including commercial loans, taxable or tax-exempt bonds, or NMTC deals. CSIBs would create access to greater pools of capital because of their incentives. In addition, the distribution system of CSIBs via investment banks and CDFIs is designed to match the needs of investors and charter schools. Today's best options to finance charter school facilities include the CDFI Bond Guarantee Program and New Markets Tax Credits. CSITCs and CSIBs will outperform both these programs as the credits/subsidies represent a longer term and the subsidy level is deeper.

The scale of the Charter School Infrastructure Program could initially match that of the QZAB program, currently sized at \$400 million per year in allocation authority. Once the concept is proven in the marketplace, the authorization for the Charter School Infrastructure Program should be determined based on a rigorous assessment of the annual demand for facility financing by charter schools.

A Charter School Infrastructure Program designed as described would require little by way of complex new mechanisms for implementation. The bond market has accepted QZABs. Both the CDFI Fund and its CDEs, many of which would qualify as CFEs, have demonstrated a capacity to allocate tax credits efficiently. Moreover, investors have accepted the role of CDFIs and CDEs as effective and efficient intermediaries. It would, in fact, be relatively easy for investors to make the leap to CSIBs which share many of the characteristics of QZABs and NMTCs. Finally, the investment in charter school facilities would help spur the economy with thousands of new jobs dispersed across the country—many of which are likely to be in high need areas.