

ROBERT A. RAPOZA ASSOCIATES

February 25, 2002

CC:ITA:RU (REG-119436-01)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C.

Dear Madam/Sir:

On behalf of the New Markets Tax Credit Coalition (Coalition), I am pleased to submit comments on the temporary regulations issued by the Internal Revenue Service on the New Markets Tax Credit (NMTC) program, under section 45D. Overall, the Coalition is satisfied with the temporary regulations and appreciates the Treasury's consideration of our previous comments. The reader will note that the vast majority of our comments simply seek clarification or elaboration on the temporary regulations. These comments have been developed by the Coalition's steering Committee and reflect the consensus position of all Coalition members.

Section 45D(c)(1)(iii)

1) This section seems to indicate that it is possible to *designate* a portion of an investment as a Qualified Equity Investment subject to 45D. For example, an investor could invest \$900,000 in 45D shares of an LLC and \$100,000 in non-45D shares of the same LLC. Tax Credits would be claimed only on the \$900,000 portion of the investment. Moreover, if the LLC described above invested \$765,000 in qualified low-income community businesses, it would meet the substantially all test under the direct tracing method ($\$765,000/\$900,000 = 85\%$).

The Coalition requests that the language be clarified throughout the regulations, especially in the substantially all section, that all calculations prescribed by the regulations pertain only to the portion of the LLC that is related to the 45D-*designated* equity.

2) A second clarification request on this section is that a loan owned by the non-45D portion of the above LLC, but that otherwise met all the qualifications of a qualified low-income community investment, could either: (a) be allocated to the 45D portion of the LLC to replace a qualified low-income community investment that paid off or (b) be reallocated to the 45D portion of the LLC to retroactively substitute for a loan which is subsequently found to be ineligible (assuming the substitute loan was continuously owned by the LLC during the same period as the ineligible loan).

Section 45D(c)(4)(i)(B)

3) This section provides that "the term qualified equity investment does not include... any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2)." Please clarify that although a CDE making an investment cannot receive tax credits in excess of its allocation for an equity investment in another CDE, an

investment in another CDE may nonetheless count as a qualified low-income community investment under 45D(d)(1)(D). For example, if an investor makes \$3 of qualified investments in a CDE (organized as a partnership or LLC) with an allocation of credits, that CDE should be able to use its allocation to designate \$2 of that investment for NMTCs. In addition, that CDE should be able to invest in a second CDE that has received its own NMTC allocation, and that second CDE should be able to designate up to \$1 of that investment for NMTCs. This second allocation of NMTCs would pass up through the first CDE to the investor. The investor would be thus able to claim NMTCs on its entire \$3 investment, benefiting from allocations to CDEs at two levels. Investors should be able to claim only one layer of NMTCs for a given qualified equity investment. The Coalition requests that this section be amended to clarify that an investment in a CDE by a CDE with an allocation is only prohibited to the extent that a qualified equity investment, as defined, is used to acquire credits.

Section 45D(c)(5)

4) The Coalition seeks more clarification on the timing of low-income community investments. For example, consider a CDE that makes an eligible low-income community investment, and subsequently draws down the NMTC dollars from their investor (a loan in a business is made on 9/30/02 and NMTC dollars drawn down on 10/31/02). We believe that those dollars should be able to be traced to the NMTC investor even though they are drawn down after the loan is made. In order to reduce recapture risk, some investors do not want their capital drawn down until they know that it can be placed in low-income community investments.

Section 45D(d)(1)(ii)

5) The Coalition appreciates that the temporary regulations provide timing flexibility on the compliance of loans purchased from other CDEs. The statute states that a qualified low-income community investment includes the purchase from another qualified CDE of any loan made by such entity that is a qualified low-income community investment. We would like Treasury to clarify that it is possible for a CDE with an allocation to buy loans from another CDE if the loans were made by the CDE on a date: (a) prior to the date on which the entity that made the loan received its designation as a CDE; and/or (b) prior to the date on which Section 45D was enacted.

Section 45D(d)(2)(i)

6) The Coalition understands that each qualified equity investment has its own credit date. However, we seek further clarification that multiple investments made by a single investor on different dates each have their own Credit date. For example, Investor A invests \$1 million in LLC X in 2002 (the 2002 Equity) and \$1 million in the same LLC X in 2003 (the 2003 Equity). We seek clarification that Investor A can receive a distribution in 2009 of all amounts relating to his or her 2002 Equity without causing a recapture event even though LLC X will be required to continue to meet the *substantially all* test on the 2003 Equity through 2010. The Coalition would like clarification that an investor that initially makes a qualified equity investment over several

years can receive a return of equity for each portion of equity invested after that portion has been invested for seven years.

7) This section provides that “amounts received by a CDE in payment... for capital, equity, or principal... must be reinvested by the CDE.” We assume the IRS does not intend to include interest payments and dividends as payment “for” capital, equity or principal. To clarify this matter, the Coalition proposes that (d)(2)(iii) (“Special rule for loans”) be amended to state that interest payments and dividends received are not considered payments “for” capital, equity, or principal for the purposes of (d)(2)(i).

Section 45D(d)(2)(iii)

8) The following comment is a particularly important issue for community development venture capital firms. We recommend that the regulations include a provision affording a cure period to CDEs that would otherwise undergo recapture in order to avoid such recapture. If a portfolio company would cause a recapture event as the result of which a CDE would go out of compliance with the substantially all requirement, the CDE would have to invest additional funds in qualified low-income community investments. In order to do so, the CDE would likely have to liquidate its holding in the non-compliant portfolio company. Because community development venture capital investments are by nature illiquid, it would likely take a significant amount of time to liquidate the non-compliant investment and then reinvest the proceeds in another portfolio company. We therefore recommend that – as with the special rule for loans in this section – CDEs be considered to be continuously invested in a qualified low-income community investment (e.g. recapture be avoided) if a non-compliant investment is liquidated and the necessary amount of proceeds there from are reinvested by the end of the calendar year following the year in which the CDE learns of non-compliance.

Section 45D(d)(3)

9) This section provides a special rule for reserves maintained for loan losses or additional investments in existing qualified low-income community investments. The Coalition appreciates the Treasury’s consideration of reserves, but feels that there are alternative forms of credit enhancement, beyond loan loss reserves. Funds expended for such credit enhancement vehicles should be counted as eligible investments. The Coalition would like clarification that dollars expended by a CDE to procure a type of credit enhancement that has the same effect as a reserve for loan losses can also be treated as a qualified low-income community investment, subject to the 5% limitation.

10) In this regard, we seek clarification as to whether and how long any such credit enhancement fees are (a) treated as invested in a qualified low-income community investment (e.g. should the cost basis of the credit enhancement expense be deemed continuously invested in the credit enhancement notwithstanding the fact that the credit enhancement may have expired) and (b) deemed to be included in the gross assets test (even though once a credit enhancement fee is paid to the credit enhancer, such funds are not assets of the CDE). The Coalition suggests that the payment of a credit enhancement fee for a reserve (e.g. letter of credit fee) should be treated as

continuously invested even if the credit enhancement expires (letter of credit with three-year term) in the same manner as an investment in worthless stock is measured by its cost basis. If the CDE receives continues investment treatment as suggested in the preceding sentence, then it would also make sense to deem the credit enhancement fee as part of the gross assets for purposes of the substantially all test.

For example, assume that Investor A makes a \$1 million investment in a CDE. The CDE invests in an \$845,000 investment and purchases a three-year letter of credit for \$10,000 that would provide \$50,000 in first loss coverage in the event that the investment defaulted. The CDE would meet the substantially all test (\$845,000 plus \$10,000 divided by \$990,000). The three-year letter of credit was sufficient credit enhancement to induce the investor to make the investment because it provided enough first loss coverage during the period when the business was reaching stabilized operation. The credit enhancement was provided at a lower use of capital for the same level of coverage (\$10,000 for the letter of credit vs. \$50,000 for a reserve account) thus allowing an \$845,000 in the business vs. an \$800,000 investment. The CDE should not be deemed to have failed the substantially all test in year four simply because the letter of credit is no longer in place.

Section 45D(d)(4)(i)(A)

11) We would like clarification that the term *any low-income community* for the qualified active low-income community business requirements in this section may include eligible census tracts in multiple communities.

12) The Coalition recommends that Treasury develop standardized reporting forms that CDEs can submit annually as part of their tax return. In addition, we recommend that Treasury develop standardized forms that CDEs can use in collecting compliance information (such as gross income, tangible assets and services provided) from the low-income community businesses in which they have investments. While CDEs will be required to certify that all information submitted is accurate and conduct their own due diligence in collecting information from businesses, having a standardized Treasury form will ease the reporting burden on CDEs and simplify reporting to Treasury. We would not seek that the form be a de facto proof of the *reasonable expectations* test, but rather that it provide some uniformity to the calculation that is expected of borrowers.

13) This section provides that 50% of a business' total gross income be "derived from the active conduct of a qualified business... within any low-income community." The Coalition is concerned that this may present a problem for CDE portfolio companies (where the CDE elects not to use 50% of either tangible property or services to meet the gross income test) that manufacture goods for sale outside low-income areas or provide services outside these areas, especially as companies grow and expand geographically over the seven-year duration of tax credit investments. Therefore, the Coalition recommends that "derived from the active conduct" be defined to mean that the activity originate in a business located in a low-income community. The Coalition also recommends that the definition of gross income include reimbursements for services – such as social services provided by nonprofit agencies.

Section 45D(d)(4)(i)(C)

14) This section measures services performed by employees as the indicator for the services portion of the qualified low-income community business test. This requirement will not allow service businesses located in low-income communities, employing low-income people, to qualify for a tax credit, if they perform a substantial amount of their services outside of the low-income area. In today's economy, with worker mobility at an all time high, the program would be best served by allowing the greatest degree of flexibility possible regarding the location of the services performed, so long as low-income people are the primary beneficiaries. As a matter of pure economics, job creation is most likely to occur in high growth areas. These areas are not likely to be low-income communities. As a policy, people living in low-income communities should be given every opportunity to participate in and benefit from economic growth. Section (d)(4)(i) C would prohibit this unless it is modified.

The Coalition recommends that this section be amended to read "at least 40 percent of the services performed for such entity by its employees are performed in a low-income community *or 40% of the employees of the qualified active low-income community business are residents of any low-income community.*"

15) It is common for some businesses, such as real estate development businesses, to take the form of a limited partnership or limited liability company with few or no employees. Instead, the general partner or the managing member operates the business on behalf of the LP or LLC. As such, it may be technically impractical or irrelevant to apply the services test to such a business. The Coalition recommends that the regulations clarify that a business in the form of a partnership or LLC with few or no employees and operated by a managing partner or managing member, respectively, will satisfy the employment services test if the managing partner or managing member satisfies the test.

Section 45D(d)(4)(iii)

16) This section addresses portions of businesses that would be eligible if they were separately incorporated. However, it is unclear what Treasury would find acceptable in this regard. For example, consider a loan by a CDE to a publicly traded company for the construction of a retail store in an eligible census tract. We believe the loan meets the qualified low-income community investment test if the borrower's operation of the single store is viewed as a separate business, but it would be helpful to have an example in this regard. Therefore, the Coalition requests an example to clarify what would be acceptable in this regard, and how Treasury will expect a CDE to document compliance.

Section 45D(d)(6)(ii)

17) This section essentially provides that failure of a low-income community business to comply with the requirements of (d)(4)(i) at any time during the seven-year investment period triggers recapture if a CDE “controls or obtains control of an entity at any time during the 7-year credit period.” Control is defined as “direct or indirect ownership (based on value) or control (based on voting or management rights) of 33 percent or more of the entity... [unless] an unrelated person possesses greater control over the entity than the CDE.”

The degree of control that a CDE has over a business should not be relevant to the determination of whether the business has ceased to be a qualified business. This provision will make NMTC investing more difficult for community development venture capital (CDVC) funds – which generally retain some voting rights in their portfolio companies – than for CDEs that invest only in the form of debt. This provision would have two alternative effects on CDVC funds, both of them negative. Either CDVC funds would be deterred from undertaking equity investments entirely, thereby undermining the intent of the NMTC legislation. Alternatively, CDVC funds making equity investments would fail to play an active role in portfolio companies. Neither result would be desirable, insofar as CDVC equity financing is greatly needed, and investor retention of voting rights is an essential way to mitigate the risk of these inherently risky investments.

Furthermore, the measurement of control at 33% is not standard with Empowerment Zones and Enterprise Communities as defined by Section 1397 of the Code, nor is it consistent with the generally applied standard definition of control. The 33% threshold – even while being the largest single stockholder – is an imperfect definition of control. For example, two members of the same family could each have 25% control. While the 33% owner would have control according to this section’s standards, the family with joint 50% control would have effective control of the corporation.

We have two further suggestions on control: First, recapture should be triggered only if the CDE has actual control at the time the CDE makes the capital or equity investment in, or loan to, the entity. Second, control should be defined as at least 80% rather than 33% and be administered only at the time of investment. Moreover, there may be a presumption of control, but the CDE should be allowed to disprove that presumption. Many CDVC funds may have 33% control over their portfolio companies, but are practically prevented from exercising this control because of the disadvantages of disrupting management. We therefore recommend that control should be defined as ownership of 80% of voting stock – a level at which a CDVC fund has true control over a portfolio company. This definition would be consistent with the definition of “control” in Section 368(c); with the requirement for inclusion in an “affiliated group” under Section 1504; and with the ownership threshold for consolidation of financial statements under Generally Accepted Accounting Principles. In any event, it is important that control be defined not as the possibility of control (through options, warrants, or certain default provisions), but actual ownership of a certain percentage of voting stock.

Regardless if the Treasury accepts our recommendation of 80%, the standard should not fall below 50%. Moreover, in such a case, it will be important to clarify the exemption for cases in which “an unrelated person possesses greater control over the entity than the CDE.” In recognition of the fact that a control group may exist, the principles of constructive ownership should apply to the word “person,” we recommend that all other related entities should be considered together for purposes of determining whether they have greater control than the CDE.

Section 45D(e)

18) If the CDFI Fund revokes the CDE certification of a entity that has received and utilized an allocation and the CDE has continuously met the substantially all requirement of paragraph (c)(1)(ii) of the section, a recapture event shall not occur if either of the following occurs:

- The original CDE requests from the CDFI Fund within 60 days of the revocation notice the reason(s) for revocation of certification and the corrective action required by the CDFI Fund to restore certification, and corrects any deficiencies within six months of receiving such information; or
- A successor CDE has been approved by the CDFI Fund and assumes the responsibilities of the de-certified CDE within 12 months of notification that CDE certification of the original CDE had been revoked.

In reviewing such requests for re-certification or successor CDE assignment, the CDFI Fund shall notify the requestor within 30 days of receipt of the request if the CDFI Fund intends to deny the request.

Section 45D(e)(5)

19) This section provides an example of recapture in which Investor A is invested entirely in Business Y and Investor B is invested entirely in Business Z. This example does not show how investors (and CDEs) are likely to diversify investments in order to reduce risk. We therefore propose the following additional example:

In 2003, A and B each acquire separate qualified equity investments in the amount of \$100,000 in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X uses \$100,000 of the combined proceeds from A and B to make a qualified low-income community investment in Y and another \$70,000 of the combined proceeds to make a qualified low-income community investment in Z. X controls both Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. In 2003, Y and Z are qualified active low-income community businesses. In 2007, Y, but not Z, is a qualified active low-income community business and X does not satisfy the substantially all requirement using the safe harbor calculation of paragraph (c)(1)(iii) of this section. Both A and B fail the substantially-all requirement using the direct-tracing calculation of paragraph (c)(5)(ii) of this section because each can only trace \$50,000 of its initial investment to a qualified low-income community investment. Therefore, under paragraph (e)(2)(ii) of this section, there is a recapture event in the amount of \$35,000 for both A and B, representing their proportional shares of Z.

Other Comments

20) Low Income Housing Tax Credits

Rental of residential housing is not a qualified low-income community business; NMTCs may not be used for the rental of housing. Further, we understand that federal depreciation rules disallow the segmentation of a building or structure and thus, NMTCs and Low-income Housing Tax Credits may not be used for the same investment since the NMTC regulations prohibit its use for residential rental property – an exception is a condominium structure, where you can bifurcate depreciation deductions and thus separate streams of tax benefits could flow to separate investors. We also interpret the regulations to say that NMTCs may be used with mixed-use developments where less than 80% of the property's gross rental income is rental income from dwelling units. The Coalition requests a clarification of exactly what is and is not allowed with the NMTC in relation to rental housing.

21) Historic Rehabilitation Tax Credits

Like any other investor, a CDE must already reduce its basis in a property by the amount of any historic rehabilitation tax credit it claims. No further limitation is needed on the use of historic rehabilitation tax credits with NMTCs. The historic rehabilitation tax credit is designed to offset the additional cost associated with meeting historic standards for rehabilitation. The NMTC is designed to address a broader financing gap for low-income community businesses.

22) Wage Tax Credits (including Work Opportunity Tax Credits, Welfare to Work Tax Credits, Empowerment Zone wage tax credits, and Renewal Communities wage tax credits)

No limitation should apply to a CDE's investment in a low-income community business that claims a wage tax credit. NMTCs and wage tax credits serve fundamentally different functions. That is, NMTCs provide capital to a business, while a wage tax credit is designed to encourage hiring of targeted employees by offsetting the additional cost of hiring, training, and turnover. The availability of NMTC financing will not obviate. Neither the CDE nor the low-income community business will typically know at the time of financing whether the low-income community business will be eligible to claim wage tax credits. There is no NMTC requirement that a business must hire targeted employees, and the number of such employees will vary from time to time.

23) Depreciation

There should be no limitation on a CDE claiming widely available depreciation benefits on investments made with the proceeds of qualified equity investment.

24) Voluntary Return or Request for Reallocation of Credits

The regulations should provide that a CDE receiving an allocation of credits may voluntarily a) turn back to the Secretary all or a portion of the credits allocated to them, without penalty, if they choose not to use the credits; or b) request that the credits be reallocated to another CDE that has an allocation of credits, provided that the CDE receiving the credits agrees to use the credits in pursuit of the business plan for which the credits were awarded. Such reallocation would be subject to approval by the Secretary.

25) Use of Census Data

The data used to define the target area in a CDE's allocation application should be consistent with the data used throughout the term of the tax credit for compliance purposes. For example, if an applicant utilizes 1990 census data for its allocation application – because it is the only data available – Treasury should continue to use 1990 census data for oversight and compliance monitoring through the Credit period.

Comments from 2001 CDFI Fund Letter

The Coalition understands that Treasury requests comments on the New Markets Tax Credit program's temporary regulations. However, the Coalition seeks to reiterate some of its comments to the CDFI Fund, which were not specifically addressed.

26) Timing of Allocation Agreements

The guidance states that a Community Development Entity (CDE) may not issue any qualified equity investments to its investors until the CDE and the Fund have executed an Allocation Agreement. According to the draft guidance, an Allocation Agreement would specify the terms and conditions of the NMTC allocation to the CDE. While we understand why such a document needs to be finalized before a CDE can enter into transactions with investors, we want some assurance that the Fund will move in a timely manner in issuing Allocation Agreements once a CDE has been notified of their allocation. Regulations will require a CDE to get 'substantially all' of its cash out in qualified low-income community investments soon after it has secured cash from investors and thus CDEs will need to develop a pipeline of qualified low-income community investments once they are notified of their allocation. Therefore, we recommend that the final regulations specify that the Fund will finalize Allocation Agreements within two months of a CDE being notified of an allocation award.

27) Bank Enterprise Award (BEA) Issue

The draft guidance would disallow a depository institution from receiving a BEA award for the provision of financial assistance to a qualified low-income community business using cash derived from NMTC investments. We recommend that this prohibition be dropped from the final regulations and that financial institutions be permitted to use the BEA program in tandem with the NMTC. Both the NMTC and the BEA program are targeted to low-income communities that

are in need of significant capital investment. Therefore, we see no reason to prohibit the programs from working together to encourage private investment in low-income community businesses.

While there is statutory language that authorizes limits on the use of the NMTC with other federal tax subsidies, there is no prohibition against using the BEA program with the Credit.

28) Evaluation

The Coalition is concerned that the draft guidelines propose an evaluation process that could be unnecessarily time consuming. While we understand the Fund has a fiduciary responsibility to underwrite NMTC allocations and insure that CDE applicants are eligible and have the capacity to carry out a proposed Comprehensive Investment Plan, we encourage the Fund to recognize the market driven nature of the NMTC program. Once a CDE is certified and secures a NMTC allocation from the Fund, it will need to market the Credit to private investors that will do their own due diligence before investing in the CDE. A CDE will need to pass the scrutiny of both the Fund and their private investors before it can actually utilize the NMTC.

The draft guidelines require that a CDE supply a Comprehensive Investment Plan that provides historical information and a minimum five-year investment strategy. Upon receiving notice of an award of an allocation, a CDE must then negotiate and finalize its NMTC Allocation Agreement with the Fund. We are concerned that the application, evaluation and final allocation processes will be onerous and could substantially delay the availability of the tax credits to spur new investment. Therefore, we suggest a streamlined application process for CDEs that have previously submitted their Comprehensive Investment Plan to the Fund for one of the other CDFI Fund program. In such cases, we also suggest that the Fund not conduct a site visit since we presume the Fund has conducted such visits in the past.

We recommend that the Fund consider having two allocation windows per year. We anticipate significant demand for NMTC allocations and having allocations made twice a year would ease the pressure on the Fund and allow greater flexibility to CDE applicants.

29) Application Scoring and Priority Points

The statute requires that the Secretary give preference to CDEs that have a track record in providing capital or technical assistance to disadvantaged businesses or communities **or** to CDEs that proposed to make qualified investments in one or more unrelated entities.

We believe the intent of the statute was to give equal treatment to these preferences and we recommend that the regulations clarify that a CDE can get preference for **either** track record or investing in unrelated businesses – not both.

In addition, we recommend that a priority be given to CDEs that commit in their application to use the NMTC to attract the predominant share of their investments from unrelated sources. This priority should also be granted to drop-down funds as long as the CDE can show that its parent

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fund received its funding from unrelated sources. Such an incentive will ensure that the Credit is used to develop new sources of investment capital for economic development. The Coalition believes that the NMTC was intended as an incentive to encourage new investment in low-income communities not as an additional subsidy for current investment efforts. Therefore, we encourage the Fund to provide an allocation to entities that make this commitment before they make allocations to entities that will be drawing investments from related sources.

30) Limits on Annual Allocations

The Coalition urges the Fund to ensure that there is both geographic diversity in how NMTC allocations are distributed as well as diversity in the types of organizations and projects that will benefit from the Credit. We suggest that allocations be distributed amongst small local and mid-sized regional CDEs as well as larger regional and national entities. In addition, we encourage the distribution of Credit allocations amongst debt funds, venture funds, mixed use funds and single purpose funds.

We believe there should be limits to the amount of a NMTC allocation that may be awarded to any single applicant in a calendar year in order to ensure that the expected benefits of the NMTC program are extended throughout the country to a variety of low-income communities. We recommend that no single applicant be awarded an NMTC allocation in excess of 10% of the amount of the allocation available in that year.

Thank you for your attention to this matter.

Sincerely,

Robert A. Rapoza

Encl: NMTCC Steering Committee List