

# ROBERT A. RAPOZA ASSOCIATES

Submitted to: Treasury Department  
Public Hearing on the New Markets Tax Credit  
Submitted by: Robert Rapoza, for New Markets Tax Credit Coalition  
March 14, 2002

## **I. Introduction**

Good morning. My name is Robert Rapoza and I am President of Rapoza Associates, a public interest consulting firm in Washington, DC. For the past three years my firm has represented the New Markets Tax Credit Coalition and I am here today to give testimony on behalf of the Coalition.

I would like to start by thanking the IRS and CDFI Fund for organizing this public hearing on the New Markets Tax Credit and the temporary regulations issued on December 26, 2001. It's an exciting new program for community revitalization and we appreciate the opportunity to give our views and suggestions on the program.

The New Markets Tax Credit Coalition is a nationwide association of local, regional, and national organizations promoting and practicing economic development in economically disadvantaged urban and rural communities. A copy of our membership list was included with our written comments and I would be happy to provide you with a copy today.

Many Coalition members have submitted testimony individually; my remarks represent the consensus positions of all Coalition members. Our written comments were submitted on February 25, 2002. I would like to start by saying that overall, the Coalition was very pleased with how Treasury handled many issues with the temporary regulations. We feel that the Treasury was very thoughtful in resolving many of the open issues and we appreciate its considerations of our earlier comments. Many of our written comments simply request more definition and clarity and I will not discuss those today. Instead, I will focus on two substantive issues that are of great concern to Coalition members. I would then like to discuss four brief points that are not specific to the temporary regulations, but are important elements to the program overall.

## **II. IRS Comments**

The first issue relates to Section 45D(d)(4)(i)(C) and the definition of services performed by qualified active low-income community businesses. 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.

I would like to illustrate this with an example. An entrepreneur establishes a cleaning service business. Her business storefront is located in a low-income community so she meets the tangible property test. She employs most of her employees from the low-income community where she is located, and thus most of the economic benefit remains within the low-income community. However, her employees provide their cleaning service in downtown office buildings located in census tracts that do not qualify.

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As a matter of pure economics, job creation is most likely to occur in high growth areas, which may or may not 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.*”

Second, the Coalition would like to comment on the definition of control and how it relates to the reasonable expectation test, which is covered in Section 45D(d)(6).

In general, the reasonable expectation test states that a business qualifies if a CDE reasonably expects that the business will meet the requirements of a qualified active low-income community business for the term of the qualified investment. However, this provision does not apply to CDEs that control the business.

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 of 33 percent or more of the entity... [unless] an unrelated person possesses greater control over the entity than the CDE.”

The 33% threshold – 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.

A 33% control threshold would make NMTC investing more difficult for community development venture capital funds – which generally retain some voting rights in their portfolio - and would have two alternative effects on such funds operating as CDEs, both of them negative. Either these CDEs would be deterred from undertaking equity investments entirely, thereby undermining the intent of the NMTC legislation. Or, alternatively, CDEs making equity investments would fail to play an active role in portfolio companies. Neither result would be desirable, insofar as CDE 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 the standard used with businesses utilizing the empowerment zone tax credit as defined by Section 1397 of the Code, which sets the standard of control at 50%. Nor is it consistent with other definitions of control in the Code which set the threshold at ownership of 80% of voting stock - in Section 386(c), Section 1504, and Section 1563.

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We recommend that the control standard be set at 80% of voting stock – a level at which a CDE has true control over a portfolio company. Practically speaking, CDEs funds may have 33% control over a portfolio company, but be prevented from exercising this control because of the disadvantages of disrupting management and putting the business at risk. Again, setting the control threshold at 80% would be consistent with other definitions of control in the Code and with the ownership threshold used for consolidation of financial statements under Generally Accepted Accounting Principles.

While we hope that Treasury accepts our recommendation of 80%, we strongly urge you to ensure that the standard not fall below 50%.

### III. Other Comments

I would now like to raise four brief, but important, issues on the New Markets Tax Credit program that do not relate directly to the IRS temporary regulations.

The first issue has to do with the use of census data for the application and subsequent compliance monitoring of a successful applicant. 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.

My second comment has to do with 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.

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, especially for those that have previously submitted their Comprehensive Investment Plan to the Fund for one of the other CDFI Fund program.

My third comment deals with temporary noncompliance and the cure period remedy. Temporary noncompliance should not result in automatic de-certification or recapture. We recommend that a CDE be granted a reasonable period of time to move a low-income community investment back into compliance once it has been deemed to be out of compliance. This would be similar to low-income housing tax credit rules permitting a reasonable cure period for noncompliance. The Coalition suggests that Treasury provide a 12-month cure period for CDEs to bring their portfolio back in compliance.

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Lastly, how will Treasury ask a CDE to verify and document that a target area meets the eligibility requirements? The target area option for identifying eligible areas is an important option, particularly for rural areas with dispersed pockets of poverty. However, we have received many phone calls from potential applicants across the country that want to better understand the process for identifying a target area and ensuring that it is approved by Treasury. We request that Treasury provide more guidance on the process of identifying target areas and ensuring they meet Treasury's criteria.

Ensuring that the New Markets Tax Credit program runs effectively and successfully is an important goal for our nation, now more than ever. This is a unique opportunity to ensure that no neighborhood in America is left behind and that we're all able to prosper from a stronger, more diverse economy. I thank you for allowing me to speak here today, and I look forward to working with you in the future to help ensure that happens.