

CRF
Community Reinvestment Fund, USA
801 Nicollet Mall, Suite 1700 West
Minneapolis, Minnesota 55402

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Eric Solomon
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220-0002

Dear Eric:

I am writing to offer some perspective and a proposal on the issue of "redemption" of qualified equity investments under Section 45D of the Code.

In August of this year, Community Reinvestment Fund, Inc. and its affiliate allocatee, National New Markets Tax Credit Fund, Inc., successfully funded a community development entity ("CDE") with funds raised by an investment partnership through a combination of (a) a sale of limited partnership units and (b) a loan provided by a syndicate of national banks and other lenders, thereby creating a so-called "leveraged" NMTC fund.

As you know, uncertainty in connection with the raising of capital, particularly while implementing a new IRC credit such as the NMTC, results in time and expense for all parties and frustrates the ultimate objective of delivering efficient capital to low-income communities. During the process of forming this leveraged NMTC fund, the issue of redemption of qualified equity investments ("QEI") was a recurring theme, particularly because of the absence of IRS guidelines and the difference of opinions of various law firms and investors as to what constitutes a "redemption." The complication and time devoted to this issue significantly increased the expenses for our initial tax credit fund transaction, caused the transaction to be sidetracked at least once for a significant period of time and slowed down the ultimate successful conclusion of the transaction.

I am therefore hopeful that you will consider the comments submitted by the New Markets Tax Credit Coalition in its letter of November 12, 2004 (the "Coalition Letter") and the other letters you will likely receive on this issue. I'm also hopeful that you will consider the issues and the proposed solution set forth below.

As you know, Section 45D(g)(3)(C) of the Code and Reg. Sec. 1.45D-IT(e)(2) provide that the new markets tax credits (the "NMTCs") taken by a holder of QEI in a CDE are subject to recapture in the event that an equity investor's interest is "redeemed". For these purposes, Section 45D(b)(5) states that a rule similar to the rule of Section 1202(c)(3) shall apply. Under this rule, distributions made to a C Corporation stockholder would generally not be considered a redemption unless and until such distributions were in excess of the sum of accumulated earnings

and profits and the stock's basis. There is no further explanation of the term redemption for purposes of the new markets tax credits in the Code or legislative history and, in particular, the redemption rules for a C corporation are not easily or logically applicable for a partnership CDE. The term "redemption" is not defined or even used in Subchapter K (except once in Code § 743(e)(6)), and is used only three times in Treasury Regulations promulgated under Subchapter K, twice in examples and once when cross-referencing to Treasury Regulation § 1.302-5(d)(6)(i).

Because of the absence of guidance on what constitutes a "redemption", we found that lenders and investors have insisted upon:

- (1) A conservative interpretation that limits distribution of cash from a partnership CDE to "taxable income" - notwithstanding the fact that the original QEI proceeds are invested in QLICI loans at or significantly above the "substantially all" threshold for the entire seven-year compliance period; and
- (2) A complicated arrangement which includes a definition of a potential "change in law" and "springing" provisions within partnership agreements and loan agreements to address the potential clarification of the "redemption rule" during the life of a transaction.

Each of these issues is discussed below.

Taxable Income Limitation

The technical problem revolves around determining when a redemption occurs by virtue of cash distributions from the CDE to the holder of the qualified equity investment ("QEI"). The technical aspects of this problem were described in great detail in a letter addressed to Mr. Paul Handleman from Novogradac & Company LLP and Nixon Peabody LLP, dated June 30, 2004. In that letter, the distinction was characterized as the difference between (a) return of capital (i.e. a redemption) and (b) distribution of profits (i.e. no redemption). We understand that most often, the problem is being addressed by an attempt to define what constituted "taxable income" at the CDE level and the imposition of a conservative limitation on distribution of cash from the CDE to the holder of the QEI.²

The "taxable income" limitation is not the appropriate method to distinguish between a redemption and a distribution of profits. In a typical leveraged NMTC Fund, the only sources of cash to a CDE, other than QEIs, are interest from QLICIs and payments of principal. Payments of principal generally must be reinvested to comply with the substantially all test. Accordingly, the net sources of cash to a CDE are profits, i.e., the interest payments on QLICIs. However, a CDE's taxable income will rarely equal the amount of interest received on QLICIs. The amortization of start-up costs over 180 months, an issue faced by every CDE, reduces taxable income to less than interest received on QLICIs.

The net result of the "taxable income" limitation on cash distributions by a partnership CDE is a "trapping" of cash at a CDE notwithstanding continued compliance with the substantially all test.

Most of this "trapped cash" results from amortized organization costs, as described above and in the Coalition Letter, accrual or payment of management fees by the CDE and modest principal amortization on QLICIs (25 year amortization).

We have included with this letter two hypothetical economic models, the first (Tab A) imposes a constraint on CDE cash distributions premised upon the "taxable income" interpretation and the second model (Tab B) assumes a CDE may distribute all cash generated by QLICI investments so long as the CDE maintains continuous compliance with the substantially all test. These models demonstrate the following:

1. The taxable income limitation model (Tab A) effectively precludes the investment partnership from making any principal repayment of its loan, thereby requiring a seven-year loan to the NMTC investment partnership on which only modest principal payments can be made. This increases the interest expense for the investment partnership, discourages many lenders from participating in the transactions, traps cash at the CDE level (which cannot pledge the cash to the partnership's lender under Revenue Ruling 2003-20) and results in a tighter credit agreement which discourages innovative or efficient delivery of capital to qualified active low-income community businesses.

2. The other model (Tab B), which allows distribution of substantially all of the CDE cash, permits the investment partnership to repay almost 20% of its loan over the seven-year tax compliance period (reference the "Principal on IP Loan" line on page 1 of both models), thereby decreasing interest expenses, making loans to an investment partnership more attractive to lenders and allowing more efficient use of capital.³

3. There is no material difference at the CDE level in terms of the amount of QEI proceeds in QLICIs during the seven-year compliance period in Tab A or Tab B - both models assume an initial "96%" substantially all threshold and slowly decreasing to 86% in the 6th year.

4. As demonstrated by the Tab B model, the ability to distribute cash flow (i.e. unrestricted by the "taxable income limitation"), results in a reduction of 19 basis points in the QLICI loan rate (representing a reduction of interest cost for qualified low-income community businesses of approximately \$1,250,000 over seven years - see the "Interest Income from Loans" line in each model). Further, the Management Fees of the sponsor of the NMTCs are not significantly deferred as they are in the Tab A model (reference "Cumulative Deferred Management Fee line of Tab A, \$654,273 of Management Fees are deferred in years 4 through 7 vs. \$1,400 deferred in the Tab B model). To demonstrate this reduction in interest cost and the deferral of management fees, you will note that we have kept the yield to NMTC investors the same in each model (reference page 3 of both models).

Change In Law

In addition to the unfavorable economic factors listed above, and the increased time and expense encountered in efforts devoted to constructing "solutions" to the absence of guidance on the

redemption issue, the NMTC documentation has become more complex than necessary. In our experience, lenders to an investment partnership investing in a CDE will insist upon "springing" provisions which provide that once there is guidance on the meaning of the term "redemption," i.e., a change in law, any cash retained at the CDE and not required to be invested in a QLICI to satisfy the "substantially all" test shall be distributed to the investment partnership upon clarification of the redemption rules by the IRS. In other words, no additional cash will be allowed to be devoted to QLICIs at the CDE level, the documentation is more complicated, and the ultimate objective of providing efficient capital to low-income communities is frustrated. Further, as noted above and demonstrated in Tab A, the trapping of cash at the CDE level significantly complicates the current payment of management fees.

By increasing the legal expense, expanding the period of time to form and close the fund, and by preventing cash from being distributed from the CDE to the QEI holder, the efficiency and attractiveness of the new markets tax credit investment is significantly reduced, thereby negatively impacting the ultimate social purpose for which the new markets tax credit was originally enacted.

Proposed Safe Harbor

I would propose to you that a safe harbor can be fashioned for the vast majority of straight-forward leveraged new markets tax credit funds. That safe harbor would provide that:

If:

(a) substantially all of the QEI proceeds (in excess of 85% or more) are invested in QLICIs which constitute loans with a maturity of seven or more years; and

(b) notwithstanding any amortization of principal, substantially all of the QEI proceeds continue to comply with the substantially all rule through the seventh year of the tax credit compliance period; and

(c) if unexpected QLICI repayments are received by the CDE, such repayments are required to be similarly invested;

Then:

the CDE should be allowed to distribute all income as cash distributions (made pro rata according to the economic interests in the CDE) without having such distributions constitute a redemption of the QEI.

An illustration of such distributions is shown as "Total CDE Income" on page 2 of the Tab B example. Such a safe harbor would be entirely consistent with the text of Section 45D of the Code (including the provisions of Section 1202(c)(3) as they relate to corporations) and all of the legislative history relating to new markets tax credits and creates a very simple line of

demarcation between return of capital and distributions of profits. Such an interpretation would also be entirely consistent with the absence of any legislative suggestion to the effect that a redemption may occur notwithstanding the fact that substantially all of the original QEI proceeds are invested in QLICIs.

I appreciate the opportunity to submit these comments to you and appreciate your willingness to consider this request. I would be happy to discuss this issue with you further at your convenience.

COMMUNITY REINVESTMENT FUND, INC.
and
NATIONAL NEW MARKETS TAX CREDIT FUND, INC.

By:

Frank Altman
President

cc:

Paul Handleman
Mary Tingerthal
Bruce A. Bonjour
Bruce Sorensen
Mike Novogradac
Herb Stevens