

New Markets Tax Credit Coalition (NMTCC)
1250 Eye Street NW, Suite 902
Washington DC 20005

November 12, 2004

Eric Solomon, Deputy Assistant Secretary
Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW \\
Washington, DC

Dear Eric:

We appreciate you and your colleagues taking the time to meet with the New Markets Tax Credit Coalition's Board of Directors last month. I am writing to follow up on the discussion we had regarding the need to clarify how a CDL can pass on cash distributions to its investors without concern as to whether or not the IRS will consider such distribution to be redemption of principal.

As we discussed, this problem arises in cases where a CDE's cash flow exceeds its taxable income, for example due to the fact that the CDL has costs that are amortized or depreciated. If CDE's cash distributions in excess of a CDE's taxable income are treated as redemption of principal then there may be a recapture of credits under Section 45D(g) due to a failure to meet the "substantially all" test or because the qualified equity investment may be considered to be redeemed by the CDL. This would prohibit CDEs from passing cash flow "earnings" through to investors, which would substantially hamper the economic feasibility of many CDE transactions.

The Coalition recommends that the IRS provide additional guidance on this issue and define "redeemed" for purposes of Section 45D(g)(3)(C) as well as clarify what constitutes a repayment of principal or equity of a qualified low-income community investment ("QLICI") so as not to violate the "substantially all" test.

CDEs may be corporations or partnerships. The issue of cash flow exceeding taxable income is primarily a concern affecting partnerships. Currently, many Allocatees are being advised to take a conservative approach to redemption which would allow a return on capital to investors only in cases where the distribution is equal to or less than the net taxable income of the CDE. This affects partnership CDEs, since the partnership structure is designed so that cash "earnings" from their investments in lower tier entities (i.e. QLICBs) are up summed to investors, regardless of the overall net taxable income at the partnership level. Restricting this ability to distribute cash earnings clearly discourages investment.

This issue not only presents further concerns in transactions where CDEs are making "equity investments" in QLICBs, but severely hinders and discourages investors from making such investments under the NMTC program. Most investments into businesses will generate taxable income <loss> pass throughs to its investors less than the cash earnings of such business, solely

as a result of depreciation deductions (e.g. company's with equipment that receive accelerated bonus depreciation plus 3-7 year depreciable lives on these assets is a clear example). These cash earnings and the ability to distribute the cash are the only reason to make such an investment. The position that a cash distribution in excess of taxable income is a redemption is clearly not the intent of the NMTC program. To the contrary the program was designed to attract tough to find capital for equity investments into qualified businesses.

Several of our Board members wanted to provide suggestions as to how the IRS might define "redeemed" and distinguish between a distribution of profits (cash earnings) and a repayment of principal or equity when evaluating a CDE's cash flow.

Since a CDE can be either a corporation or a partnership, the redemption of an equity investment by a corporate CDE should be governed by Sections 301 and 302. Amounts treated as an ordinary dividend under Section 301(c)(1) should not be considered amounts received in redemption of an equity investment in a corporate CDE since these distributions are out of corporate earnings. To the extent some portion of the distribution is treated as a return of basis under Section 301(c)(2), or is treated as a redemption under Section 302, then that portion should be treated as an amount "redeemed" for purposes of Section 45D(g)(3)(C).

As it relates to partnerships, we suggest that a tracing of the source of funds for the distribution be used. For example, assume a CDE partnership makes a \$1 million loan to a qualified active low-income community business ("QALICB") at a 5% interest rate, the CDE receives \$50,000 of interest income, has \$5,000 of amortization expense at the CDE level (resulting from up-front organization fees paid out of the initial QEI), has taxable net income of \$45,000 and distributes \$50,000 of cash to its partners. Since the source of the distributed funds arises solely from the interest income, an amount of cash distributions equal to the interest income, in this case \$50,000 should clearly be deemed a cash distribution from operating income and not a return of the partners' equity investment in the CDE.

It seems this approach can be supported through the existing 1.4513-1T regulation. Under 1.45D-1T(d)(2)(iii) periodic principal payments are treated as continuously invested in a QLICI if the amounts are reinvested in another QLICI by the end of the following calendar year. If this condition is met, the "substantially all" test should also be met. A payment of interest on a loan that is treated as a QLICI is not a payment of principal and should not create an issue with respect to the "substantially all" test since it does not impact the basis of the assets taken into consideration for the purpose of testing "substantially all". It seems to follow logically that a distribution of this cash from the CDE to its partners arising from the interest income, even though the cash exceeds the taxable net income in our example above due to the amortization expense, should not constitute a redemption of the equity investment in the CDE.

As it relates to CDEs treated as partnerships which make QLICIs by making capital or equity investments in QALICBs, we suggest that Treasury consider looking to the partnership agreement, in the case of a QALICB partnership, or to Sections 301 and 302, as previously discussed, with respect to corporate QALICBs. In the case of a QALICB treated as a partnership, we suggest that Treasury provide a safe harbor that stipulates that (i) cash flow from operations is deemed to be a return 'on' capital; and (ii) if the partnership agreement does not provide for a

return of partner capital through cash flow from operations, then the cash distributions are deemed to arise from current operations and not a return of capital. This concept of tracing the source of funds is similar to the interest tracing rules found under Regulation 1.163-8T and Notice 89-35. However, cash distributions funded by debt proceeds or the sale of partnership assets would be deemed to be a return of QLICI.

We appreciate the fact that the December deadline for finalizing the regulations is quickly approaching and I hope these additional comments on redemption are helpful. Please feel free to call me or Alison if you have any questions or need clarification on the comments put forward in this letter.

Sincerely,

Robert A. Rapoza