

New Markets Tax Credit Coalition (NMTCC)
1250 Eye Street NW, Suite 902
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Eric Solomon
Deputy Assistant Secretary for Regulatory Affairs
Office of Tax Policy
Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Eric:

I would like to thank you on behalf of the New Markets Tax Credit Coalition for all the work that you and your colleagues are doing to clarify technical issues related to the New Markets Tax Credit.

While we have discussed a number of critical issues with you in the past several months, this letter is focused on the items that we believe need to be addressed as soon as possible and hopefully before the August 29th deadline for first round allocation applications. Issues 1- 4 are the highest priority for the Coalition. The other issues, while important do not rise to that level.

Issue 1: Definition of Control

Of particular concern to CDEs that plan to make equity investments with NMTC capital is the definition of control in the temporary regulation (Section 45D(d)(6)(ii)). Failure of a business to comply with the requirements of a Qualified Low-Income Community Business at any time during the seven-year investment period triggers recapture. The temporary rule states that a CDE investing in an unrelated business can avoid recapture if it demonstrates that at the time the investment was made, there was a reasonable expectation that the business would remain in compliance for the term of the investment or loan. However, if a CDE controls the business in which it invests, and that business falls out of compliance, recapture is immediate. The temporary regulations define 'control' as "direct or indirect ownership or control of 33 percent or more of the entity... [unless] an unrelated person possesses greater control over the entity than the CDE. "This 33% threshold is far too low and will prevent Community Development Venture Capital Funds that form CDEs from using the credit since their investors would not be protected by the reasonable expectation provision. ' 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. Establishing an 80% control threshold is consistent with other definitions of control in the IRS Code and with the ownership threshold used for consolidation of financial statements under Generally Accepted Accounting Principles.

Issue 2. Terms and Conditions for Recapture Prevention

The Coalition seeks clarification as to the terms and conditions under which a CDE may be granted a waiver or a cure period to remedy a Qualified Low-Income Community Investment that falls out of compliance (Section 45D(g)(2)B). The Low Income Housing Tax Credit allows one year to correct noncompliance and we recommend that the same one-year cure period be granted to CDEs that fall out of compliance.

Issue 3. Allowable Activities for Lower Tier CDEs

CDEs can use Qualified Equity Investments to invest in or lend to Qualified Low-Income Community Businesses, invest in or lend to CDEs, purchase loans from CDEs, or provide financial counseling and other services to Qualified Low-Income Community Businesses. The statute is silent on what a lower tier CDE can do with funds it receives via an investment or loan from an upper tier CDE. However the temporary regulations restrict the activities of a lower tier CDE to investing in or lending to Qualified Low-Income Community Businesses or providing financial counseling and other services to such businesses (Section 45D(d)(1)(iv) A). Under the temporary regulation lower tier CDEs cannot purchase loans from CDEs or invest in or lend to CDEs.

We do not see that any policy objective is achieved by limiting the activity of lower tier CDEs. It does however limit the use of NMTC dollars for activities that are critical to Coalition members. For example, the National Community Investments Fund (NCIF), which plans to apply for and allocation of credits and operate as a tier ICDE, has reasons relating to bank regulatory requirements for wanting to be able to lend to bank holding company CDEs (tier 2 CDEs) and have them be able to downstream loan proceeds to their bank subsidiary CDEs (tier 3 CDEs). This activity is not allowed under the current temporary regulation.

We feel strongly that lower tier CDEs be able to make loans to or investments in other CDEs and be able to purchase loans from CDEs, which is a significant recapture management technique.

The substantially all requirement is unchanged and at least 85% of the investment has to reach the street within 12 months no matter how many CDEs a Qualified Low-income Community Investment flows through.

Issue 4: Leverage

The Coalition seeks clarification that an Investment LLC may make Qualified Equity Investments in a CDE. In most cases, the Investment LLC will take both equity investments as well as debt. These funds (equity and debt) will be used to make Qualified Equity Investments. The Investment LLC would pledge its stock or capital interest in the CDE to its lender(s) as collateral for the loan(s). The CDE would allocate NMTCs and distribute dividends and, at the end of the Credit period, capital, to the Investment LLC. The Investment LLC would allocate NMTCs and, after repaying its lender(s), available cash among its owners based on their capital interests, with no special allocations.

It is common business practice for equity investors in partnerships and LLCs to use the financial strength of their equity investments to arrange for borrowed money as part of the dollars used to pursue the business activity of the partnership. Similarly, an individual taxpayer could use a home equity line of credit to make Qualified Equity Investments. Or member banks may secure an advance from the Federal Home Loan Bank in the form of debt and use the funds to invest equity in a business, or for that matter, a Qualified Equity Investment. Further, corporate investors in NMTCs could raise their investment funds from a variety of sources - including debt. We believe that to disallow partial debt financing in an Investment LLC would create an unlevel playing field at variance with both common business practice and tax policy.

Allowing an Investment LLC to make qualified equity investments will bring into the market an entire class of non-profit, tax-exempt investors, including pension funds that are not eligible to receive credits but could make loans to an Investment LLC and contribute to the objectives of the NMTC.

This clarification would not undermine the purpose of the NMTC. Private sector capital in the form of equity investments will still flow to low-income communities. On the ground, at the community level, the Investment LLC's Qualified Equity Investment will look exactly like other investments from other investors.

As with other investors, an Investment LLC will make Qualified Equity Investments in the form of cash to certified Community Development Entities (CDEs). CDEs will be required to use Substantially All of the Qualified Equity Investments to provide loans, investments or financial counseling to qualified businesses in low income communities. CDEs will still be held accountable to meet the all requirements of law and regulations.

Because this is a common practice, we urge Treasury to clarify that an Investment LLC can be established for the purpose of making Qualified Equity Investments in CDEs. It is currently unclear whether the use of such an Investment LLCs would be allowable under the NMTC program. Coalition members are unaware of anything in the temporary regulations that disallows this practice and several tax attorneys have indicated that the Investment LLC structure falls within the provisions of the regulations and the law. Members of the Coalitions strongly support the practice and would appreciate clarification.

Issue 5: Multiple Loan Sales

Related to the issue of allowable activities for lower tier CDEs, the Coalition seeks clarification on whether the purchase of loans is limited to a single purchase transaction, or whether a chain of purchase transactions among several CDEs is allowed. The Coalition believes that such a chain of purchase transactions is clearly within the legislative intent and reflects the reality of practices used within established capital markets. We do not see any opportunity for abuse, as long as each entity in the chain of transactions is a CDE and Qualified Equity Investments are deployed for Qualified Low Income Community Investments.

Issue 6: Warehouse Line of Credit

Throughout the consumer and commercial mortgage lending industry, lenders utilize warehouse lines of credit to make and hold pools of loans that they assemble for securitization or sale to secondary market purchasers. The use of a warehouse line makes the process more efficient for both the originator of the loans and the secondary market purchaser because it dramatically reduces the number of transactions that must take place between the parties. This device is increasingly used in the Low Income Housing Tax Credit industry to assemble pools of projects prior to seeking investor capital pay-ins.

Because the use of warehouse lines is so common in the pooling of real estate assets, the Community Reinvestments Fund (CRF) and other CDEs have assumed that it would be possible to use a warehouse line of credit to assemble loans in advance of calling for pay-ins of capital by qualified equity investors. The Qualified Equity Investment would be used as the permanent source of funding for the Qualified Low income Community Investment. Since the investor cannot claim tax credits until the equity investment is actually made in the CDF, the use of a warehouse line actually results in a later triggering of the credits, which is, presumably, a more conservative use of the credits.

We appreciate your consideration of these six issues and would be happy to discuss them with you further if you have questions.

Sincerely,

Robert A Rapoza

cc: Paul Handleman, Tax Law Specialist, Internal Revenue Service

Stephen Watson, Attorney-Advisor, Office of Tax Legislative Counsel

Tony Brown, Administrator, Community Development Financial Institutions Fund

Linda Davenport, Financial Equity Manager, Community Development Financial Institutions Fund