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ATTORNEYS AT LAW

June 30, 2004

Mr. Paul Handleman
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2004-26)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: New Markets Tax Credit Temporary Regulations

Dear Paul:

This letter is to request guidance from the Internal Revenue Service regarding an issue that is important in transactions involving the new markets tax credit under Section 45D of the Internal Revenue Code of 1986 (the "Code"). This issue is the extent to which cash distributions can be made from a Community Development Entity ("CDE") to its equity members without such distributions being treated as a redemption under Section 45D.

Section 45D(g)(3)(C) of the Code and Reg. Sec. 1.45D-1T(e)(2) provide that the new markets tax credits (the "Credits") which an equity investor in a CDE has taken are subject to recapture in the event that an equity investor's interest is redeemed. Section 45D(b)(5), under the heading "Redemptions", states that a rule similar to the rule of Section 1202(c)(3) shall apply.¹ Under this rule, distributions made to a C Corporation stockholder would generally not

¹ Note that Section 45D(b)(5) applies for purposes of subsection 45D(b). Presumably it was also intended to apply for purposes of subsection 45D(g). Section 1202(c)(3) states:

"(3) Certain purchases by corporation of its own stock

(A) Redemptions from taxpayer or related person

Stock acquired by the taxpayer shall not be treated as qualified small business stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(B) Significant redemptions

Stock issued by a corporation shall not be treated as qualified business stock if, during the 2-year period beginning on the date 1 year before the issuance of such stock, such corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of such 2-year period.

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.

Redemptions, dividends and distributions

If a CDE is a C corporation, the term redemption is defined as the corporation acquiring stock from its shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock. Sec. 317(b). A redemption of corporate stock can be treated as a sale or exchange, a dividend or a return of basis depending upon several factors such as how much stock is redeemed and the voting power of the stock redeemed. Secs. 301 and 302. Accordingly, the term "redemption" in the C corporation context has a mechanical definition that does not by itself determine the tax treatment of the transaction.

The term "redemption" is not commonly used in partnerships and limited liability companies which are treated as partnerships for federal income tax purposes (Section 317(b) being limited by its terms to Part I of Subchapter C). In a partnership the income or loss of the partnership is allocated directly to its partners and included by the partner on its tax return. Cash distributions to partners are not themselves taxed unless a partner receives a distribution in excess of his tax basis or the distributions are more properly characterized as something else (e.g., a disguised sale).

The issue is whether the drafters of Section 45D(g)(3)(C) when using the term "redeemed" meant any return of capital, as opposed to a distribution of profits, or an actual purchase of an ownership interest by the CDE in exchange for property. The reference to Section 1202(c)(3) would seem to indicate that the latter is the correct interpretation since Section 1202(c)(3) addresses actual or deemed purchases of stock and not mere returns of capital. Moreover, Section 45D(g)(3)(B) provides that violation of the substantially all test is also a recapture event. Because a large return of capital, as opposed to a distribution of profits, could not be made without violating the substantially all rule, one logical interpretation is that Section 45D(g)(3)(C) refers to actual purchases of ownership interests by the CDE.

However, if Section 45D(g)(3)(C) is interpreted to mean that any return of capital, as opposed to a distribution of profits, is a redemption, then the issue becomes how to distinguish

(C) Treatment of certain transactions

If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of subparagraphs (A) and (B), such corporation shall be treated as purchasing an amount of its stock equal to the amount treated as such a distribution under section 304(a)."

between a return of capital and a distribution of profits. If profits are defined by the CDE's taxable income, this will raise problems because many CDE's will have net cash flow in excess of their taxable income because of the amortization of start-up costs over 60 months. Moreover, even in a C corporation context, the calculation of earnings and profits pursuant to Section 312 only starts with taxable income and makes several adjustments from there. Accordingly, using taxable income as the amount to determine between a distribution of profits and a return of capital is not consistent with how such determinations are made for other purposes of the Code.

Community Development Entities

Under the new markets tax credit program a CDE uses the equity invested by its members to make loans or investments in qualifying activities. These activities may be qualified businesses, the purchase of loans from other CDEs, loans or investments in other CDEs, or financial counseling and technical assistance. In any of the first three categories of qualifying use, the loans or investments by the CDE will earn income and, sometime after the 7 year recapture period, be repaid to the CDE. Although there is no provision prohibiting a CDE's loans or investments from amortizing, any return of principal on the loans or investments made by a CDE will have to be reinvested in another qualifying investment during the 7 year period to the extent necessary to satisfy the "substantially all" test in Reg. Sec. 1.45D-1T(c)(5). Accordingly, a common arrangement used to date for these loans and investments provides that the loans will be interest only for a 7 year period and any equity investments will not be permitted to be redeemed or repaid during that time. Under this arrangement all cash received from the CDE each year on its loans or investments is income to the CDE and need not be reinvested. Instead, this income is used to pay operating expenses of the CDE and then to distribute the remainder to the equity investor of the CDE.

In the event that the CDE distributes all of its cash after payment of operating expenses, and where the CDE has no expenses from that year or prior year that are capitalized and amortized, the cash distribution of the CDE to its investor will generally match its taxable income. However, in the event that the CDE uses some of the cash received from its equity investors to pay currently deductible expenses or to pay capital costs which are depreciated or amortized, then taxable income will be less than the distribution. In the event that cash received from interest income pays capital costs which are depreciated or amortized, then taxable income will exceed cash available for distribution in the year the costs are paid, and this difference will reverse itself in the subsequent years, as depreciation or amortization expense is recognized.

Internal Revenue Service Guidance

We are requesting guidance on the proper treatment of a CDE's distribution of cash from operations to its investors. We believe that the term "redemption" should be limited to an actual purchase of ownership interests by the CDE. See Secs. 45D(g)(3)(B), 317(b) and 1202(c)(3).

However, if the term redemption is interpreted to mean any return of capital, as opposed to a distribution of profits, we believe that the temporary regulations should contain a safe harbor defining what is a distribution of profits, i.e., a distribution that is not a redemption. We propose that to the extent that distributions made by a CDE to its equity investor do not exceed the “operating income” (defined below) of the CDE that they would not be treated as a redemption of the equity investor’s interest. The “operating income” of the CDE would start with federal taxable income. The CDE would then add back three items:

- (1) depreciation and amortization expense, to the extent the underlying depreciable or amortizable assets were paid for with investor equity, and
- (2) expenses, to the extent they were paid for with investor equity, and
- (3) realized losses from investments of the CDE (such as, for example, from bankruptcy of QALICBs).

Further, to the extent that such “operating income” is not distributed in one year but is instead deposited into a reserve, a distribution in a future year of these funds will be treated as operating income in that year.

In the alternative, the safe harbor could provide that to the extent that distributions made by a CDE to its equity investor do not exceed the “net cash flow” of the CDE, as that term is defined in the disguised sale regulations, they would not be treated as a redemption of the equity investor’s interest. Under the regulations governing the disguised sale rules, there are exceptions for treatment of a contribution and distribution as a sale if the distribution is either a guaranteed payment, a preferred distribution or an operating cash flow distribution.² For guaranteed payments and preferred distributions, a critical factor is whether the payment or distribution is reasonable in amount compared to the capital of the partner on which the payment is based. The regulations provide that the payment or distribution is reasonable if it does not exceed the amount determined by multiplying the partner's unreturned capital (or weighted average capital balance) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate, at the appropriate compounding period.

² Reg. 1.707-4.(a) and (b). Reg. 1.707-4(a)(i) states, “The term guaranteed payment for capital means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. See section 707(c). For this purpose, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.”

In addition, the regulations provide an exemption for distributions which do not exceed the “net cash flow” of the partnership for the year.³ Under this principle, rather than using an “interest factor” times the capital of the partner, the partnership may distribute its effective cash earnings to a partner who has contributed property without triggering sale treatment, but may not distribute the principal amount of the partnership’s assets or investments.⁴

The regulations also confirm the concept of a deposit in a reserve and a future year distribution as permitted. Reg. 1.707-4(c) provides that guaranteed payments, preferred distributions, and operating cash flow distributions do not lose their character by reason of being retained for distribution in a later year.

One of the purposes of the new markets tax credit program is to provide a shallow subsidy to investors so that they will make investments in low income communities which are riskier or lower yielding because they will be getting an added return based on the new markets tax credits. These credits allow a CDE to reduce the interest rate on its loans to the lowest level consistent with paying its operating expenses and making the required return to the equity investor. To the extent that a portion of the interest earnings of the CDE cannot be distributed to the equity investor, because there is uncertainty that they would be treated as a redemption, this may require the CDE to make loans of higher interest to its borrowers than it needs to for economic reasons. For example, a CDE may have to make to a borrower at a given rate in order

³ Reg. 1.707-4(b)(2) provides, “the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership’s business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by—

- (A) Principal payments made on any partnership indebtedness;
- (B) Property replacement or contingency reserves actually established by the partnership;
- (C) Capital expenditures when made other than from reserves or from borrowing the proceeds of which are not included in operating cash flow; and
- (D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.”

⁴ However, the concept of multiplying the net cash flow by the partner’s percentage interest should not be applicable here. This concept in the disguised sale rules is intended to account for a contributing partner with less than all of the interest in the partnership receiving a distribution which should be treated as a sale for that partner only. The use of the net cash flow definition to define what is not a redemption is intended to allow the CDE to distribute all of its effective income on a cash basis, without regard to the percentage interests of the partners in specific items. These percentages in specific items could vary over time or be dependent on the source of the repayment, which in any case is not relevant to the treatment of CDE income. If the net cash flow definition is used, it would be a limit on distributions to all partners each year, no matter what their percentage interests are.

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to distribute a sufficient amount to its equity investor. If the CDE cannot distribute all of its interest income because of tax losses, it may have to raise the interest on its loan to the borrower to raise its taxable income sufficiently to distribute the required amount. This result occurs, in part, because a CDE finds itself in a negative interest rate arbitrage situation with the accumulated cash income that it holds but cannot distribute for fearing of causing a redemption. This uncertainty reduces the efficiency of the program and creates higher borrowing costs to residents and businesses in low income areas, who were intended to be the chief beneficiaries of this program. For this reason, the resolution of this issue is important to the program's ability to best meet the goals set for it by Congress.

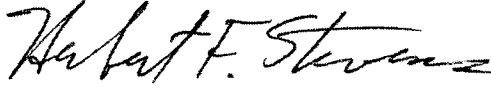
Thank you for your consideration of this request. Either of the undersigned would be happy to discuss this further at your convenience.

Sincerely yours,

NOVOGRADAC & COMPANY LLP

NIXON PEABODY LLP

By: 
Michael J. Novogradac

By: 
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