

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

June 11, 2002

Mr. Eric Solomon
Deputy Assistant Secretary for Regulatory Affairs
Office of Tax Policy
Internal Revenue Service
1500 Pennsylvania Avenue NW
Washington, DC 20220

Via Courier: please deliver to 15th Street entrance

Dear Mr. Solomon:

On behalf of the New Markets Tax Credit Coalition (Coalition), I am writing to request clarification on several points in the temporary regulations issued by the Internal Revenue Service on the New Markets Tax Credit (NMTC) program, under section 45D on December 26, 2001 and NMTC statute. These comments have been developed by the Coalition's steering Committee and we would appreciate an opportunity to speak with you regarding them.

Clarification Requests on the Statute:

1) Section 45D(b)(1)(C)

Voluntary Return or Request for Reallocation of Credits: Allocated credits must be returned to the CDFI Fund if, after five-years, the CDE does not place them with an investor. The Coalition seeks clarification that a CDE receiving an allocation of credits may either a) voluntarily turn back to the Secretary all or a portion of the credits allocated to them, without penalty, if they choose not to use the credits; or b) voluntarily request that the credits be reallocated to another CDE that has an allocation of credits, provided that the CDE receiving the credits agrees to use the credits in pursuit of the business plan for which the credits were awarded.

2) Section 45D(d)(2)(C)

Separately Incorporated: The primary purpose of the New Markets Tax Credit is to spur new private economic investment in low-income communities. Section 45D(d)(2)(C) states that "the term 'qualified active low-income community business' includes any trades or businesses which would qualify as a qualified active low-income community business if such trades or businesses were separately incorporated." The Coalition seeks clarification on Treasury's standard for determining whether a qualified active low-income community business meets this "separately incorporated" test and how a CDE documents this.

3) Section 45D(i)(1)

This Section states that the Secretary shall prescribe regulations "which limit the credit for investments which are directly or indirectly subsidized by other Federal tax benefits (including credit under section 42 and the exclusion from gross income under section 103).

a) Low Income Housing Tax Credits (LIHTC): Rental of residential housing is not a qualified low-income community business; NMTCs may not be used for the rental of housing. Further, we understand that federal depreciation rules disallow the segmentation of a building or structure and thus, NMTCs and LIHTC may not be used for the same investment since the NMTC regulations prohibit its use for residential rental property - an exception is a

condominium structure, where you can bifurcate depreciation deductions and thus separate streams of tax benefits could flow to separate investors. We also interpret the regulations to say that NMTCs may be used with mixed-use developments where less than 80% of the property's gross rental income is rental income from dwelling units. The Coalition requests a clarification of exactly what is and is not allowed with the NMTC in relation to rental housing.

b) Historic Rehabilitation Tax Credit (HRTC): This Section should be interpreted to not include the HRTC. The purpose of the HRTC is to encourage preservation of historic buildings by offsetting costs associated with meeting historic standards for rehabilitation. The NMTC is designed to address a broader financing gap for low-income community businesses. Combined projects would be attractive to investors who may not otherwise invest in low-income areas. The Coalition seeks clarification on how the NMTC may be combined with the HRTC.

Clarification Requests on the Temporary Regulations:

4) Section 45D(c)(1)(iii)

Designate a Portion of a Qualified Equity Investment: This section seems to indicate that it is possible to designate a portion of an investment as a Qualified Equity Investment subject to 45D. For example, an investor could invest \$900,000 in 45D shares of an LLC and \$100,000 in non-45D shares of the same LLC. Tax Credits would be claimed only on the \$900,000 portion of the investment. Moreover, if the LLC described above invested \$765,000 in qualified low-income community businesses, it would meet the substantially all test under the direct tracing method ($\$765,000/\$900,000 = 85\%$). The Coalition requests that the language be clarified throughout the regulations, especially in the substantially all section, that all calculations prescribed by the regulations pertain only to the portion of the LLC that is related to the 45D-designated equity.

5) Section 45D(c)(5)

QLIC-backed Securities: Members of the Coalition, such as the Community Reinvestment Fund (CRF), periodically sell portfolios of loans to affiliated qualified special purpose entities that, in turn, sell asset-backed notes (notes backed by the community development loans) in the secondary market to banks, pension funds, and other investors throughout the nation. These transactions permit entities to provide capital liquidity to local community development lenders that they would likely not be able to achieve on their own. The dollars received from Coalition members by the community lenders from these loan sales are then re-lent to other community businesses, thereby expanding the impact of the local lenders' work.

This technique permits the recycling of capital by access to the secondary markets; the Coalition would like to clarify that this technique would be available to them with the NMTC program. Would a CDE, which has been allocated NMTCs, continue to satisfy the 'substantially all' requirement if the CDE sold all of its QLICs (whether or not to a CDE) and received as consideration:

a) Cash to be reinvested in QLICs; and

b) Subordinated asset-backed notes collateralized by the QLICs being sold.

6) Section 45D(d)(1)(ii)(A)

Timing and Compliance of Second-Tier CDEs: Once receiving a qualified equity investment in exchange for the NMTC, a CDE has one-year to place the money in a qualified low-income community investment. Moreover, substantially all of the proceeds from the qualified equity investment must be placed in qualified low-income community investment. An example of an eligible qualified low-income community investment may include investments in other (second tier) CDEs. However, it is not clear what portion of this "second tier" CDE's funds must be invested in qualified low-income community investments and/or how long it has to do so. The Coalition seeks clarification on the timing and compliance issues of second tier CDEs.

7) Section 45D(d)(3)

Alternative Forms of Credit Enhancements: This section provides a special rule for reserves maintained for loan losses or additional investments in existing qualified low-income community investments. The Coalition appreciates the Treasury's consideration of reserves, but feels that there are alternative forms of credit enhancement, beyond loan loss reserves. Funds expended for such credit enhancement vehicles should be counted as eligible investments. The Coalition would like clarification that dollars expended by a CDE to procure a type of credit enhancement that has the same effect as a reserve for loan losses can also be treated as a qualified low-income community investment, subject to the 5% limitation.

8) Section 45D(d)(4)(i)(C)

Limited Partnerships / Limited Liability Companies and the Services Test: It is common for some businesses, such as real estate development businesses, to take the form of a limited partnership or limited liability company with few or no employees. Instead, the general partner or the managing member operates the business on behalf of the LP or LLC. As such, it may be technically impractical or irrelevant to apply the services test to such a business. The Coalition recommends that the regulations clarify that a business in the form of a partnership or LLC with few or no employees and operated by a managing partner or member, respectively, will satisfy the employment services test if the managing partner or managing member satisfies the test.

9) Section 45D(g)(2)(B) of the Temporary Regulations

a) Loss of CDE Certification and QLICI: The Coalition seeks clarification that it is possible for a CDE that loses its CDE status to have a period of time to either regain its CDE certification or transfer qualified low-income community investments to an eligible successor CDE.

b) Terms and Conditions for Recapture Prevention: Further, the Coalition seeks clarification as to what are 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.

c) Continual Certification of Selling CDEs: One eligible use of NMTC proceeds is the purchase of eligible loans from other CDEs. However, the compliance obligation of CDEs that sell their loans to other CDEs and then no longer participate in the NMTC program is not clear. The Coalition seeks clarification that CDEs, which sell their eligible loans to other CDEs, will not need to maintain their CDE certification if they no longer plan to participate in the NMTC program.

I appreciate your consideration of the issues that have been raised and hope that you can provide some clarification as CDEs begin the process of developing their allocation application.

Sincerely,

Robert A. Rapoza

cc: Paul Handleman, Internal Revenue Service
Stephen Watson, Attorney-Advisor, Office of Tax Legislative Counsel
Tony Brown, Director, CDFI Fund
Linda Davenport, Equity Funds Manager, CDFI Fund