

May 10, 2004

**Sent Via Mail and Internet**

Mr. Paul F. Handleman  
IRS Chief Counsel's Office  
1111 Constitution Ave., N.W.,  
Room 3026  
Washington, DC 20224

CC:PA:LPD:PR (REG-115471-03)  
Room 5203, Internal Revenue Service  
POB 7604, Ben Franklin Station  
Washington, DC 20044

Dear Paul:

We are writing in response to the Department of Treasury's request for comments on the revised temporary regulations relating to the new markets tax credit (NMTC) as published in the Federal Register issued March 11, 2004. We would like to commend you and your staff on the work you did in providing additional guidance for many areas that critically needed such guidance in order to ensure the success of the NMTC program. Novogradac & Company LLP appreciates the opportunity to submit the following comments.

**Taxable income**

Temporary Treasury Regulation 1.45D-1T(e)(2) indicates that a recapture event occurs if the qualified equity investment ("QEI") is redeemed by the community development entity ("CDE"). There is no guidance as to what constitutes a redemption of a QEI by a CDE that is a partnership for federal income tax purposes. In order to provide private equity markets with incentive to invest in low-income areas and communities, it is essential to use the New Markets Tax Credit to demonstrate that such investments can be both socially and financially rewarding. It is important that CDEs be allowed to provide investors with a return *on* their investment during the seven year credit period. Due to the lack of guidance, many industry professionals are recommending that CDEs limit distributions to their investors to cumulative undistributed taxable income. This limitation is being adopted in order to avoid the risk that the distribution could be deemed a redemption of the investor's QEI. We recommend that Treasury provide guidance as to what specifically constitutes a redemption of a QEI by the CDE. In the alternative, we recommend that Treasury create a safe harbor formula that allows certain minimum distributions.

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### **Recapture and right to cure**

The recapture rules are clearly the most troubling aspect of the NMTC program with full recapture (plus interest) over the entire life of the investment. A grace period of six months should exist for a CDE to take remedial action(s) from the time it discovers (or reasonably should have discovered) that it (or its investments) is not in compliance. The CDE should have the right to extend the cure period an additional 6 months in the event the error can not be corrected within 6 months.

### **Direct tracing**

Treasury Temporary Regulation Section 1.45D-1T(c)(5)(ii) indicates that the substantially-all requirement is satisfied if at least 85 percent of the taxpayer's investment is directly traceable (the "direct tracing" method) to qualified low-income community investments ("QLICs"). This provision places an undue administrative burden on CDEs. Many CDEs will be receiving multiple QEIs and making multiple QLICs. As a result, they would be required to establish numerous cash accounts in order to definitively "directly trace" the individual QEIs to related specific QLICs. We recommend that guidance should be provided that allows any reasonable allocation method adopted by the CDE that is consistently applied and is used and documented contemporaneously with receipt of QEIs and making of QLICs.

### **Substantially-all**

Temporary Regulation Section 1.45D-1T(c)(5)(i) requires that the substantially-all test be measured (using either the safe harbor or direct tracing method) every six-months during the 7-year credit period. This requirement creates an administrative burden for many CDEs as many CDEs will receive equity commitments from their investors and the CDEs will draw down on those commitments as the CDEs makes loans or equity investments in QLICs. As a result in some situations a CDE may have 52 QEIs originate in a given taxable year, which means that the CDE would have to perform the substantially-all test 52 times in the given taxable year. We recommend that Treasury provide that a CDE be allowed to measure the substantially-all test quarterly, where they have multiple QEIs received in a quarter.

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### **Profit motive**

Internal Revenue Code Section (“IRC §”) 183 in general disallows deductions, including losses and credits, attributable to activities that are not engaged in for profit. Guidance has been provided that indicates that this rule does not apply to LIHTC projects. The IRS should issue similar guidance for CDEs and their investors. This would reflect congressional intent, as Congress created certain types of QLICIs that specifically do not appear to require a profit motive (e.g., investments that provide financial services to businesses in a low-income community). The profit motive issue is a particularly significant one when a partnership invests in a CDE. One of the partners may invest principally to receive tax benefits while the other partner may invest to receive cash flow.

### **Investments in Nonprofits**

In order for investors in CDEs to claim NMTCs on their investments in a CDE, the CDE must generally invest substantially all of its investors’ equity in qualified active low income community businesses (“QALICB”). The definition of a QALICB includes the words “Active...Business.” Questions have arisen to how this active business requirement applies to CDE investments in nonprofits.

IRC §45D and the Treasury Regulations thereunder specifically provide that a “qualified active low-income community business means...a corporation (including a nonprofit corporation)...” Similarly, the General Explanation states that a qualified active business can include an organization that is organized on a nonprofit basis. The problem with the statutory construction is that after stating that a corporation could be a nonprofit corporation, the statute states (and the regulations state) that under the gross income test, the corporation must generate receipts from the “Active conduct of a qualified business.” Additional guidance is needed to clarify this matter.

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### **Investments in other CDEs**

Temporary Treasury Regulation Section 1.45D-1T(d)(iv) indicates that any investment in, or loan to, any CDE (the "Recipient CDE") constitutes a QLICI but only to the extent that the Recipient CDE uses the proceeds of the investment or loan to (from the "Investing CDE") to make investments in, or loans to QALICBs or to provide financial counseling services. Additionally, the investments in, or loans to QALICBs (or financial counseling services) provided by the Recipient CDE would have to constitute QLICIs if it were made directly by the Investing CDE.

A conservative reading of these requirements would imply the Investing CDE would be required to directly trace its investment in or loan to the Recipient CDE and also directly trace the use of the proceeds by Recipient CDE (i.e. investments or loans to QALICBs made by the Recipient CDE). This would place an undue administrative burden on the Investing CDE and may in fact prove to be impossible to do. If the Investing CDE invests in or loans to a Recipient CDE that is a bank, it may not be possible to directly trace the Investing CDE's investment or loan to the Recipient CDE's investments in or loans to QALICBs. We recommend that an Investing CDE be allowed to document that it has satisfied these requirements using any reasonable allocation method adopted by the Investing CDE and Recipient CDE that is consistently applied and is used and documented contemporaneously with receipt of the investment by the Recipient CDE and the making of QLICIs by the Recipient CDE.

### **Partnership allocation of New Markets Tax Credits**

IRC §45D and §704(b) provide no specific reference to IRC §45D and how the NMTC should be allocated among partners in a partnership. Given the uniqueness of the NMTC which does not directly follow an easily identifiable economic cost like the low-income housing tax credit and in the absence of current specific guideline, it appears that allocation of NMTC among the partners in a partnership should be in a manner that is most consistent with the existing IRC §704(b) partnership allocation regulations. Therefore, the NMTC should be allocated in the same manner as the NMTC basis reduction.

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The Treasury Department has announced that its business plan includes developing regulations that will address how the IRC § 45D NMTC should be allocated to the partners of a partnership under IRC §704(b) and will address related partnership issues. The announcement also referred to a targeted timetable for the notice of proposed rulemaking of December 2003. This issue continues to be a pressing one and it would be helpful if guidance could be issued as soon as possible.

### **Basis reduction and flow-through losses**

The NMTC provides for basis reduction which occurs as the credit is claimed. The NMTC basis reduction is “top down”, the losses flow “bottom up” and there are no flow-through basis adjustment rules. This puts the NMTC investor in a unique position to have no basis but allocable losses and required basis reductions. Guidance is therefore needed to clarify the treatment of Excess Losses and Excess Basis Reductions. The treatment of losses as “suspended” similar to at-risk losses limited by an investor’s at-risk basis appears to be a feasible solution.

### **Passive activity rules**

Internal Revenue Code §469 limits the ability of certain taxpayers such as individuals, closely held C Corporations, personal service corporations, estates and trusts to use losses and credits generated from passive activities. Determining the character of the income, loss, and new markets tax credits is a complex issue for both the investors and the CDEs. CDEs could perform a direct tracing of the income/loss to the qualified active low income community business to determine the character but the logistical, administrative and financial burden of this approach would make it prohibitive for the CDE to disperse its qualified equity investments in a variety of businesses. There is a need for guidance in the form of safe harbor guidelines to help the CDEs determine the character of the credit, income, and loss without tracking 100% of its qualified active low income community investments.

### **Low-income communities**

In certain cases, the CDFI Fund’s website has produced conflicting results (when compared to other sources) regarding whether a given census tract is a low-income community. Treasury should issue guidance as to which source is the determinant source for determining whether a census tract is a low-income community. The census bureau’s website may be the appropriate source.

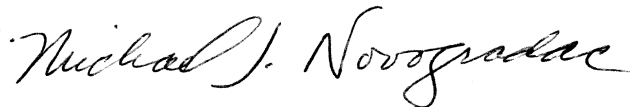
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Thank you for the opportunity to comment on the revised temporary regulations relating to the NMTC. Please do not hesitate to contact me if you have any questions regarding our comments. I can be reached at (415) 356-8000 or via e-mail at [michael.novogradac@novoco.com](mailto:michael.novogradac@novoco.com).

Yours very truly,  
NOVOGRADAC & COMPANY LLP

A handwritten signature in cursive script that reads "Michael J. Novogradac".

By:  
Michael J. Novogradac