

May 9, 2003

Sent Via Mail and Internet

Mr. Eric Solomon
Deputy Assistant Secretary for Regulatory Affairs
Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Eric:

With the award of the first round of New Market Tax Credits behind us the questions and issues we have raised in the past have become increasingly crucial to address. We have prioritized and grouped issues and questions into three categories. The first category includes an issue which we believe may affect the viability of the program and should therefore be addressed immediately. The second category includes issues that will reduce administrative cost and improve efficiencies within the new market tax credit program, and the third category includes issues that will further enhance the effectiveness of the new market tax credit program. The categories are as follows:

Pressing Issue

- Definition of Active Business

Improve Efficiencies and Reduce Administrative Costs

- Application of the 3 factor test where the business has no employees
- Profit motive
- Passive activity rules

Broaden the New Market Tax Credit Program

- Use of escrows
- Partnership allocation of New Markets Tax Credits
- Use of lines of credit
- Recapture and right to cure

Pressing Issue

Definition of Active Business

The Internal Revenue Code provides that the qualified business must be a qualified “active” low income community business. The issue arises as to what the definition of “active” business is and when the business must meet the “active” business test. If the definition of “active” business contemplates generation of current revenue, then development real estate will not be an “active” business. As such, the definition of “active” business should either:

- (1) not require current revenue, or
- (2) allow a reasonable period of time to become an “active” business.

To the extent that guidance is not provided in this area, many investors will not invest in real estate that is under construction as they will be concerned about this test. Similarly, many investors will not invest in venture capital or other start-up business until they have revenues. We believe that the new markets tax credit program was intended to include businesses in a development stage without current revenues.

Improve Efficiencies and Reduce Administrative Costs

Application of the 3 factor test where the business has no employees

The NMTC applies a three factor test including the gross income requirement, tangible property requirement, and the services requirement to determine if an active business is in a low-income community. The three factor test is designed to ensure that a substantial portion of the gross income of the business is generated in a low-income community, that a substantial portion of the tangible property used by the business is situated in a low-income community, and a substantial portion of the services provided by the employees of the business are provided in a low-income community. Guidance is required on how to apply these tests if the business has no employees. As it stands now, we believe that most, if not all, CDEs will require that the QALICBs in which they invest have at least one employee before they invest. This requirement will add additional unnecessary administrative costs.

Profit motive

Internal Revenue Code §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 low-income housing tax credit projects. The IRS should issue similar guidance for CDEs and their investors. This would reflect congressional intent, as Congress created certain types of QLICs 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 issue when a partnership invests in a CDE, and the partnership has debt. We also note that the legislative history of this section contemplates that an exception to the profit motive.

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 passive activity character of the income, loss, and new markets tax credits generated by an investment in a CDE 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 low income community investments.

Broaden the New Market Tax Credit Program

Use of escrows

Guidance is requested as to what restrictions the CDE can place on the use of money invested/loaned to qualified active low income community businesses. Guidance is needed from the Internal Revenue Service on the following:

- (1) manner of use of the reserve or escrow accounts;
- (2) the need for written approval by the CDE to withdraw funds from such a reserve or escrow; and
- (3) whether the CDE can require a third party escrow agent's written approval for withdrawing funds for permitted uses of the reserve or escrow account.

Partnership Allocation of New Markets Tax Credits

Internal Revenue Code §45D and §704(b) provide no specific reference on 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 guidelines, it appears that allocation of NMTC among the partners in a partnership should be in a manner that is most consistent with the existing §704(b) partnership allocation regulations. Therefore, the NMTC should be allocated in the same manner as the NMTC basis reduction which in turn should be allocated in the manner agreed to by the partners of the partnership and that is consistent with the partnership allocation safe harbor rules under existing Treasury Regulations.

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Use of lines of credit

Guidance is sought on whether CDEs can use lines of credit to assemble loans in advance of calling for pay-ins of Qualified Equity Investments from investors. The use of lines of credit to make and hold pools of loans will allow for a more efficient process by reducing the number of transactions that must take place.

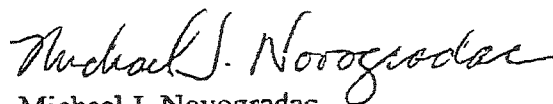
Recapture and right to cure

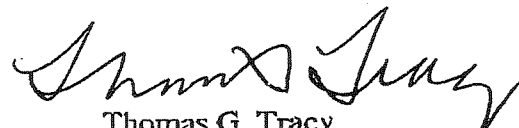
The recapture rules are clearly the most troubling aspect of the NMTC program with full recapture (plus interest) over the life of the investment. A grace period of six months should exist for a CDE to take remedial action(s) from the time it discovers (or reasonably should have discovered) that it is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

Conclusion

We appreciate the opportunity to provide these comments and would be happy to discuss any of these comments with you. Please do not hesitate to contact us if you have any questions regarding our comments. Michael Novogradac can be reached at (415) 356-8000 and Tom Tracy can be reached at (760) 804-6026. Our e-mail addresses are michael.novogradac@novoco.com and tom@hunterchase.com.

Yours very truly,


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