IRS Comment Letters
National Congress for Community Economic Development Comment
on Proposed Regulations (REG-119436-01) Regarding New Markets Tax Credit

Document Date: July 2, 2001

NATIONAL CONGRESS FOR COMMUNITY ECONOMIC DEVELOPMENT

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July 2, 2001

CC:M&SP:RU (REG-119436-01)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW.
Washington, DC

Dear Madam/Sir:

The National Congress for Community Economic Development is pleased to submit comments on the advance notice of proposed rulemaking issued by the Internal Revenue Service on the New Markets Tax Credit (NMTC). NCCED is a member of the New Markets Tax Credit Coalition and supports the comments made by that Coalition and signed by its convener, Robert Rapoza.

NCCED represents the nation's 3,600 community based development organizations (CDCs) that have developed more than $71 million square feet of commercial and industrial space, created 247,000 jobs, and provided $1.9 billion in loans outstanding (at the end of 1997) to 59,000 businesses. We expect CDCs to be successful users of the New Market Tax Credit program.

Question Number 1.

New Markets Tax Credit may be claimed only with respect to qualified equity investments in a CDE. Section 45D(b)(1)(B) requires CDEs to use substantially all of the cash from a qualified equity investment to make qualified low-income community investments.

1a. How should "substantially all" be defined for purposes of section 45D(b)(1)(B)? For example, what percentage should constitute "substantially all" of the cash from a qualified equity investment?

The regulations governing the 'substantially all' test must strike a balance between ensuring that Community Development Entities (CDEs) get capital out on the street and at the same time ensure that CDEs are not impeded in the way that they do business.

We think the 'substantially all' test should be considered met if a CDE has at least 85 percent of its cash derived from Credits in qualified low income community investments. This would permit a CDE to use up to 15 percent of its total cash from the Credit to cover costs related to fund management.

Establishing the 'substantially all' standard at 85 percent would make it consistent with the 'safe

harbor' standard which by statute is set at 85 percent. The 85 percent test should be measured at fiscal year end of the CDE, since principal repayments are monthly (ongoing). We are concerned that it will be an accounting nightmare to track the 85 percent on a monthly or more regular basis (i.e., consider the percentage of investment outstanding only at year end).

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1a. How should "substantially all" be defined for purposes of section 45D(b)(1)(B)? For example, what percentage should constitute "substantially all" of the cash from a qualified equity investment?

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We think the 'substantially all' test should be considered met if a CDE has at least 85 percent of its cash derived from Credits in qualified low income community investments. This would permit a CDE to use up to 15 percent of its total cash from the Credit to cover costs related to fund management.

Establishing the 'substantially all' standard at 85 percent would make it consistent with the 'safe
harbor' standard which by statute is set at 85 percent. The 85 percent test should be measured at fiscal year end of the CDE, since principal repayments are monthly (ongoing). We are concerned that it will be an accounting nightmare to track the 85 percent on a monthly or more regular basis (i.e., consider the percentage of investment outstanding only at year end).

1b. What amounts should be treated as used to make qualified low-income community investments? For example, how should issuance costs (including underwriters compensation) and reserves be treated?

We recommend that a CDE be considered to have 'substantially all' of its cash in qualified equity investments if at least 85 percent of its cash is either invested in or loaned out to qualified low-income community investments, committed and legally obligated to qualified low-income community investments, or committed to a reserve fund. At no time would a CDE be able to have more than 10 percent of these funds committed to reserves.

It is important that CDEs be able to satisfy the 'substantially all' test and at the same time use their NMTC capital to provide the types of financing required by low-income community businesses that are intended to benefit from the Credit. For example, CDEs must have the ability to provide lines of credit to their borrowers or provide construction loans that commonly disperse only 50 percent of a loan at closing. Therefore, we recommend that as long as a CDE has a legally binding commitment to invest in a low-income community investment, those funds should be considered to be invested for the purpose of meeting the 'substantially all' test. In essence, these funds are already committed to a qualified investment activity.

Non-performing assets that are in compliance with the low-income community investments requirements should be included for purposes of the 'substantially all' test and for the purpose of meeting the 'safe harbor' test.

The 85 percent 'substantially all' standard we recommend would permit a CDE to use up to 15 percent of its total cash from the Credit to cover fund management. We support flexibility for the CDC because we are concerned that if 15 percent is kept at the CDE level to manage and an additional amount is put into a reserve at a low interest rate, it may be very difficult to achieve investor yield requirements.

We recommend that reserves be funded in the name of the business funded, not in name of CDE, if reserve bumps the total funding amount below the 85 percent threshold. The CDE can still maintain control of the reserve (i.e., approve withdrawals).

1c. How much time under section 45D(b)(1)(B) should a CDE have to invest the cash from a qualified equity investment in a qualified low-income community investment?

1d. How should repayments of equity or principal in respect of a qualified low-income community investment be treated for purposes of section 45D(b)(1)(B)? For example, are there circumstances when a CDE should not be required to reinvest any such amounts in another qualified low-income community investment during the 7-year credit period?

Once a CDE has secured a qualified equity investment from an investor, it needs sufficient time to loan or invest its cash in qualified low-income community investments before it is required to meet the 'substantially all' test. In addition, whether a CDE makes its qualified low-income community investments in the form of loans or equity investments, it will receive principal and/or capital re-payments throughout the seven-year credit period. We believe these funds should be reinvested in qualified low-income community investments during the course of the seven-year credit period and we recommend that the 'substantially all' test provide a grace period that allows CDEs time to accumulate these repayments, find new and viable qualified investments, and reinvest its cash.

In addition, during the out years of the credit, particularly years six and seven as CDEs work to liquidate their portfolios, the regulations will need to provide flexibility in how the 'substantially all' standard is enforced. A CDE cannot be expected to reinvest principal and/or capital paid back in year six or seven of the term and yet without flexibility in how the 'substantially all' test is implemented, a CDE would be out of compliance if they failed to meet the test. We recognize that CDEs doing equity investing will require less time up front to place investments once they have

secured cash from qualified equity investments but will require more flexibility in the out years as they begin to exit their investments and liquidate their NMTC portfolios in years six and seven. In contrast, CDEs planning to concentrate on lending will require more time upfront once they have secured cash from qualified equity investments and are less concerned about having flexibility in the out years as long as they are guaranteed a grace period for reinvesting principal repayments.

Therefore, we recommend that a CDE be given the option of using one of the following formulas to monitor compliance with the 'substantially all' test. While both formulas are based on the 'substantially all' standard being set at 85 percent, they are designed to ensure that a CDE has the flexibility to ramp-up and ramp-down its investment activity as needed. We support flexibility in this regard. For example, what happens if a CDE elects the six months option in year 2002 and in year 2003 it needs 12 months to invest cash in the qualified business? Does the six month election made in 2002 restrict the CDE?

Both of these proposals assume that in order for cash to be counted towards meeting the 'substantially all' test, a CDE would need to document that it was either invested in or loaned out to qualified low-income community investments, or committed and legally obligated to qualified low-income community investments, or committed to a reserve.

Option 1: A CDE would have up to 6 months from the time it secures cash in the form of a qualified equity investment to the time it is required to comply with the 'substantially all' test. By the end of year one a CDE would be required to have at least 85 percent of its cash in qualified equity investments in order to satisfy the 'substantially all' test and the CDE would be required to maintain this level of investments in years two through five in order to maintain compliance. In year 6 the 'substantially all' standard would be reduced to 65 percent and in year seven the standard would be reduced to 45 percent. This formula would guarantee a net weighted average investment level of 70.3 percent.

Option 2: A CDE would have up to 12 months from the time it secures cash in the form of a qualified equity investment to the time it is required to comply with the 'substantially all' test. In years two through six, a CDE would be required to maintain 85 percent of its cash in qualified equity investments in order to satisfy the 'substantially all' test. In year 7 the 'substantially all' standard would be reduced to 65 percent. This formula would guarantee a net weighted average investment level of 70 percent.

We recommend that a CDE be required to select one of these monitoring formulas twelve months after it makes its first low-income community investment and is required to begin reporting on compliance.

We recommend that CDEs be granted a grace period of up to 12 months to reinvest any principal and/or capital re-payments made back to the CDE from qualified low-income community investments. This grace period would allow time for principal/capital paybacks to accumulate and time for the CDE to identify new qualified low-income community investments. During the 12-month grace period, any principal or capital repayments would not be counted towards meeting the CDEs 'substantially all' test. The reinvestment period (i.e., if 12 mos.), should also be measured once a year at year end, to avoid difficult monthly accounting.

However, after years three or four, return of capital should be allowed without any recapture. It is difficult if not impossible to reinvest money after year four in these types of investments and still expect return on the investment as well as return of capital by year seven. Churning funds after money is repaid may be a negative issue for investors.

1e. How should the 'substantially all' requirement under section 45D(b)(1)(B) be administered during the 7-year credit period?

We recommend that a CDE be required to certify compliance as part of its tax return for each fiscal

year, based on standards set forth in an IRS form worksheet attachment to the tax return. The CDE would certify that each of its low-income community investments meets the required compliance tests and that it is in compliance with the 'substantially all' test by certifying that it meets one of the proposed compliance tests recommended in our response to question number Id.

We recommend that Treasury develop standardized reporting forms that CDEs can submit annually as part of their tax return. In addition, we recommend that Treasury develop standardized forms that CDEs can use in collecting compliance information from the low-income community businesses in which they have investments. While CDEs will be required to certify that all information submitted is accurate and conduct their own due diligence in collecting information from businesses, having a standardized Treasury form will ease the reporting burden on CDEs and simplify reporting to Treasury.

Temporary noncompliance should not result in de-certification or recapture if cured within a reasonable time. This would be similar to low-income housing tax credit rules permitting a reasonable cure period for noncompliance.

IRS Question Number 2

Section 45D(b)(3) contains a safe harbor under which the "substantially all" requirement of section 45D(b)(1)(B) will be treated as met if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments.

2a. How should "aggregate gross assets" be defined under section 45D(b)(3)? For example, are there any assets of a CDE that should not be taken into account for these purposes?

We recommend that 'aggregate gross assets' be defined as all assets treated as such under generally accepted accounting principles, and should include cash received from investors, capital and equity investments and loans made by the CDE, cash or investments held in reserve, and commitments to make qualified low-income community investments. Section 1202(d)(2)(A) of the Code defines 'aggregate gross assets' with respect to gains on certain small business stock as the amount of cash and the aggregate adjusted bases of other property held by the corporation.

2b. How should the aggregate gross assets of a CDE be determined under section 45D(b)(3)?

CDEs should be required as part of their tax returns to document that they meet the aggregate gross assets test on an annual basis as suggested in our response to question number 1e. The determination should be made annually and certified by the CDE as part of its tax return, based on an attached IRS worksheet prepared by the CDE. If the CDE falls out of compliance at any time during the year, it should be allowed up to one year to cure the noncompliance, or a reasonably longer period if necessary.

Temporary noncompliance should not result in de-certification or recapture if cured within a reasonable time. This would be similar to low-income housing tax credit rules permitting a reasonable cure period for noncompliance.

2c. How should compliance with the 85 percent test of section 45D(b)(3) be determined? For example, should the CDE be required to satisfy the test throughout the entire 7-year credit period following the issuance of a qualified equity investment? Should any grace • periods be provided? If so, what should those grace periods be?

As with the 'substantially all' test, we recommend that CDEs have adequate time to deploy cash investments upfront once investments are procured. As we recommend with the implementation of the 'substantially all' test in our response to question 1d, we recommend that a CDE be granted a degree of flexibility in satisfying the 'safe harbor' test in the early years of the credit as it ramps up

its investments as well as during the out years (years six and seven) as it ramps down investment activity. As with 'substantially all', we recommend that CDEs be given two options for satisfying the 'safe harbor' tests. These flexible tests would ensure that the 85 percent 'safe harbor' standard is enforced and yet allow for the realistic implementation of the credit by CDEs. As we recommended in our response to question number 1 d, we suggest that CDEs be granted a grace period of up to 12 months to reinvest any principal and/or capital re-payments made back to the CDE from qualified low-income community investments. This grace period would allow time for principal/capital paybacks to accumulate and time for the CDE to identify new qualified low-income community investments. During the 12-month grace period, any principal or capital repayments would not be counted towards meeting the CDEs 'safe harbor' standard.

IRS Question Number 3

As indicated previously, section 45D(b)(1)(B) requires CDEs to use substantially all of the cash with respect to a qualified equity investment to make qualified low-income community investments. Under section 45D(d)(1)(A), the term 'qualified low-income community investment' includes any capital or equity investment in, or loan to, any qualified active low-income community business. Section 45D(d)(2)(A) provides that the term "qualified active low-income community business" means, with respect to any taxable year, any corporation (including a non-profit corporation) or partnership if for the year (i) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business (as defined in section 45D(d)(3)) within any low-income community, (ii) a substantial portion of the use of the tangible property of the entity is within any low-income community, (iii) a substantial portion of the services performed for the entity by its employees is performed in any low-income community, (iv) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of the business, and (v) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to nonqualified financial property (as defined in section 1397C(e)).

3a. How should "substantial portion" be defined for purposes of section 45D(d)(2)(A)(ii) and (iii)?

We recommend that the 'substantial portion' be considered met if at least 25 percent of a businesses' use of tangible property or performance of services takes place within a qualified low-income community. The statute requires that at least 50 percent of a business' total gross income be derived from active conduct in a qualified low-income community. We believe the statute intended for the 'substantial portion' standard to be established well below the 50 percent test.

We are concerned that the requirement that 50 percent of a business' total gross income be "derived from the active conduct of a qualified business within any low-income community" may present a problem for CDE portfolio companies that manufacture goods for sale outside low-income areas or provide services outside these areas, especially as companies grow and expand geographically over the seven-year duration of tax credit investments.

We therefore recommend that "derived from the active conduct" be defined to mean that the activity originate in a business located in a low-income community. For manufacturing businesses, this would mean that 50 percent of production- but not sales - must occur within a low-income community. For services businesses, this would mean that 50 percent of services must be provided by employees of offices in low-income communities, even if the services themselves are provided in other geographies. Moreover, we recommend that the expansion of facilities outside low-income communities be considered a distinct "portion" of a business as defined in section 45D(d)(2)(c) of the NMTC statute, unless otherwise elected, so as not to disqualify the business under the gross income test.

We recommend that the following multi-criteria tests be used in determining whether a qualified low-income community business satisfies the use of the tangible property test and the service performance test. We believe the Credit was intended to assist a variety of low-wealth community businesses, thus multi-criteria tests need to be developed.

For example, the 'tangible property' test should be flexible enough to accommodate a school bus service operating within a low-income community even if the company's bus barn is located outside the community. In addition, we believe that the credit should accommodate telecommunications or trucking companies that are headquartered in a low-income area but whose primary assets are located or used elsewhere.

Similarly the business services requirement should be implemented in a way that can accommodate companies that are based in or managed from a location in a qualified low-income community even though they provide services such as office cleaning or temporary staffing in central business districts that are not necessarily low-income.

Tangible Property Test We recommend that the tangible property test be considered met if a business satisfies one of the following criteria:

a) the business is located in a qualified area;

b) the business operates a major facility in a qualified area;

c) the business' primary business activity takes place in a qualified area; or d) the business' primary mission is working with people in qualified areas

Services Requirement: We recommend the service requirements be considered met if a business meets one of the following criteria:

a) the business is located in a qualified area;

b) the business operates a major facility in a qualified area;

c) the business' primary business activity takes place in a qualified area; or d) the business' primary mission is working with people in qualified areas.

3b. When should the determination be made regarding whether a trade or business constitutes a 'qualified active low-income community business'? For example, should the determination be made at the time of the investment in the business based on reasonable expectations? Under what circumstances, if any, should an investment in a business lose its status as a qualified low-income community investment under section 45D(d)(1)(A) by reason of a failure of the business to satisfy the requirements for a qualified active low-income community business under section 45D(d)(2)? Should the degree of control of the CDE over the business be relevant to this determination?

We recommend that compliance be determined at the time a CDE makes a qualified low-income community investment. After that, we suggest that the principal test used in determining compliance be the location of the business. The most likely scenario of a business falling out of compliance is if it moves out of a low-income community or targeted area.

CDEs should not be subject to decertification, or an investor subject to recapture, if it is later discovered that a low-income community business was not qualified or has ceased to qualify as such, so long as the low-income community investment was based on the CDE's reasonable expectations at the time the investment was made and the CDE takes reasonable steps to address the problem.

While our strong preference be that compliance be determined at the time of the investment, our fail back position would be that Treasury establish a test to determine that a CDE is acting in 'good faith' in making qualified low wealth community investments. We suggest that regulations establish a 'safe harbor' for a CDE that chooses to meet a 'good faith' test and thus avoid recapture if it takes reasonable steps to correct non-compliance when and if it occurs.

We suggest that a CDE be granted a 'safe harbor' if it agrees to:

> a) require the business, at the time the investment is made, to certify that it does not intend to move into an ineligible area within the compliance period,
>
> b) require the business to sign a financing agreement that triggers immediate repayment if the business moves to an ineligible area within the compliance, and
>
> c) take reasonable steps to recover its investments within a reasonable period, short of forcing the business into bankruptcy.

Bankruptcy or other economic failure of the low-income community business should not disqualify it as such. For the tax credit program to attract investments, (economic risk should not also be a risk of CDE de-certification or investor recapture). Nor should economic success of the low-income community business, with expansion beyond the qualified low-income community, disqualify it as such, so long as the portion of the business that received the investments continues to operate in the qualified low income area. Investors should not have to worry about recapture except in the most narrowly defined significant circumstances, or else the tax credit incentive program may not be effective.

We recommend that CDEs that make qualified low-income community investments in businesses in which they, or a subsidiary, have a controlling interest, be held to a higher compliance standard than CDEs that invest in firms in which they do not have a controlling interest. As we recommended above, there should be a 'good faith' test to determine whether or not a CDE did due diligence in making its qualified low-income community investments. In addition, we suggest in our response to question number 6b, that there be a reasonable cure period during which the CDE be expected to move the investment back into compliance. However, if a CDE makes a qualified low-income community investment in a business in which they, or a subsidiary, have a controlling interest and the business moves out of compliance and cannot be cured within a reasonable period of time despite the good-faith efforts of the CDE -then recapture goes into effect.

We suggest that "controlling interest" refer to an entity that controls 50 percent or more of the voting power in a corporation or partnership. This 50 percent standard is consistent with the standard applied to businesses operating in Empowerment Zones and Enterprise Communities as defined by Section 1397 of the Code, incorporating Section 52 of the Code and its implementing regulations.

There are, however, circumstances in which a CDE, as a controlling shareholder, would better serve the interests of the business and the business' minority shareholders by changing the business in such a way that would threaten compliance with the NMTC. The CDE may be required to take actions in order to avoid violating its fiduciary duties to the business and its minority shareholders but at the same time such actions may move the business out of compliance with NMTC regulations. Where the CDE, or representatives thereof, exercise the CDE's voting control through representation on the board of directors of an entity, those directors acting on behalf of the CDE, and thus CDE itself, assume duties of loyalty and due care to the business and its shareholders. Although the CDE would in such a scenario enjoy the protections of the business judgment rule, circumstances might arise where the CDE would incur liability to the business and

its shareholders were the CDE not to take action jeopardizing compliance with the NMTC. At a minimum, such circumstances would include those in which the CDE must act to avoid bankruptcy or insolvency of the business. In such cases we recommend that a CDE have an opportunity to demonstrate to Treasury that maintaining compliance with NMTC would create a reasonable possibility of legal liability for the CDE.

As to CDEs with a controlling ownership interest in a business but without direct control on the board of directors of a business, the CDE, either as a partner in a partnership or as majority shareholder in a closely-held corporation, owes a fiduciary duty extending to other partners and minority shareholders, although that duty is somewhat different from that imposed in the context of control through the board of directors. Regardless, a CDE, eider as a partner in a business or as a majority shareholder in a closely-held corporation, potentially faces a risk of liability similar to that described in the text above, and should be entitled to the same consideration by Treasury in the event the business falls out of compliance with the NMTC.

In closing, there should be little if any risk, especially risk tied to performance. Recapture should be tied to negligence, fraud, etc. and not on poor investment decisions. This is a shallow subsidy for speculative investments.

3c. Should special rules be provided under section 45D(d)(2)(A) for determining whether a newly formed entity meets the requirements for a qualified active low-income community business?

It is important that the NMTC be available to help finance new businesses in communities where there is little business activity. To ensure that start-ups can qualify for NMTC capital, we recommend that a CDE be permitted to rely on 'projected business activity' in satisfying the requirement that a substantial portion of a business' activity is derived from a qualified low-income community. The CDE should be allowed to rely on reasonable expectations based on a certification by the new business supported by its business plan.

Once a newly formed business has been in operation for twenty-four months, we recommend that it be required to meet the general compliance tests that all other low-income community businesses are required to meet in order to stay in compliance with the Credit.

IRS Question Number 4

Section 45D(d)(1)(C) provides that the term "qualified low-income community investment" includes financial counseling and other services to businesses located in, and residents of, low-income communities. What types of services should constitute 'financial counseling and other services' for these purposes?

We recommend that 'financial counseling and other services' be defined to include a broad range of activities, including services that promote community development and are integral to making qualified low-income community investments. Such services would include costs associated with identifying investment opportunities, preparing business owners to use financial products offered to them, underwriting loans and investments, helping business owners create viable business plans, and, after loans and investments are made, enhancing business planning, marketing, management, and financial skills of business owners and serving on their boards of directors.

IRS Question Number 5

Section 45D(d)(1)(D) provides that the term "qualified **low-income community** investment" includes any equity investment in, or loan, to a CDE.

5a. What restrictions, if any, should apply to the use by a CDE of the proceeds of a qualified

low-income community investment received from another CDE?

5b. Under what circumstances, if any, should an investment by one CDE in another CDE lose its status as a "qualified low-income community investment" under section 45D(d)(1)(D)? Should the degree of control of the investing CDE over the other CDE be relevant to this determination?

Any proceeds of an investment from another CDE should meet the same standards of the CDE. For example, accountability to the "target market" is critical. Specifically, community accountability should be met by having representatives of the "target market" on their governing board or use other approaches, such as an advisory board, focus group or community meetings, and that the guidance definition of "representative of low-income community" include a majority who are actual residents or actively involved/employed in the communities.

IRS Question number 6

Under section 45D(g)(3)(B), a recapture event (requiring an investor to recapture credits previously taken) may occur with respect to an equity investment in a CDE if the CDE ceases to use substantially all of the proceeds of the equity investment for qualified low-income community investments.

6a. What circumstances should constitute a change in use of the proceeds of a qualified equity investment that triggers a recapture event under section 45D(g)(3)(B)?

We recommend that the primary focus of compliance be the location of the business and, as stated in our response to question number 3d, we would like to see compliance determined at the time a CDE makes a qualified low-income community investment. If further scrutiny is necessary, then the sole test used in determining compliance should be whether the business continues to be located within a qualified low-income community.

6b. What remedial action(s), if any, should a CDE be permitted to take to avoid recapture under section 45D(g)(3)(B)?

We recommend that a CDE be granted a reasonable period of time to move a low-income community investment back into compliance once it has been deemed to be out of compliance. Regulations should provide a reasonable cure period similar to that provided by the Low Income Housing Tax Credit.

As recommended in our response to question 3b, we suggest that Treasury establish a standard to determine whether a CDE is making a 'good faith' effort to meet compliance versus a standard for 'abusive intent'. If a CDE's qualified investment is found to be out of compliance and the CDE was operating with 'abusive intent' then recapture goes into effect. If a CDE can demonstrate that the CDE made a 'good faith' effort in investing in a qualified investment but for reasons beyond its control the business is no longer in compliance, and the non-compliance cannot be cured, then recapture would not be triggered.

IRS Question Number 7

Section 45D(i)(1) provides that Treasury may prescribe regulations that limit the new markets tax credit for investments that are directly or indirectly subsidized by other Federal tax benefits (including the low-income housing tax credit under section 42 and the exclusion from gross income under section 103). Under what circumstances should investments be treated as directly or indirectly subsidized by other Federal tax benefits?

Tax-Exempt Bonds: A CDE should not be permitted to use the proceeds of a qualified equity investment to purchase tax-exempt bonds. However, there should be no restriction on a qualified

low-income community business' use of tax-exempt bonds *sold to third parties,* even if the low-income community business receives other financing from a CDE attributable to a qualified equity investment. The use by a low-income community business of tax-exempt bonds sold to third parties would be separate from the CDEs financing of the business.

Low Income Housing Tax Credits: Since the rental of residential housing is not eligible under the NMTC, Housing Credits and NMTCs would not generally be available on the same investments. Just to be certain, however, it might be useful to exclude from the definition of a LCB the *development* (i.e., not just the *rental)* of housing receiving (or expected to receive) Housing Credits. The financing of the nonresidential portion of a building should be a qualified low-income community investment regardless of whether Housing Credits are claimed on the residential portion of the building. For this purpose, the amount of the low-income community investment should not exceed the portion of the building's cost reasonably attributable to nonresidential use.

Historic Rehabilitation Tax Credits: Like any other investor, a CDE must already reduce its basis in a property by the amount of any historic rehabilitation tax credit it claims. No further limitation is needed on the use of historic rehabilitation tax credits with NMTCs. The historic rehabilitation tax credit is designed to offset the additional cost associated with meeting historic standards for rehabilitation. The NMTC is designed to address a broader financing gap for low-income community businesses.

Wage Tax Credits (including Work Opportunity Tax Credits, Welfare to Work Tax Credits, Empowerment Zone wage tax credits, and Renewal Communities wage tax credits): No limitation should apply to a CDE's investment in a low-income community business that claims a wage tax credit. NMTCs and wage tax credits serve fundamentally different functions. That is, NMTCs provide capital to a business, while a wage tax credit is designed to encourage hiring of targeted employees by offsetting the additional cost of hiring, training, and turnover. The availability of NMTC financing will not obviate. Neither the CDE nor the low-income community business will typically know at the time of financing whether the low-income community business will be eligible to claim wage tax credits. There is no NMTC requirement that a business must hire targeted employees, and the number of such employees will vary from time to time.

Depreciation: There should be no limitation on a CDE claiming widely available depreciation benefits on investments made with the proceeds of qualified equity investment.

IRS Question Number 8

Section 45D(i)(2) and (4) provides that Treasury may prescribe regulations that prevent the abuse of the purposes of section 45D and that impose appropriate reporting requirements.

8a.What anti-abuse rules may be necessary for carrying out section 45D?

Safeguards should be put in place to ensure that a CDE cannot divert principal and/or capital repayments to be paid as dividends to their investors. We recommend that dividends be limited to actual earnings on a taxable basis and that any payments to investors that cannot be traced as such should be considered repayment of principal and trigger a recapture event if not paid back to the CDE and reinvested appropriately.

Investors should be able to claim only one layer of NMTCs for a given qualified equity investment.

The following example presents a potential abuse. Two CDEs - "CDE-A" and "CDE-B" - each receive allocations for NMTCs on $1 million of qualified equity investments. Investor-I makes a qualified equity investment of $1million in CDE-A, a limited partnership or LLC. CDE-A uses the proceeds to invest in CDE-B, also a limited partnership or LLC. CDE-B uses substantially all of these proceeds to finance qualified businesses. Technically, Investor-I might claim two levels of NMTCs on its single investment of $1 million. The NMTCs allocated to CDE-B would pass through

CDE-A to Investor-I. The NMTCs allocated to CDE-A would also go to Investor-I. We do not believe that such double-dipping should be permissible.

8b. What types of reporting requirements should be imposed for carrying out section 45D?

We reiterate that reporting should be on an annual basis and focus on documentation needed to ensure compliance. We suggest that CDEs be required to provide the following information: financial statements, list of investors, closing and commitment dates, list of eligible investments, terms of investments and location of investments. Other information may be required if it is not included in a CDEs financial statements including information on loan loss or investments reserves and financial counseling and other services to businesses.

As we suggested in our response to question 1 e, Treasury should develop standardized reporting forms that CDEs can submit annually as part of their tax return. In addition, we recommend that Treasury develop standardized forms that CDEs can use in collecting compliance information from the low-income community businesses in which they have investments. While CDEs will be required to certify that all information submitted is accurate and conduct their own due diligence in collecting information from businesses, having a standardized Treasury form will ease the reporting burden on CDEs and simplify reporting to Treasury.

Additional Comments

1. CDEs Purchasing CDE Loans

Section 45(d)(1)(B) provides that the term "qualified low income community investment" includes CDE's purchase from another CDE of any loan made by such entity that is a qualified low- income community investment. Neither the statute nor the accompanying report makes reference as to how the proceeds from such a loan sale must be spent by the CDE from whom the qualified loans are purchased. The Administration's FY 2001 General Explanation of Revenue Proposals states that a CDE would be treated as indirectly making a qualified low-income community investments when it purchases loans made by a CDE, which in turn uses the proceeds from the transaction to provide additional capital or financial services to qualified active community businesses.

We believe that imposing the requirement that a CDE purchase loans only from another qualified CDE provided the proceeds from such loan sales be used to provide capital for qualified low-income community investments would unduly restrict the activity of CDEs. This was not the intent of the statute.

We recommend that a CDE that purchases loans from another CDE instead. The other CDE should be required to demonstrate that either the loans they purchase qualify as low-income community investments or that they be required to document that the proceeds from such loan sales will be used to provide additional capital for qualified low-income community investments.

2. Assigning Value to CDE Assets

In assigning an initial value to an investment a CDE would consider either the original principal in the investments or the market valuation, whichever is lower. Any gain on the investment would only be recorded at the point the CDE exits the investment.

This does not preclude the earning and distribution of dividends on these investments prior to redemption of the CDE's investment.

In terms of defining the valuation process, valuations should be based on the valuation of the business, which looks not only at the balance sheet, but also at the income statements and cash flows, as well as an assessment of the future business prospects. We recommend that CDE valuation policies be developed that are consistent with the venture capital industry as a whole.

This specific issue of valuation is not applicable to CDEs operating as lenders or those making capital investments in real estate.

3. Tracing CDE Investments and Differentiating Between Capital Paid Back and Earnings

This question relates to CDEs making venture investments and is not applicable to CDEs making loans or capital investments in real estate since with most debt structures principal and interest are more defined and therefore easier to trace.

We recommend that Treasury allow the maximum flexibility in how a CDE structures its investment activity while at the same time guarding against abuse. The following examples illustrate the type of tracing that should be required of CDE investments funds.

Example 1. CDE receives $1,000,000 in investments and makes one $850,000 stock purchase investment in a qualified business. Each year the business pays a 50 percent dividend for seven years and at the end of the seven years repurchases the stock at 100 par.

Example 2. CDE receives $1,000,000 in investments and makes one $850,000 stock purchase investment in a qualified business. Each year the business pays a 50 percent dividend for seven years and at the end of the seven years charges off the investment.

In the first example, we do not see any problem. In the second example, the value of the investment disappeared sometime during years six and seven. In this ease the dividend during this period should have been recorded as a repayment of principal. The key is matching the repayments to the valuation on the investment. If the valuation at least maintains its value, dividend payments can be fairly recorded as earnings. If the valuation goes down, the venture fund should reach back - probably not more than 1 year, to reclassify earnings as principal.

In addition, it is important to record stock redemptions as repayment of principal, on the initial cost of the stock - with earnings recorded on the valuation increase on that stock.

It is important that CDEs develop valid valuation policies and procedures and audit mechanisms to ensure that valuations are performed properly and effectively. We suggest that CDEs be required to include a valuation policy in their application for a NMTC allocation and that a final valuation policy be approved by Treasury as part of the CDE's NMTC Allocation Agreement.

We appreciate your consideration of these comments and look forward to working with you as you move ahead in implementing the New Markets Tax Credit.

Sincerely,

/s/Carol
Wayman
Director, Policy
Research and
Development