

IRS Comment Letters
Community Development Venture Capital Alliance Comment on Proposed Regulations
(REG-119436-01) Regarding New Markets Tax Credit

Document Date: June 29, 2001

June 29, 2001

CC:M&SP:RU (REG-119436-01), room 5226
Internal Revenue Service
P.O.B. 7604 Ben Franklin Station
Washington, DC 20044

Dear Madam/Sir:

Community development venture capital (CDVC) funds invest in businesses that create jobs, entrepreneurial capacity and wealth to advance the livelihoods of low-income people and the economies of distressed communities. Because many of their investments are in low-income communities, CDVC funds are logical candidates for New Markets Tax Credit (NMTC) allocations.

The Community Development Venture Capital Alliance (CDVCA) is the trade association of CDVC funds. As a member of the New Markets Tax Credit Coalition (Coalition) and New Markets Group (Group), we endorse the responses of both the Coalition and the Group to the IRS's Advance Notice of Proposed Rulemaking, sent under separate cover. CDVC funds differ from other potential users of NMTCs in two respects, however; first, they invest in businesses with high growth potential (as opposed to, for example, commercial real estate), and second, they invest in the form of equity and subordinated debt with equity kickers (rather than senior debt). Because of these differences, below we provide comments to supplement those of the Coalition and Group that are intended to enable CDVC funds to make the best possible use of the exciting NMTC program.

First a brief background note about CDVC investing: A typical CDVC fund has a life of ten to fifteen years, with the first five years being the investment period during which investments are made; during the remainder of the life of the fund, investments in new companies are not made, but follow-on investments may be made in existing portfolio companies, as appropriate, and investments are exited. CDVC funds are more patient in their exit strategies than traditional venture capital funds, but will exit from a successful investment within a few years if doing so is consonant with a portfolio company's growth plans.

With this as background, we provide the following responses to the IRS questions:

• **Question 1: Substantially All Test**

D. Reinvestment

The NMTC legislation requires that investments in Community Development Entities (CDEs) be maintained for seven years. We support the concept of long-term, patient capital, and are pleased that the credit is available for such a period of time. However, we are concerned about two situations occurring within seven years of investment in a CDE that might trigger the need for a CDE to reinvest tax credit proceeds from one qualified business to another: return of principal on an amortizing loan and successful early exit from an investment. Because they have limited investment periods and do not always have an appropriate pipeline of

investments, CDVC funds are not able to reinvest proceeds at will. Recommendation: We recommend that so long as an investment in a qualified business does not have an initial term of fewer years than the remaining life of the credit, principal received from any investment during the life of the credit need not be reinvested in another qualified business. A model for this provision may be found in the SBIC regulations, which provide as follows: The minimum duration/term of a financing must be for a period of five years. Common stock, options and warrants cannot require redemption by the portfolio company within the first five years. For debt, voluntary prepayment must be allowed. Investments may be exited in fewer than five years, however, if the transaction is part of a change in ownership that, *inter alia*, promotes the sound development or preserves the existence of the portfolio company. 13 CFR §107.830, §107.835, §107.750.

• Question 3: Qualified Low-Income Community Investments

A. Definition

· *Exclusion of Businesses that Develop/Hold Intangibles for License/Sale:* The conference report--but not statute--excludes from the definition of qualified active businesses "any business consisting predominantly of the development or holding of intangibles for sale or license." We agree that companies set up solely for the purpose of *holding* intangibles for license or sale do not advance the purposes of the statute and should not be included. However, companies that *develop* intangibles do potentially advance the purpose of the legislation and should be included. If intangibles *are* deemed to include patents or other intellectual property, the conference report provision would limit the ability of CDEs to use NMTC funds to invest in high-growth-potential businesses such as software companies. *Recommendation:* businesses that develop software and patents should be considered qualified active businesses.

B. Administration

· *Timing of determination: Recommendation:* The determination of whether a trade Or business constitutes a "qualified active low-income community business" should be made at the time of the investment in the business. A business' failure to meet any one of the criteria more than a year after the initial investment therefore should not result in loss of status as a qualified investment. The New Markets Venture Capital regulations may serve as a model in this regard. 13 CFR §108.760(c).

Should the IRS seek a greater degree of assurance that portfolio companies will remain qualified for the duration of the tax credit period, we recommend a "good faith" test. Specifically, a CDE would be required to document at the time of initial investment it has performed sufficient due diligence to determine that the portfolio company has demonstrated an intention and likely ability to remain a qualifying investment for the duration of the tax credit period.

· *Degree of CDE control:* The degree of control that a CDE has over a business should not be relevant to the determination of whether the business has ceased to be a qualified business. Such a provision would make NMTC investing more difficult for CDVC funds--which generally retain some voting rights in their portfolio

companies--than for CDEs that invest only in the form of debt. This provision would have two alternative effects on CDVC funds, both of them negative. The provision would either deter CDVC funds from undertaking equity investments entirely or from retaining voting rights in their equity investees. Neither result would be desirable, insofar as CDVC equity financing is greatly needed, and investor retention of voting rights is an essential way to mitigate the risk of these inherently risky investments. Alternatively, high growth companies with potential to create good jobs for low-income people would refuse to accept much-needed equity investments from CDEs in the knowledge that CDEs would prevent them from taking any action that might jeopardize their status as qualified businesses, even if such actions constituted logical ways to grow a business and would provide even more jobs and services in low-income areas.

If the degree of control that a CDE has over a business is nonetheless a factor in determining whether the business has ceased to be a qualified business, "control" must be defined carefully. We agree with the NMTC Coalition position that control should be defined as at least 50% of voting power. However, we prefer that control be defined as ownership of 80% of voting stock. This is because typical CDVC agreements provide that certain events trigger 50% voting power; however, CDVC funds are often reluctant to exercise control in such situations because of the disadvantages of disrupting management. In contrast, a CDVC fund with 80% voting power has true control over a portfolio company. Moreover, the 80% definition is in keeping with the ownership threshold for consolidation of financial statements under Generally Accepted Accounting Principles.

In any event, it is important that control be defined not as the possibility of control (through options, warrants, or certain default provisions), but actual ownership of a certain percentage of voting stock.

· Question 4: Financial Counseling and Other Services

For the reasons below, we support the recommendation of the NMTC Coalition 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.

Investing in low-income community businesses is resource intensive. The typical annual cost for management of a CDVC fund and provision of technical assistance to potential and actual portfolio companies is 8% of funds under management. Thus, for a fund with committed capital of \$10 million, this cost would be \$800,000 annually until investments are harvested.

Moreover, the cost of management poses a cash flow burden on CDVC funds in the early years for two reasons. First, as with all venture capital funds, the cost of management for a CDVC fund is a function of committed capital, even if not yet paid in. This means that during each year of a \$10 million fund's investment period, the management cost is the same \$800,000, regardless of whether \$1 million or \$10 million in capital has been called from investors and invested in qualifying businesses in that year. Second, in contrast to loan funds, which usually receive interest income from the beginning, most CDVC funds have no or only minimal current return in the early years because they invest patient capital. Particularly in their early years, CDVC funds--like other venture

capital funds--must therefore pay the costs of management from capital contributions. If they are unable to do so, CDVC funds will not be able to provide the management and technical assistance necessary to ensure successful investments in low-income communities.

It is therefore essential that the term "financial counseling and other services" be read broadly to allow CDEs to pay for the extensive development services that are vital to their efforts to provide financing in low-income areas effectively. Allowing a portion of tax credit investments to be used for these services will promote the ultimate purpose of the program. The extent to which funds may be used for these purposes will be limited by investors (because using funds for other than investment purposes will lower returns), and no further limits need be placed on this use by regulation.

Recommendation: Financial Counseling and Other Services should be defined to include a broad range of activities, similar to the definition of Development Services, in the CDFI Fund regulations: "services that promote community development and are integral to making qualified low-income community investments". 12 CFR §1805.104(q). These 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.

· **Question 5: Intermediaries**

Under the statute, investments in financial intermediaries such as CDVCA are qualified low-income community investments insofar as these intermediaries are CDEs. We are pleased with this provision, which was intended to allow organizations like CDVCA to help smaller entities that may not have the infrastructure necessary to apply for and report on NMTC proceeds. To achieve this objective fully, it is important that the qualified low-income community investments in which intermediary CDEs invest not be subjected to the same level of tracking as the intermediary CDEs themselves. To this end, we join with the National Community Capital Association in making the following alternative recommendations.

Recommendation:

1) Do not require tracing at the second-tier CDE level for Community Development Financial Institution (CDFI) intermediaries, but put other mechanisms in place to prevent fraud and abuse.

In this case, we believe that it makes sense to have a separate evaluation process for organizations that apply as CDE/CDFI intermediaries, which focuses on both the intermediaries' financing track record to the extent one exists and the CDEs/CDFIs in which they have invested, similar to the intermediary component of the CDFI Fund. Having a separate process (and different reporting) for intermediaries would prevent any organizations from simply receiving an allocation and setting up a second-tier CDE in order to avoid the NMTC reporting/recapture burdens. One mechanism to prevent abuse for CDE/CDFI intermediaries could include working into the certification and re-certification process for CDEs the possibility of decertifying second-tier CDEs if they are not using funds for their purposes stated in their community development missions.

Another mechanism to prevent abuse could be for second-tier investments from CDE/CDFI intermediaries to be limited to certified CDFIs, as these organizations have already undergone a more extensive review process than the CDE requirements.

2) Require tracing at the second-tier CDE level, but make the reporting and recapture burdens less for the second-tier CDEs, such as:

(a) requiring the second-tier CDE to be evaluated only for the substantially-all test at one point in time (i.e. one year after receiving an investment from a first-tier CDE), and

(b) requiring the second-tier CDE to only send a certification letter to Treasury that they are meeting the requirements of the substantially-all test (rather than the full paper work required of the first-tier CDE).

Again with this option, it probably makes sense to have a separate evaluation process for CDF--JCDFI intermediaries which focuses both on the intermediaries and the CDEs/CDFIs in which they invest.

• **Question 6: Recapture**

We agree with the NMTC Coalition that the principal test used in determining compliance should be the location of the business. However, it is possible that in order to meet its growing need for space, a portfolio company will have to relocate a short distance to a location that happens not to be in a qualifying census tract but which nonetheless employs the same people and serves the same community. We therefore propose that businesses that have moved out of low-income areas be considered to remain in compliance (and therefore not trigger recapture) if they continue to serve low-income communities and/or employ people of low income.

• **Other**

• **Coordination with New Markets Venture Capital**

NMTC and New Markets Venture Capital (NMVC) were initially conceived as complementary programs. It was anticipated that some CDFIs would create NMVC companies and understood that NMTC allocations could be used to raise the NMVC private equity match. This year's expedited NMVC timeline poses a challenge to such coordination, however. NMVC applications were due in May, conditional designations will be announced in July, and private equity matches must be raised by September 14, 2001. *Recommendation:* We recommend that conditionally-designated NMVC companies automatically be deemed CDEs, and that NMTC allocations in the amount of the private capital matches required for NMVC companies for that year be set aside for NMVC companies each year. CDVCA is making every effort to extend this year's NMVC timeline in order to allow for coordination between NMVC and NMTC this year. We recommend that IRS work with CDFI and SBA to coordinate the two programs, even if this involves an expedited NMTC allocation process specifically for conditionally-designated NMVC companies.

• **Request for Clarification**

If a CDE wishes to accept equity investments from both taxable and non-taxable investments, must it apply for an allocation for the total amount of investments or may it apply for an allocation for the amount of investments expected to come from taxable entities only? Please provide

an example for an anticipated \$10 million CDE, with \$5 million expected from taxable investors and \$5 million expected from non-taxable investors that invests \$7.5 million in qualified low-income community investments: must the CDE apply for a \$10 million NMTC allocation (and then allocate NMTCs proportionally to all investors--\$3.75 million each, even if the non-taxable investors are unable to take advantage of those credits due to their tax exempt status), or may it apply for a \$5 million NMTC allocation (and then allocate all \$5 million in NMTCs to those taxable investors only, even if other CDE financial benefits--for instance, income--are allocated proportionally among all investors). Please note that the latter option would ensure that NMTC allocations are not "wasted" on non-taxable investors in CDEs, and that maximum public benefit is derived from the NMTC program.

Thank you for consideration of these comments. We hope you will be able to integrate these in any further guidance or regulations that IRS may issue. Should you have any questions, do not hesitate to contact me at (212) 980-6790, ext. 18.

Sincerely,

/s/

Kerwin Tesdell
President

cc: Eric Solomon, Senior Advisor for Tax Policy, U.S. Department of Treasury
Jeff Berg, Acting Director, CDFI Fund