

IRS Comment Letters
PricewaterhouseCoopers Comment on Proposed Regulations
(REG-119436-01) Regarding New Markets Tax Credit

Document Date: June 22, 2001

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The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
Attn: CC:M&SP:RU (REG-119436-01), room 5226
POB 7604, Ben Franklin Station
Washington, DC 20044

Dear Mr. Commissioner:

The venture capital partners of one of our clients have requested that we submit their enclosed comments in response to the Internal Revenue Service request for comments on Section 121(a) of the Community Renewal Tax Relief Act of 2000. They are very qualified to comment on the New Markets Tax Credits Program as a result of their experience with similar programs on the state level. They raise venture capital and private-equity funds from the private sector for use in targeted areas, including areas that would be considered low-income communities under IRC Section 45D. Further, these funds have been raised under incentive programs using state tax credits similar to the New Markets Tax Credit Program.

They anticipate participating in the New Market Tax Credit Program and intend to request an allocation of tax credits pursuant to IRC Section 45D. Given their experience, if they receive an allocation, they expect to raise the full amount allocated to them shortly after the allocation is made, and would be delighted to meet with representatives of the IRS to discuss these comments further and offer any other assistance that you may feel appropriate.

Thank you for your time and consideration of these comments. Please contact me for further information on the client, similar programs or if you wish to discuss these comments further.

Sincerely,

/s/John R. Harman III

Enclosure

**Comments regarding the New Markets Tax Credit Program – Section 121(a)
of the Community Renewal Tax Relief Act of 2000**

Overview and General Comments

Our investment strategy currently envisions creating a Qualified Community Development Entity ("CDE") that would raise a significant amount of capital under the Program from its investors all at once (a "single-funding" CDE). These funds

then would be dedicated for investment in low-income communities, primarily those communities that are within and around the metropolitan areas to which our current funds are dedicated. This would allow us to leverage the deal flow, personnel and infrastructure in these locations to invest funds raised under the New Markets Tax Credit Program (the "Program") efficiently and prudently. Given this structure, we believe that it is particularly important to address the timing and holding periods of the required investments in low-income communities.

In our experience, the single-funding CDE is one of the two structures that are likely to be used by CDEs in attracting capital under the Program, the other being a CDE that raises funds for a particular project or transaction that is identified prior to closing (a "single-project CDE"). Single-project CDEs most likely will be established to fund real estate redevelopment transactions and other large "one-off" transactions that can support the costs of a one-time capital raising transaction. There is also the possibility that a CDE might secure commitments from its investors and then make capital calls as investments are identified. Given the fact that the investors will not begin to earn tax credits under the Program until they actually invest in the CDE, this structure may prove to be less attractive than a single-funding CDE. Furthermore, this structure is really just a variation of the "single-project" CDE (several capital draws for large identified investments) and presents many of the same issues as does a "single-project" CDE.

Unlike a single-project CDE, we prefer to establish a single-funding CDE that will serve as an ongoing capital source for businesses in the low-income communities in which we operate. We will not identify the businesses into which we will invest until after the funds has been raised. Over a period of several years after we have raised capital under the Program, we would invest those funds in many different businesses in, these low-income communities. This structure will ensure that many businesses have an opportunity to receive investments from the fund and increase the likelihood that the fund can grow to be an independent, self-funding capital source that can continue to provide capital for businesses located in low-income communities long after the sunset of the Program. In addition, a single-funding CDE will be able to spread the cost of fund-raising over many different investments and, therefore, be able to make very small investments that would not be cost-effective under a single-project structure. We believe that it is important for the IRS to keep both of these structures in mind as it drafts the regulations for the Program, so as not to inadvertently eliminate the use of either type of fundraising structure.

Specific Comments

1. The 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.

(a) 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?

Section 45D(b)(3) establishes a safe harbor for the "substantially all" requirement contained in Section 45D(b)(1)(B) that is satisfied if a CDE invests at least 85% of its aggregate gross assets in qualified low-income community investments. Provided a reasonable amount of time is given for the CDE to invest the proceeds that it receives from the issuance of Qualified Equity Investments ("QEIs") into qualified low-income community investments (See comment 1(c) below), we do

not feel that the 85% requirement is unreasonable.

Under this safe harbor provision, a CDE will have 15% of the gross proceeds from any issuance of QEIs to fund the offering and closing costs of the issuance of the QEIs (underwriting fees, legal fees, accounting fees, etc.), as well as to pay management fees to cover the costs and expenses of operating the CDE on a day-to-day basis. This portion of the proceeds should be sufficient. Typically, closing costs and underwriting fees range from 5-10% of the funds raised, with management fees averaging approximately 2.5% annually. With respect to the annual management fees, it is important to note that we also recommend that income from the investments made by the CDE will also be available to fund this expense.

While we would support lowering the threshold to a percentage less than 85%, as a reduction would provide additional flexibility in structuring both the fundraising process and the CDE's operations, we would also point out that too low of a percentage would seem to defeat the purpose of the "substantially all" test, which is to ensure that the vast majority of the proceeds of any offering of QEIs are invested in qualified low-income community investments.

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

Section 45D(d) sets forth the four general categories of qualified low-income community investments that are permitted under the Program. The comment will address each type of investment individually.

(A) any capital or equity investment in, or loan to, any qualified active low-income community business

With respect to direct investments by a CDE into qualified active low-income community businesses, we recommend that the full dollar amount actually invested into such businesses be treated as having been invested. Items such as underwriter's fees, broker fees, closing costs, commitment fees, etc. are common expenses associated with making investments and, thus, should be considered the costs of, and part of, the investment. Thus, if a CDE invests \$1 million in preferred stock issued by a qualified active low-income community business, the CDE should receive credit for a \$1 million investment, even if a certain portion of the proceeds of the investment are used to pay an underwriting commission. Likewise, if the CDE makes a loan that carries a 2% commitment or closing fee, the CDE should get credit for the full amount of the loan. On the other hand, funds held in reserve for future follow-on investments in a qualified active low-income community business should not be counted as invested until such time as the funds are actually invested into the qualified business. Since these types of investments consist of actual transfers of cash to businesses, it seems appropriate that the full amount so transferred by the CDE in consideration for the security (whether through the issuance of stock or through a loan) should be considered when determining whether or not the CDE has satisfied the "substantially all" test. In addition, the amount transferred can be easily determined and tracked.

(B) the purchase from another qualified community development entity of any loan made by such entity that is a qualified low-income community investment

In our opinion a CDE that purchases a loan or a portion of a loan from another

CDE should receive credit for the lower of (i) the principal amount (or portion thereof) of the loan purchased and (ii) the price paid to the other CDE for the loan.

Since the focus of the calculation should be on the funds received by the qualified business, it seems appropriate that the purchasing CDE should only be entitled to credit for the portion of the principal amount of the loan that it purchases. For example, if due to interest rate fluctuations, a CDE is willing to purchase a \$400,000 principal amount loan from another CDE for a purchase price of \$410,000, the purchasing CDE should only receive \$400,000 credit for the investment, since that is all that was actually invested in the qualified low-income community business. On the other hand, if the same loan, due to a decrease in credit quality, was purchased by the second CDE for \$200,000, it does not seem appropriate to give the purchasing CDE credit for more than the amount of funds it spent acquiring the loan. The standard set forth in the first paragraph of this comment should address both situations.

(C) financial counseling and other services specified in regulations prescribed by the Secretary to businesses located in, and residents of low-income communities

We believe that it is important for CDEs to be involved in all areas of economic development in the communities that they serve. Counseling with respect to business plan drafting and financing alternatives should be encouraged. If a CDE bears the costs of putting on drafting workshops or economic development seminars that are held in low-income communities, these clearly should be included as an investment under the program. In addition, CDEs should be encouraged to support, counsel and provide value-added assistance to the companies in which it invests. The costs of providing those services, whether provided internally or through third-party consultants, should also be included as investments. These are only a few of the potential services that a CDE could offer to the low-income communities that it serves.

Given the wide array of services that could be provided by a CDE, it is unlikely that a regulation encompassing all of them is feasible. On the other hand, it is our view that this is an area that is ripe for potential abuse if not subject to rather strict guidelines and auditing. In order to prevent abuse, perhaps such expenses could be subject to approval by the IRS or the Community Development Financial Institutions Fund (the "Fund"), depending on who will have direct oversight of CDEs. If the regulating entity determines that a cost or expense was improperly incurred or does not qualify under the Program, no credit would be given for that expense. This would be determined as part of the periodic audits and reviews of the CDEs. Additionally, the IRS might consider placing a cap on the total amount (calculated as a percentage of the funds that a CDE must invest in low-income communities) of credit that a CDE may receive from these types of activities, so as to ensure that every CDE has at least some capital investment aspect.

If a comprehensive rule is not adopted and a more *ad hoc* analysis is chosen, we do suggest, however, that CDEs be given the ability to seek approval of these types of expenses prior to actually spending the money. This will ensure that a CDE does not incur a large expense in trying to help the communities it serves only to lose credit for such an investment as the result of a later audit. This would also give the regulating entity the opportunity to guide the CDEs and encourage them to provide the services that the particular low-income communities served by the CDEs need. Perhaps the IRS can adopt a regulation that spells out several categories that are approved with an additional provision that lets the IRS approve expenses on a case by case basis. This may reduce some of the oversight required of the regulating entity.

(D) any equity investment in, or loan to, any qualified community development entity

All funds actually advanced to a CDE should be counted; provided that the 85% (or lower percentage that the IRS establishes) "substantially all" test also applies to such funds.

(c) 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?

As mentioned in the general comments set forth above, we intend to establish a single-funding CDE that would invest in businesses located in low-income communities over time. We will not identify businesses in which to invest prior to issuing QEIs, but rather will first issue QEIs, and then only after the funds are raised, begin to analyze deal flow and invest in businesses in low-income communities. This structure, of course, assumes that there will be a sufficient amount of time from the date on which QEIs are first issued to the date by which the "substantially all" test must be satisfied, during which we would identify and fund qualified active low-income community businesses.

We recommend that CDEs be given at least five years to satisfy the "substantially all" test. If the deadline is any shorter than five years, the Program will most likely be limited to single-project CDEs that focus on individual transactions. Such a CDE would issue QEIs only once a transaction was identified and ready to be funded. This works well for real estate redevelopment and other types of "one-off" transactions but not for a fund concept. In order to provide an ongoing capital source for businesses in low-income communities, however, a CDE needs to be able to first raise funds, then work in the community to create deal flow and fund prudent deals as they come along. It is important to understand the amount of work that the CDE will have to do in the community to identify and facilitate good investment opportunities. It is very difficult to do this if the funds are not guaranteed but rather must be found after the deals are identified. Therefore, any requirement that the 85% (or lower) test be satisfied immediately or even within a short period of time, risks eliminating the potential for the Program to create these types of ongoing sources of capital.

If there is a counterbalancing concern that funds raised under the Program might be held uninvested until some date close to the five year deadline and then invested in full, we suggest that investment milestones could be added that could be tested after the second, third, fourth and fifth anniversaries of the issuance of QEIs. For example, the CDE may be required to invest 30% of the funds by the second year, 50% by the third, 65% by the fourth and 85% by year five. Compliance with this type of requirement could be confirmed as part of an annual audit/review of the operations of each CDE. Failure to meet the milestones established by the regulations would constitute a recapture event under the Program. This type of investment milestone structure has worked quite well with the state tax credit programs under which we currently operate.

Creating ongoing sources of capital for low-income communities should be an important goal of the Program. Without some structure like these staggered investment hurdles, the Program's effect will most likely be limited to "one-off" transactions and real-estate deals, which, in our view, would be quite unfortunate and a missed opportunity. In addition, it would all but eliminate the ability-of CDEs to establish micro-lending programs that have been quite successful in low-

income communities because such micro-lending programs consist of many small transactions. If the CDEs were to have to raise funds for each transaction or even for each group of transactions every six months, the transaction costs for small investments would become prohibitive. A single-funding CDE would be able to spread the cost of fundraising over an entire portfolio of investments and, therefore, make even the smallest investments cost-effective.

(d) 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?

As mentioned above, we believe that the most effective way to administer the "substantially all" test is to establish specific investment milestones that must be satisfied over time by the CDEs. This structure involves a determination of the cumulative amount of investments made in qualified businesses by the CDE. It seems impractical to require that the funds dedicated to the low-income communities be invested continuously throughout the seven-year period. This requirement would prohibit the use of single-funding CDEs and result in the use of single-project CDEs almost exclusively. It would eliminate any hope of establishing single-funding CDEs to serve as recurring sources of capital for low-income communities.

The more appropriate paradigm, in our opinion, is to take the view that the federal government has issued a certain amount of tax credits in exchange for a commitment from a CDE that a certain amount of funds will be invested in low-income communities. The CDE makes the commitment to invest these funds over time. Once it has placed 85% of the funds that it raises into investments in low-income communities, the CDE has fulfilled its end of the bargain. Furthermore, requiring reinvestment of funds returned to a CDE from its portfolio companies would penalize those CDEs that have made the most successful investments. These CDEs would wind up investing far more than the 85% required of all CDEs, while CDEs who have poor investment performance would most likely only invest the minimum 85%.

Additionally, it is impractical to expect a CDE to have new investments identified at exactly the time when its earlier investment mature. There is no guarantee that a CDE will have another prudent investment identified at the point when, for example, one of its earlier loans is paid in full.

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

As mentioned above, we recommend that there be a phase-in period after QEIs are issued during which the CDE would be able to find and fund investments in low-income communities. If the IRS thinks it helpful, there could be milestones included like the ones mentioned above. We suggest an annual audit/review by the primary regulating agency to determine that the CDE has satisfied the investment requirements.

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.

(a) 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 the gross proceeds from the issuance of any QEIs. This number is readily determined and is directly linked to the amount of tax credits (and therefore the cost to the government) issuable under the Program. In addition, this will discourage CDEs from incurring exorbitant closing costs, etc., as the costs of closing will not reduce the overall amount of money that must be invested in low-income communities.

In addition, we do not think it advisable to include other assets held by the CDE in the calculation of "aggregate gross assets." If this were the case, most applicants would establish separate entities without assets through which they would issue QEIs. This merely creates additional costs to the Program and reduces its efficiency for no perceived benefit.

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

See comment 2(a) above.

(c) 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 mentioned in the comments above, we recommend that a set of investment milestones be imposed on CDEs that would ensure that, within five years of the issuance of QEIs, 85% of the "aggregate gross assets" of the CDE would be invested in low-income communities. For example, if a CDE issued QEIs on December 31, 2001 yielding proceeds of \$10 million, the investment schedule would require that \$3 million be invested in low-income communities by December 31, 2003, \$5 million by December 31, 2004, \$6.5 million by December 31, 2005 and \$8.5 million by December 31, 2005. This schedule ensures that the funds flow to low-income communities on a schedule that is faster than the schedule on which the tax credits are taken.

Use of this type of phase-in schedule is the only mechanism that will allow the Program to be utilized to establish single-funding CDEs that can be sources of capital rather than one-time providers of capital. If the funds must be invested immediately after they have been raised, the Program will most likely be used exclusively for "one-off" transactions that have a likely seven-year holding period. It would simply be prohibitively expensive to try to structure a fund that had to draw down funds from investors (issue QEIs) each time an investment in a low-income community was identified. In addition, a structure that mandates immediate investment also favors large investments, which can justify one-time transaction costs. Often what low-income communities need are micro-lending programs and "angel"-type equity capital in denominations that are simply too small to justify the costs of issuing new QEIs for each investment. Therefore, if one of the goals of the Program is to establish efficient sources of capital that can be accessed by businesses in low-income communities on an ongoing basis, some type of phase-in of the 85% requirement is needed.

One safeguard that has been used under other similar programs to ensure that

the entities do not lose, as a result of bad investment decisions, the funds that they raise prior to making the qualified investments in low-income communities, is a restriction on the types of investments that the CDE may make with the proceeds of QEIs while it is sourcing investments. For example, the guidelines might require that CDEs only invest the proceeds from the issuance of QEIs in government securities and other investment-grade securities, until the CDE identifies qualified low-income community businesses in which to invest.

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)).

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

In general we recommend that the "substantial portion" tests should be satisfied at the 50% level. If a business can demonstrate that at least 50% of its tangible property is located within a low-income community, it should be deemed to have satisfied this requirement. With respect to the employee requirement, we would suggest that satisfaction of this requirement could be demonstrated if at least 50% of the employees of the business have their principal place of employment in a low-income community. The difficult question with employees will always be salespersons. These types of employees will usually be mobile and hard to tie to a single location. The IRS might consider specifically addressing the sales representative issue; however, a 50% test should provide sufficient flexibility to address most businesses.

With that being said, we do think that it would be advisable to include within the rules a process by which a CDE could apply to either the Fund or IRS, depending on which is the main regulating entity, to approve a business that does not quite meet the exact requirements of the definition of a qualified active low-income community business. This would give the regulating entity the ability to approve borderline cases that, in its opinion, would promote the aims of the Program and benefit the particular low-income community where the business is located.

(b) 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 strongly recommend that the determination of whether or not a business is a qualified active low-income community business should be made at the time of the CDE's initial investment therein. In most cases the CDE will not have control over the businesses in which it invests. To penalize the CDE for the future actions of businesses in which it invests would seem somewhat unfair. To prevent abuse, the regulations could include a provision that would not give the CDE credit for a particular investment if the business in which the investment was made ceased to meet the criteria of a qualified active low-income community business within some very short time frame (i.e. 90 days) after the CDE's investment,¹ unless the business could offer a good faith business reason for the change in status. This would prevent a CDE from structuring an investment as a low-income community investment when in substance the business would not qualify, but still allow the business enough flexibility to operate in a prudent manner.

The IRS might also consider adding a provision that would let a business qualify as a qualified active low-income community business, if after, and as a result of, the investment in such business by a CDE, the business meets the requirements of the definition. This would allow a CDE to fund the relocation of businesses to low-income communities. Such a requirement, for example, might require that the business satisfy the criteria within 90-120 days after receiving the investment from the CDE. This type of rule could prove to be a powerful economic development tool for low-income communities by allowing them to attract established businesses that, absent the availability of investment capital under the Program, would have no interest in relocation.

(c) 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?

We do think that it would be appropriate to include provisions that would allow for qualification of newly formed entities. Provided such a business could demonstrate through its business plan and planned use of proceeds from the investment by the CDE that its operations would result in its satisfying the criteria of the qualified active low-income community business definition, a CDE should be able to fund such a business. The IRS may want to consider also including provisions by which it could review the operations of the newly formed entity after some period of time to examine whether or not the business did eventually meet the criteria. If the business was found to have included misrepresentations in its business plan or use of proceeds, the CDE should receive no credit for the investment. This review should be conducted within the time frame in which the newly formed business projects that it will be in compliance with the definition. We also think it would be prudent to restrict CDEs from making investments in qualified businesses that are affiliated with the CDE prior to making the investment. In particular with respect to new businesses, such an affiliation could give the perception of impropriety.

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 purposes?

As mentioned above in comment 1 (b), we feel that there are many different ways in which a CDE can provide services to the low-income communities that it serves. These services can be general in nature (sponsoring economic development seminars for an entire community) or company specific (working with a business to write a business plan or to find the right personnel). Due to the broad array of services that could be performed, we recommend that the IRS resist issuing a rule that would specifically list what would qualify. It seems that this would be extremely difficult and could potentially result in worthwhile activities being disallowed. As suggested in comment 1(b), an *ad hoc* approval would offer the CDEs much more flexibility in their ability to structure and participate in the those activities that the particular low-income communities that they serve need. The IRS could issue some general guidance on the types of activities that certainly will qualify with an additional provision that includes any cost or expense approved by the IRS or the Fund. This structure may reduce the oversight of the regulating entity by limiting the pre-approval process only to those types of costs and expenses that are not clearly listed.

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

(a) 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?

If a CDE is to get credit toward the "substantially all" test for investments in other CDEs it only seems appropriate that the funds invested in the second CDE also be subject to the "substantially all" test. In that case, we recommend that the test be raised to 100% to ensure that CDEs do not use layers of CDEs to reduce the total amount of funds that are required to be invested in low-income communities.

(b) 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?

We believe that an investment by a CDE in another CDE should lose its status as a qualified low-income community investment if a "recapture event" (as defined in 45D(g)(3)) occurs with respect to the CDE in which the investment is made. This ensures that the first CDE cannot eliminate the need to comply with the Program's rules merely by investing through another entity. In addition, we feel that this rule should be applied regardless of the amount of control that the investing CDE has over the CDE that receives the investment. If a CDE is aware of the need to force the receiving CDE to comply with the Program's requirements, the investment agreement between the two entities can be crafted to provide sufficient oversight by the investing CDE to ensure compliance by the receiving CDE.

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.

(A) 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)?

As mentioned above, we recommend that an investment milestone structure be included through which a CDE can achieve compliance with the 85% "substantially all" test over time. Given this structure, the event that would trigger a recapture event would be a failure by the CDE to invest the appropriate percentage of funds in low-income communities by the dates set forth in the investment milestone schedule. This assumes that a CDE is not required to continually be in compliance with the 85% test, which, as discussed above, we feel is impractical other than for large, "one-off" transactions.

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

Under the structure we propose, there would be two instances where a CDE would be subject to a recapture event under section 45D(g)(3)(B). The first would be a situation where the CDE simply failed to invest sufficient funds in qualified low-income community investments by the deadlines established in the regulations. In this situation, because compliance is within the control of the CDE, we feel that the CDE should be allowed only a short remedial period during which to come into compliance, perhaps 30 days. Such a short time frame will only be of any help to a CDE that was close to satisfying the requirement and only failed due to events beyond its control, such as the delay in the closing date of a planned investment. It would not provide enough time for a CDE that was chronically late to make up for its failure to invest in a timely manner.

The second situation involves a CDE that believes that it has complied with the investment milestones but, as a result of a review/audit by the regulating entity, finds that one or more of its investments do not qualify. In this situation, we believe that it is only fair that the CDE be given a longer period of time, perhaps 120 days, in which to find a new investment to replace the one that the regulating entity rejected. This would prevent a CDE from experiencing a recapture event when, in good faith, it had believed it satisfied all of the Program's requirements.

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 investment be treated as directly or indirectly subsidized by other Federal tax benefits?

Other than the benefits listed in the request for comments, we are unaware of other federal tax benefits that should be addressed. Our general comment is that any investment that would otherwise qualify as an investment in a qualified active low-income community business should be rejected under this type of regulation only if other federal tax credits can be earned as a result of such investment. The regulation should be, in effect, limited only to ensure that there is no "double-dipping" with respect to federal tax credits.

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.

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

Throughout these comments we have indicated areas where we believe anti-fraud type provisions would be appropriate. In addition, the IRS should consider adding failure by a CDE to comply with reporting requirements established by regulation or giving false information about or misrepresenting its investments as recapture events. In general, the potential for recapture provides the regulating entity with the leverage to force CDEs to respect the Program's requirements. Therefore, any anti-abuse provisions should be tied to either the rejection of an investment as qualifying as a low-income community investment (indirectly leading to a recapture event) or a recapture event in and of itself.

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

Especially if an investment milestone structure is adopted, the regulating entity should impose annual reporting requirements. A CDE should report to the IRS and the Fund, on an annual basis, the amount of QEIs it has issued, who the investors were, who currently is eligible to take the credits as a result of holding the QEIs, the date on which they were issued, and detailed information about the low-income community investments that it has made (number, dollar amount, location). In addition, CDEs should collect sufficient data from the businesses in which they invest to demonstrate the status of such businesses as qualified active low-income community businesses (i.e. financial statements, asset lists, affidavits attesting to compliance, business plans, etc.), all of which shall be made available to the representatives of the regulating entity as part of its annual review/audit of the CDE.

Throughout these comments, we have made reference to an annual audit/review of the CDEs by the regulating entity. We believe that this type of review is needed to ensure that the CDEs are continuously in compliance with the requirements of the Program and to provide the IRS with the earliest indication that a CDE is no longer in compliance and that credits must be recaptured. Having been through several of these types of audits in the several states in which we operate, we would be happy to share our views on how these audits could best be conducted.