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

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THE ENTERPRISE FOUNDATION

July 2, 2001

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

Dear Madam/Sir:

The Enterprise Foundation appreciates this opportunity to comment on the above-referenced advanced notice of proposed rulemaking (ANPR) regarding regulations the Internal Revenue Service may release governing the New Markets Tax Credit (NMTC).

Enterprise is a national nonprofit community development organization that raises capital and deploys it through community-based groups for affordable housing and economic development initiatives in distressed neighborhoods nationwide. Our subsidiary, the Enterprise Social Investment Corporation (ESIC), has used the Low Income Housing Tax Credit to generate $3.2 billion of private equity investment to finance more than 70,000 affordable apartments for low-income people. In addition, ESIC has used the Historic Rehabilitation Tax Credit to finance innovative commercial and office redevelopments of abandoned industrial sites.

Enterprise was actively involved in helping develop and advocate for enactment of the NMTC. The Credit is the most promising incentive for economic development in distressed areas in more than 20 years. It is tailor-made to work within the nation's increasingly sophisticated and demonstrably successful system for bringing private capital into parts of the country that were left behind during the recent historic economic expansion. As the economy slows, the Credit becomes an even more important resource. We urge the Service to publish regulations implementing the Credit this year so low-income neighborhoods, which will be most impacted by sluggish economic growth, will not fall farther behind. We pledge our assistance to the Service in that effort.

As a steering committee member of the New Markets Tax Credit Coalition, Enterprise wholeheartedly endorses the Coalition's comments on the ANPR. This letter reiterates and expands somewhat upon those comments regarding issues we believe are particularly important.

Substantially All Test

Question 1 of the ANPR deals with the "substantially all test," that is, how community development entities (CDEs) should be required to meet the statutory directive that "substantially all" their cash received in exchange for investments be deployed in "qualified low-income community investments."

We recommend that "substantially all" be defined as 85 percent of the cash received in exchange for investments in a CDE. (This would allow a CDE to use 15 percent of cash for administration and management.) We recommend that the 85 percent be comprised of funds either invested in or

loaned to qualified low-income community investments, committed and legally obligated--such as through a line of credit or construction loan--to qualified low-income community investments or committed to a reserve fund. We recommend a cap of 10 percent on funds committed to reserves. We recommend that non-performing assets that are in compliance with the low-income community investment requirements should be included for purposes of the substantially all test and for the purpose of meeting the similar 85 percent tracing "safe harbor."

In addition, we recommend that a CDE be given the option of using one of the following formulas to monitor compliance with the substantially all test:

> *Option 1:* A CDE would have up to six months to comply with the test each time it secures cash in the form of a qualified equity investment. 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 investment in years two through five in order to maintain compliance. In year six, 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 percent.
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> *Option 2*: A CDE would have up to 12 months to comply with the test each time it secures cash in the form of a qualified equity investment. 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 seven, the substantially all standard would be reduced to 65 percent. This formula would guarantee a net weighted average investment level of 70 percent.

Under each formula, the "clock" would start ticking each time a CDE receives an investment. We recommend that a CDE be required to select one of these monitoring formulas on the first annual income tax return that the CDE files after the 12-month deadline has expired. 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 the cash was 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.

We recommend that a CDE be granted a grace period of up to 12 months to reinvest any principal and/or capital re-payments made back to it 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 the substantially all test.

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 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 formulas previously described.

We recommend that Treasury develop standardized reporting forms that CDEs can submit annually. 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, a standardized Treasury form will ease the reporting burden on CDEs and simplify reporting to Treasury.

Qualified Active Low-Income Community Business

Question 3 deals with the definition of "qualified active low-income community business," including how a business may meet the statutory requirement that at least 50 percent of its gross income be derived from "active conduct" in low-income communities. Question 3 also addresses how a business should meet the statutory requirements that a "substantial portion" of its performance of services and use of tangible property occur in a "qualified low-income community." And Question 3 deals with the conditions under which a business would cease to be "qualified."

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 NMTC 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 necessarily sales--must occur within a low-income community. For service 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, unless otherwise elected, so as not to disqualify the business under the "gross income test." Finally, we recommend that the regulations provide that a business may expand outside a low-income community without losing its qualified status by forming a separate subsidiary, such as a limited liability company, to conduct business in the non-qualified area.

We recommend that the following multi-criteria tests be used in determining whether a qualified low-income community business satisfies the "tangible property test" and the "service performance test." These multi-criteria tests were developed in order to ensure that a variety of low-community businesses that we believe the Credit was intended to assist can be reached.

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 may not be low-income.

Total Gross Income Test
We recommend that a business be able to satisfy the gross income test if it can demonstrate that 50 percent of the business' total gross income is derived from:
a) active business conducted in a qualified area;
b) operation of a major facility in a qualified area; or
c) working with people in qualified areas.

Tangible Property Test: We recommend that the tangible property test be considered met ifa 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 performance test" be considered met ifa 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.

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 would be if it moved out of a low-income community or targeted area.

A CDE should not be subject to decertification, or an investor 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 is that compliance be determined at the time of the investment, our fall-back position would be that the Service establish a test to determine that a CDE is acting in "good faith" in making qualified low-income community investment(s). 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 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 tomove 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 period; 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 NMTC 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 community. Investors should not have to worry about recapture except in the most narrowly defined significant circumstances, or else the NMTC may not achieve the purposes Congress intended in creating it.

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's activity be 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. Traditional practice under Internal Revenue Code Section 501 (c)3 supports the concept of considering projected business activity.

Once a newly formed business has been in operation for 24 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.

Recapture

Question 6 of the ANPR deals with recapture of Credits.

We recommend that the primary focus of compliance be the location of the business and, as stated above, we recommend that compliance be 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.

We recommend that a CDE be granted a reasonable period of time--at least 12 months--to move a low-income community investment back into compliance once it has been deemed out of compliance before recapture occurs. Regulations should provide a reasonable cure period similar to that provided by the Low Income Housing Tax Credit. In addition, we recommend that a CDE be able to substitute a noncompliant investment with an investment that is in compliance in order to avoid recapture.

Finally, we recommend that IRS 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 would occur. If a CDE can demonstrate that it 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 occur.

Other Tax Incentives

Question 7 deals with limitations Treasury may impose on NMTC investments that are directly or indirectly subsidized with other tax incentives.

As a general matter, we strongly encourage the Service to specifically allow in the regulations "tandem" or "coordinated" investments, in which separate funds seek different tax incentives when the funds invest in separate projects, even though the projects are part of the same integrated business or development.

Tax-Exempt Bonds: A CDE should not be permitted to use the proceeds of qualified equity investments to purchase tax-exempt bonds. However, there should be no restriction on a qualified low-income community business's 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.

Low Income Housing Tax Credits: Since the rental of residential housing is not an allowable low-income community investment, 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 qualified business the *development--not* just the *rental---of* housing receiving (or expected to receive) Housing Credits. The financing of the nonresidential portion of a mixed residential/commercial building should be a qualified low-income community investment regardless whether Housing Credits are claimed on the residential portion of the building. In such case, 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 Credit it claims. No further limitation is needed on the use of Historic Credits with NMTCs. The Historic Credit is designed to offset the additional cost associated with meeting historic standards for rehabilitation, i.e. property. 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. 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 over time.

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

Once again, we appreciate this opportunity to comment. We look forward to continuing to work with the Service to implement this important new initiative.

Sincerely,

F. Barton Harvey

Chairman of the
Board & Chief
Executive Officer