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The Enterprise Social Investment Corporation
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January 6, 2005

Mr. Eric Solomon
Acting Assistant Secretary of the Treasury
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Room 3104
Washington, D.C. 20220

Mr. Paul F. Handleman
Office of the Associate Chief Counsel
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, D.C. 20044

Re: Final Regulations Issued December 22, 2004

Dear Messers Solomon and Handleman:

I am writing to you to comment on the final Treasury Regulations to implement the New Markets Tax Credit program issued on December 22, 2004. While the regulations contain some very helpful provisions, including the redemption safe harbor, they created two very serious problems. The problems we have faced with these two provisions are shared by a number of other allocatees. Resolution of these problems prior to the January 21, 2005 eligibility date is crucial for those allocatees who have applied for credit in the third round.

I. Tenant Look Through

First, the tenant rule contained in Section 1.45D-1(d)(5)(ii) has the effect of disqualifying the residential portion of a mixed-use building from qualification as a QLICI. The disqualification stems from the provision that loans to a real property rental business do not count as a QLICI to the extent that a lessee of the real property is not a qualified business under paragraph (d)(5). Since a tenant who occupies a unit as a principal residence does not use the unit in a qualified business, the loan would not be treated as a QLICI. We do not believe that the exclusion of residential rental units was intended by Treasury or the CDFI Fund. The exclusion is inconsistent with the first sentence of (d)(5)(ii) which would permit loans to buildings that were depreciable as a commercial building even though such buildings contain a substantial residential component. See Section 168(e)(2).

In addition, the position that rental real estate loans should be disqualified as a QLICI by looking through to the businesses conducted by tenants is inconsistent with the legislative history of Section 45D, which states in the conference committee report; "Rental of improved commercial real estate located in a low-income community is a qualified active business, regardless of the characteristics of the commercial tenants of the property." The statute itself states in Section 45D(d)(3)(A) that "the

rental to others of real property located in any low- income community shall be treated as a qualified business if there are substantial improvements located on such property[.]” Based upon the statutory language and the legislative history, the regulations should not disqualify portions of investments in rental real property based upon the business conducted by the tenants.

The difficulties caused by the adoption of the tenant look through rule are illustrated by the uncertainties generated by the prohibition on rentals to tenants whose predominate business is the development, sale or licensing of intangibles. It is very difficult to determine exactly what kind of business is conducted by a prospective office tenant. The application to a start-up biotech or computer software business may be clear, but the application of the rule to many other circumstances is extremely confusing. For example, the offices of a restaurant franchise business would likely not qualify to the extent that the company did not own and operate a significant number of its own restaurants. If the predominate source of revenue of the company was the collection of franchise fees, it would not qualify. A subsidiary of a financial services firm that conducts a commodities business, buying and selling currency futures contracts, or any swap, cap, collar or notional principal contract would be treated as a business predominately selling intangibles. A film or music production company may likewise generate the predominate share of its revenue from the licensing or sale of intangibles. The office of a university that licenses patents received by its professors would not be a qualified tenant. If a University rents space, the landlord may be required to exclude the use of the space by such subsidiary to establish a reasonable expectation of compliance. How would the landlord even know of the existence of such a subsidiary? It is not clear if the test is applied to the tenant, or to a consolidated group of which the tenant is a member. Does a major league baseball team qualify? Its income may consist of licensing TV and radio rights and licensing concession and parking rights. Does Microsoft qualify? Who can tell without a detailed analysis of the books and business plan of the company? Most tenants would not share such information with a landlord.

The uncertainty in the lease-up process cannot be overstated, especially given the difficulty in leasing commercial properties in higher risk areas. Many tenants will refuse to give a covenant that their business is not now and will not be at any time in the next 7 years predominately comprised of the sale and licensing of intangibles. The negative effects of this rule outweigh any positive aspects of avoiding potential abuses.

II. Substantial Improvement

The second major problem is the substantial improvement rule. As drafted, this rule would preclude an allocatee from making permanent loans which close after the completion of construction. The rule requires that capital costs of an amount equaling or exceeding 50% of the cost of the land be incurred after the QLICI is made. A loan that closes at a point in time after construction completion would not qualify as a rental real estate loan. We cannot find any indication in the statute or its legislative history that permanent loans do not qualify as a QLICI. Indeed, many allocatees included permanent financing as part of the business plan described in their application to CDFI Fund for an allocation of New Markets Tax Credits and the CDFI Fund rewarded those business plans with an allocation.

If the goal is to avoid recycled funds, it would be possible to prohibit refinancing of a permanent loan. The existence of take out permanent financing, on the other hand, is a necessary part of the construction process. Construction lenders will not lend without a commitment for permanent financing which will provide the funds required to repay or "take out" the construction loan. As a result, permanent financing is essential to the creation of new assets. I will also note that it would be

permissible to refinance a permanent loan to a business, since such refinancings are not subject to the substantial improvement rule. I do not understand why the provision of permanent financing is permissible for business loans but not for real estate loans.

The substantial improvement rule also makes it difficult to close historic rehabilitation investments. In those transactions, equity investments are frequently made in three installments: at closing, at construction completion and at stabilization of the project, generally measured by satisfaction of a debt service coverage ratio. The completion installment and the stabilization installment would not constitute QLICs under paragraph (d)(5)(ii) of the regulations. Requiring an equity investor to place all of its investment at risk prior to completion of construction substantially changes the relative economic and risk profile of an investment.

The deferred effective date of these provisions of the regulations does not provide adequate protection. The inclusion of these two rules in the regulations was a substantial surprise to the New Markets Tax Credit community. We have closed transactions that do not comply with the substantial improvement and tenant rules contained in the regulations and which currently require QLICs to be made after February 22, 2005. These transactions must be restructured, possibly at substantial cost and damage to both the allocatees and the QLICBs. To the extent that an allocatee does not fund an installment that no longer qualifies for New Markets Tax Credit, litigation would be the likely result. The same is true for several transactions that we are currently negotiating and which are ready to close by the January 21, 2005 CDFI third round funding deadline, but for these issues.

These difficulties could be eliminated by changing the effective date of the tenant and substantial improvement rule to exempt transactions as to which a binding contract was entered into prior to February 22, 2005. Such a binding contract rule is typical in tax legislation and would have a much more equitable application than a rule which punishes QLICs made after February 21, 2005.

Thank you very much for the opportunity to comment on these regulations: It would be extremely helpful to receive clarification of these issues as soon as possible, especially in light of the January 21 target date for allocatees who have applied in the third round and in light of the February 22, 2005 effective date. Please contact me if you have any questions or comments regarding these matters. I look forward to hearing from you.

Sincerely,

Charles R. Werhane
Executive Vice President