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Capital for Communities –  
Opportunities for People<sup>SM</sup>

September 2, 2011

CC:PA:LPD:PR (REG-114206-11)  
Room 5203  
Internal Revenue Service  
PO Box 7604  
Ben Franklin Station  
Washington, DC 20044

Dear Sir/Madam:

On behalf of Community Reinvestment Fund, USA, ("CRF"), I appreciate this opportunity to comment on regulations proposed by the Internal Revenue Service, ("IRS"), to modify the New Markets Tax Credit (IRC Section 45D) to facilitate and encourage investment in non-real estate businesses in low-income communities. Our comments respond to the IRS' Advanced Notice of Proposed Rulemaking published in the *Federal Register* on June 7, 2011.

### **BACKGROUND**

CRF is a nationally certified CDFI, and the nation's leader in channeling resources from the capital markets to support community development financing activities. Our mission is to transform the community development finance system by accessing capital markets on behalf of local lending organizations so that together we can create long-term sustainable jobs, finance the businesses that generate jobs, and strengthen the social ecosystem that supports them – particularly in low-income communities. Since 1988, CRF and its affiliates have delivered nearly \$1.3 billion in capital, primarily to small businesses located in more than 750 communities across the country. This lending has, in turn, leveraged \$1.3 billion in additional funds for total project resources. In collaboration with our network of 157 local lending partners, we have funded a total of 2,310 loans located in 46 states and the District of Columbia. Through these activities, CRF has directly assisted more than 500,000 families, including financing 17,465 homes of which 17,138 are affordable, providing credit to 1,300 small businesses, creating or retaining almost 44,000 jobs and funding community facilities that serve 426,000 families.

CRF was founded on a vision improving the lives of people living and working in economically disadvantaged areas by creating a secondary market for community development loans. For more than 23 years, we have fulfilled this vision by purchasing and pooling loans from community development financial institutions ("CDFIs") and other community-based nonprofits, as well as governmental and quasi-public lending agencies. We transform these loan pools into securities that are sold to banks, thrifts, insurance companies, pension funds and other qualified institutional investors. In this way, we bring capital from Wall Street to Main Street.



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 2 of 9

As the first nonprofit financial intermediary to issue securities collateralized by community development loans, we continually seek to connect underserved communities to new sources of capital. Since 1989, we have issued nineteen series of Community Reinvestment Fund Revenue Notes totaling \$325.3 million and three securities backed by affordable housing loans. In 2004, CRF marked a major milestone, by issuing two rated debt offerings; one secured by a pool of affordable housing loans, and the second collateralized by small business loans. In both cases, the highest class of certificates or tranches received a “AAA” rating from Standard & Poor’s. Subsequently, we have issued two more rated debt offerings that brought more than \$100 million in capital to low-income communities.

In keeping with our commitment to finance businesses in distressed communities, CRF was an early and strong proponent of the New Markets Tax Credit (“NMTC”) Program. We were instrumental in shaping this new program because we saw the potential of the tax credit to support the credit needs of business borrowers. Using our very first allocation, we pioneered the development of our own NMTC loan product that provides long-term, flexible, credit at below-market interest rates for both for-profit and non-profit businesses seeking to purchase operating facilities or equipment for their operations. This type of capital has become increasingly difficult to access in the wake of the Great Recession, yet it is *essential* for businesses to create jobs and growth – particularly in economically challenged communities.

Since the inception of the NMTC Program in 2000, CRF has established a powerful and proven track record of originating and managing tax credit investments to underserved businesses located in low-income communities across the country. Together with its affiliate, National New Markets Tax Credit Fund, Inc., (“NNMTCF”), CRF has become one of the largest allocatees in the country, receiving tax credit allocations in six of the eight funding rounds totaling \$674.5 million and investing \$52.5 million on behalf of other allocatees. Working through our local lending partners, CRF has used tax credit resources *exclusively* to make flexible loans to businesses and community facilities located in highly distressed low-income communities. To date, we have funded 370 NMTC loans totaling \$679.4 million, which have created or retained 17,212 jobs and served more than 296,000 low-income people and residents of low-income communities in 187 cities in 34 states. No other CDE is deploying New Markets Tax Credits specifically for business lending purposes on this scale.

It should also be noted that NNMTCF has funded more Qualified Low-Income Community Investments, (“QLICs”), than any other Community Development Entity, (“CDE”). According data collected by the CDFI Fund at the end of



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 3 of 9

2009, NNMTCF's portfolio of 264 individual QLICs was more than 20 times larger than the average CDE's portfolio of 13 QLICs.<sup>1</sup> The second largest portfolio consisted of 98 QLICs, or only 37% the size of our portfolio.

### GENERAL COMMENTS

We would like to express our appreciation to the Internal Revenue Service for their efforts to encourage greater New Market Tax Credit investment in operating businesses. Nothing is more important to the health and well being of our economy than supporting businesses that can create living wage employment opportunities and economic growth in low-income and underserved communities. We must use all "tools in our tool box" to jump-start our economy by helping business borrowers gain access to appropriate credit and capital. We whole-heartedly support efforts to modify the NMTC program regulations to make it easier for CDEs and their Investors to provide capital to operating businesses.

As noted above, CRF's affiliate, NNMTCF, is a national leader and perhaps the CDE most active in using the tax credit to provide credit to operating businesses. This financing activity is at the very core of our business model and how we deploy NMTC resources. We designed our NMTC loan product with flexible terms to support operating companies of all sizes, regardless of how the financing is used. Our objective is to ensure that operating companies get access to the financing they need to conduct their on-going business activities. We do not place restrictions on the purpose or use of the loan. Delivering the benefits of the tax credit more effectively and efficiently to operating businesses is one of the best ways to ensure that we make capital available to the "engines" of economic growth in our economy, i.e. businesses that can create jobs and get the country moving again.

We are greatly encouraged by this opportunity to suggest modifications to the NMTC regulations and would like to offer the following recommendations to enhance the ability of CDEs to make more non-real estate investments.

The first order of business is to clearly define the types of loans and/or investments these regulatory modifications seek to facilitate. In our view, ***the goal is to promote greater use of the tax credit for loans and/or investments to non-real estate operating companies that can create jobs and growth in low-income communities.*** However, these loans and investments should be available to meet *any* financing needs of an operating company. Except for those uses specifically excluded by statute, there should be *no* restrictions placed on how the resources are used, *only* that these funds *must* be used to support firms whose predominant business activity is *NOT* the development, management or leasing of real estate.

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<sup>1</sup> See report on NMTC Program Projects Financed through 2009 at [http://www.cdfifund.gov/docs/nmtc/nmtc\\_qlici\\_2009.jpg](http://www.cdfifund.gov/docs/nmtc/nmtc_qlici_2009.jpg).



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 4 of 9

The proposed regulations define *"....a non-real estate qualified active low-income community business as any business whose predominant business activity (measured by more than 50 percent of the business' gross income) does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate."* The language proposed restricts the type of loan or investment to one which is not *".....connected to the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate."*

We agree with the first part of the proposed definition, but oppose the limitation placed on the purpose of the loan. CRF has a successful track record of making NMTC loans to operating businesses for the purchase, rehabilitation, construction of their facilities, the acquisition of large equipment and general working capital purposes. Virtually all of our tax credit allocations have been used to support operating businesses and we understand their need for flexible financing. With this in mind, the regulations should seek to encourage financing for non-real estate operating companies, (and any Special Purpose Entities, ("SPEs"), they may establish), *solely* on the basis of the predominant business activity of the firm. If the objective is to increase the availability of NMTC resources to meet the financing needs of operating businesses so that they can create growth and jobs in low-income communities, then the regulations *should not* proscribe the purposes for which these resources may be used. Operating businesses need the greatest latitude to deploy the tax credit proceeds in a way that helps the company to grow and provide employment and economic opportunities for residents of underserved communities.

We propose the following modified language to reflect a more flexible approach to defining a non-real estate qualified active low-income community business.

*(9) Non-real estate qualified active low-income community business – (i) Definition. The term non-real estate qualified active low-income community business, ("**NRE QALICB**"), means any qualified active low-income community business (as defined in paragraph (d)(4) of this section) (or a **Special Purpose Entity established by the non-real estate qualified active low-income community business solely for the purpose of holding real estate or equipment**) whose predominant business activity (measured by more than 50 percent of the business' gross income) does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate. The purpose of the investment or loan must not be connected to the development (including construction of new facilities and rehabilitation/enhancement of existing facilities **except for facilities used primarily in such operating business**), management, or leasing of real estate."*



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 5 of 9

As part of the definition of a "non-real estate qualified active low-income community business," we also propose that the 12-month safe harbor period providing that funds which are to be used for construction are to be considered "working capital" be extended to 18 months. This longer time frame is more appropriate for an operating business which when involved in a construction project is also conducting its normal trade or business. Accordingly, the construction time is often longer for an operating business to complete a construction project as opposed to a real estate developer who has no other concerns than completing construction.

In addition to clearly defining a "non-real estate qualified active community business," the IRS must address the primary disincentives to using the NMTC for non-real estate operating companies: the 7-year term of the tax credit combined with investor concerns related to the reinvestment and "substantially all" requirements (IRC 45D – 1(c)(5)).

The 7-year term presents a problem for tax credit investors because operating businesses typically take the form of amortizing loans or investments with shorter maturities. In the event that principal on amortizing loans is repaid during the seven year period, the CDE is required to redeploy the principal repayments within a specified period of time or trigger "recapture" of the tax credit. Investors are keenly aware of the severe penalties associated with recapture should a CDE fail to meet the "substantially all" requirement at any point during the 7-year compliance period. The risks and uncertainties associated with reinvesting principal repayments cause investors to be extremely hesitant to make qualified equity investments ("QEIs") in CDEs engaged in financing operating businesses. Instead, investors prefer make NMTC investments in CDEs that can guarantee that a QEI will remain fully invested in a qualified low-income community investment ("QLICI") for the full term of the tax credit. These requirements discourage CDEs from offering flexible financing products that operating businesses need, such as revolving lines of credit, working capital and equipment loans.

To encourage greater NMTC investment in non-real estate operating businesses, CRF supports the recommendation proposed by the New Market Tax Credit Coalition, ("NMTC Coalition")<sup>2</sup> that the IRS provide a special rule, or "safe harbor" protection for any community development entity, ("CDE") organized to make Qualified Low-Income Community Investments, ("QLICs") in operating businesses.<sup>3</sup> Under this "safe harbor" protection, CDEs investing in operating businesses that receive a return of investment, such as amortized principal repayments, will not trigger recapture penalties if they are unable to re-invest in another operating business. Inability to redeploy the return on investment would not constitute a failure to comply with the "substantially all" requirement that, in turn, activates recapture of the tax credit.

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<sup>2</sup> CRF is both a founding member and a prior Chair of the New Markets Tax Credit Coalition.

<sup>3</sup> See New Markets Tax Credit Coalition letter to Mr. Michael Mundaca, Acting Assistant Secretary for Tax Policy, U.S. Department of Treasury, March 23, 2010.



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 6 of 9

This safe harbor rule would address investor concerns about making QEIs in a CDE that provides financing to non-real estate operating businesses by removing the possibility of recapture due to principal or other possible repayments.

We support the language proposed by the Coalition with a few highlighted modifications which requires a CDE seeking safe harbor protection to:

1. Satisfy the substantially all test as defined in paragraph 1.45D-1(c)(5), with the initial deployment of the Qualified Equity Investment (QEI) into one or more (Qualified Low Income Community Investments (QLICs) made in one or more Qualified Active Low Income Community Businesses (QALICBs) as long as the ***predominant activity of the business does not include the development, management or*** leasing of a real estate project or projects; and
2. Any amounts received by the CDE as a return of capital, equity or principal with respect to such a QLICI must either be reinvested in another qualified non-real estate business or retained by the CDE for the remaining term of the 7-year credit period.

To implement this "safe harbor" protection/provision, the Coalition suggests that the CDFI Fund amend its Allocation Agreement to ensure that any CDE using this exemption is required to make a reasonable effort to re-deploy any principal that is returned within the compliance/regulatory period and present evidence of such effort. Existing IRS anti-abuse provisions would also be applied to any CDE transactions.

Investors in a CDE that fails the proposed test would not be subject to recapture. However, the CDE would be subject to the range of remedies set forth in the Allocation Agreement, which could include debarment from receiving further NMTC allocations and/or participating in other CDFI Fund programs. We share the view of our Coalition colleagues that the safe harbor proposal would encourage investors to work with CDEs that have experience and a business plan in place to provide flexible debt and/or equity products, including working capital and equipment loans, to non-real estate operating businesses.

CRF believes the IRS needs to make it easier for operating companies to use the tax credit for whatever financing needs they may have. We offer our definition of a non-real estate qualified active low-income community business as a way to provide flexibility to use NMTCs for any operating company purpose.



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 7 of 9

Coupled with the safe harbor proposal offered by the NMTC Coalition, we think these two changes would foster greater use of the tax credit by operating companies.

### SPECIFIC COMMENTS

#### A. Streamlined Substantiation Requirements for Second Tier CDEs Making Small Loans to Non-Real Estate Businesses.

The Treasury Department and the IRS are soliciting comments on whether the substantiation requirements governing investments under Sec. 1.45D-1(d)(1)(iv)(A)(1) should be simplified in cases where: (i) The second CDE uses the new markets tax credit proceeds to make smaller-sized loans (for example, less than \$250,000) to non-real estate businesses; (ii) neither the second CDE nor the non-real estate business receiving the new markets tax credit proceeds is affiliated with the primary CDE or the qualified equity investment investors; and (iii) the second CDE demonstrates that, at the time of initial investment in the non-real estate business, the non-real estate business receiving the new markets tax credit proceeds met some basic qualifying requirements (for example, the business is in a low-income community).

**1. Would simplifying the substantiation requirements in the manner proposed facilitate greater new markets tax credit investment in non-real estate businesses? Are there other areas where Sec. 1.45D-1 could be modified to achieve a similar outcome?**

As noted above in our General Comments, simplifying the substantiation requirements as proposed would *not necessarily* facilitate greater new markets tax credit investment in non-real estate businesses. To encourage broader use of the NMTC to finance operating businesses, the IRS should provide a clear definition of a non-real estate qualified active low-income community business, a longer time period in which funds (non-qualified financial property) may be used for construction of a project, and "safe harbor protection" against recapture of the tax credit for CDEs making qualified low-income community investments in operating businesses. These modifications to the program regulations would be far more effective in removing the barriers CDEs face when trying to make loans or investments available to non-real estate operating businesses by making it easier to qualify a transaction for financing under this program.

In our view, the changes proposed do not address the true disincentives such as investor concern about potential recapture and the flexibility to use funds for working capital purposes in a reasonable time period. Moreover, both the primary and the secondary CDE are bound by the regulations that govern the New Markets Tax Credit program and simplifying the substantiation requirements will not alter the requirements of this program. We urge the IRS to focus on the true impediments that limit the use of the tax credit by operating businesses.

**2. The Treasury Department and the IRS believe that, if there is to be a simplification of the substantiation requirements for these transactions, there may need to be a cap on the total transaction size. Is \$250,000 the appropriate cap to put on the initial loan size? Should special considerations be made for follow-on investments and/or lines of credit? For example, should there be a cap on the total aggregate investment in one business? If so, what should that cap be?**



September 2, 2011

Encouraging NMTC NRE Investments Comment Letter

Page 8 of 9

CRF is particularly concerned about the ability of small businesses to access affordable, appropriate credit in the midst of a serious economic downturn. We believe that the size of transactions also drives the cost and these costs must be determined by the marketplace. Rather than focusing on simplifying the substantiation requirements for smaller transactions (those \$250,000 or less), the Agency should seek to address the impediments to qualifying transactions that provide financing to operating companies such as a definition of a non-real estate QALICB and ways to reduce the punitive nature of recapture under this program. We are convinced that removing these hurdles will reduce the costs associated with NMTC transactions, making even small deals more economic.

We also wish to note that any modifications should not be targeted to very small transactions of \$250,000 or less. Larger firms are also having difficulty accessing credit. If the goal of this effort is to promote greater use of the NMTC for non-real estate firms that create jobs and growth in low-income communities, then we should not impose limitations on the size of the transaction that qualify for more flexible treatment.

**3. What are the appropriate minimum requirements that a non-real estate business should satisfy in order for the second CDE to be able to take advantage of the simplified substantiation requirements (for example, the business must be located in a low-income community, employ community residents, etc. at the time of initial investment)? How should this be measured (for example, that substantially all of the real property is located in a low-income community)?**

Again, we do not believe the proposed changes will have the desired effect. Furthermore, we are confused by the notion that the second CDE can somehow skirt regulations and/or a contract that the organization may have signed to use the proceeds of a loan in compliance with the NMTC program requirements.

**4. Should the Treasury Department and the IRS consider additional limitations (other than those specified) on unaffiliated CDEs or businesses? For example, should the regulations require that the second CDE be a non-profit entity or the affiliate of a non-profit entity?**

No, the Treasury Department and the IRS should not place additional limitations on unaffiliated CDEs or businesses such as requiring that the second CDE be a non-profit entity or the affiliate of a non-profit entity.

## CONCLUSION

We appreciate this opportunity to share our views and recommendations on regulatory changes that could stimulate greater NMTC investment in operating businesses. We commend the IRS for their dedication and commitment to enhancing this program to meet the needs of non-real estate business borrowers. The tax credit should be an effective tool for helping businesses, especially those located in low-income communities, to access the capital and credit that will enable them to grow and create jobs in this challenging economic environment.



September 2, 2011  
Encouraging NMTC NRE Investments Comment Letter  
Page 9 of 9

Please do not hesitate to contact me with any questions regarding comments included in this letter.

Sincerely,

A handwritten signature in blue ink, appearing to read "Frank Altman".

Frank Altman  
President and CEO