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Sent: Monday, October 02, 2006 4:31 PM
To: Sharon.Kay@do.treas.gov
Cc: Rob.Hanson@ey.com; walter.goldberg@ey.com
Subject: background paper for US Bank meeting

Sharon - I have attached a brief background paper outlining the issues we hope to cover during our meeting at 3:00 tomorrow. I appreciate your assistance and look forward to our meeting.

Regards,

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October 2, 2006

The Honorable Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
1500 Pennsylvania Avenue, N.W.
Room 3064
Washington, D.C., 20220

Dear Mr. Solomon:

This letter is a follow-up to my recent letter requesting a meeting with your office on behalf of our client, (the "Bank"), I have enclosed a brief white paper outlining the nature of an issue that has developed with respect to the Bank's new markets tax credit investments and a possible approach to addressing it through the issuance of administrative guidance.

We appreciate your willingness to discuss this matter and look forward to our meeting with you and your colleagues on October 3rd.

Sincerely,
Fred H. Copeman

cc: Michael Desmond (Tax Legislative Counsel)
Sharon Kay (Accountant Advisor)

New Markets Tax Credit Investments & Profit Motivation

Background

The New Markets Tax Credit ("NMTC") program was enacted in 2000 as new Section 45D of the Internal Revenue Code (the "Code"). The intent of Congress in enacting the NMTC program was to encourage the development of new businesses in low-income communities that have traditionally been under-served by the capital markets. NMTCs are allocated by the CDFI Fund of the Treasury Department to qualified Community Development Entities ("CDE's") in accordance with the requirements set out in Section 45D and the regulations promulgated thereto. The NMTC is subject to the general business tax credit rules of Section 38 and shares a number of characteristics with the low- income housing tax credit, the historic rehabilitation tax credit, the tax credits for producing energy from renewable sources and other congressionally-mandated tax benefits.

The legislative history of Section 45D notes that the limited number of tax incentives had proven to be an obstacle to capital formation for businesses located in inner city and rural communities. As a result, the NMTC was designed as an income tax subsidy to attract private investment to development opportunities in these areas. While the legislative history refers to the fact that CDE's are expected to sell equity interests to NMTC investors, the question of whether they would also be required to receive a cash return on their capital was not addressed. The only direct indication of Congressional intent on this issue is found in a colloquy between Senators Baucus and Rockefeller concerning the

potential impact on the NMTC program of codifying the economic substance doctrine.¹ That colloquy refers to a footnote in the Senate Finance Committee Report on the JOBS Act² stating that it was intended that the NMTC be treated in the same fashion as the housing tax credit and the historic tax credit, as a congressionally-mandated tax benefit, and affirming that NMTCs would not be counted as tax benefits under the proposed law for purposes of determining whether NMTC transactions possessed economic substance.

(the "Bank") has a long record of supporting community re-development initiatives in low-income and distressed communities, including having made more than \$500mm of NMTC investments. As a national banking institution subject to the Community Reinvestment Act³ ("CRA"), the Bank is subject to periodic examination of its performance as a lender, investor and service provider in low-income communities within its service area. Under the "investment test" of the CRA, an assessment is made as to whether the Bank has made qualified community development investments that are consistent with safety and soundness principles. In this context, the Bank's CRA performance both as a general matter, and with particular respect to its performance under the investment test, has been rated as "outstanding" by federal bank examiners. In addition to the Bank's active involvement as an investor in low-income housing, historic and NMTC investments, the Bank applied for and received an NMTC allocation from the CDFI Fund in May, 2006.

NMTC Market Overview

The introduction of Section 45D attracted an extraordinary degree of interest from community groups, local entrepreneurs, community development banks and others after its enactment. This level of interest is best illustrated by the roughly ten to one ratio between the NMTC allocations applied for versus the NMTC authority available under the statute. As the first generation of NMTC transactions began to evolve, practitioners looked to Treasury for clarification as to whether CDE's could structure their transactions using equity from traditional tax credit investors and leverage from a third party lender. The issuance of Revenue Ruling 2003-20 laid the foundation for structuring NMTC transactions to accommodate differing economic objectives of capital providers without distorting the program's public purpose.

In the two years since the Revenue Ruling was released, the level of interest in and understanding of NMTC investments has continued to increase. While demand for these investments has increased significantly, the supply of NMTCs is of course fixed by statute. The resulting demand/supply imbalance has given rise to a marked increase in the level of capital that each dollar of NMTC attracts. At current market "pricing", NMTC investors effectively contribute nearly \$1 of equity for every \$1 of NMTC they are allocated, after adjusting for the loss in net value attributable to basis reduction. As NMTC pricing has increased, investment yields have fallen (in a fashion much like the market for low-income housing tax credits) and investors now accept returns based solely on the tax benefits available from their investment in the CDE.

These developments in pricing and the compression of non-tax economic returns have had two very clear outcomes: 1) the additional equity generated by these investments has

resulted in higher levels of development capital per dollar of NMTC allocated (an excellent result as a matter of public policy) and investors have had to accept increased risk that their investments might be challenged as lacking economic substance due to the absence of any meaningful non-tax yield. This concern is exacerbated by recent modifications in the financial statement treatment of "uncertain" income tax positions adopted by publicly-traded companies⁴.

Representative Transaction

To assist the discussion around this topic, we will share an organizational chart and financial summary during the meeting which summarizes an NMTC investment recently made by the Bank. Notwithstanding differences in business terms from one NMTC transaction to the next, the transaction we will discuss is representative of both the Bank's investments and those being consummated in the market more generally. In this transaction, like many of its type, it is expected that there will be a small amount of cash flow available to repurchase the Bank's interest at the end of the compliance period. This very modest distribution will not make a significant contribution to the Bank's expected after-tax return but typically has been required by tax counsel to assure the parties to the transaction that the Bank would be treated as a partner for federal income tax purposes. That said, the modest level of projected non-tax yield to the Bank might beg the question of whether it has any reasonable possibility of sharing in future profits and, by extension, whether its investment could survive a challenge that it lacked an economic profit motive.

Request for Clarification

NMTC investments are subject to a considerable array of potential challenges grounded in statute, regulations and/or judicial doctrine that were designed or have evolved to insulate the government from abusive tax shelter transactions. Thus, for example, while Section 183 does not appear to directly limit NMTCs, the various entities in which the Bank is directly or indirectly invested may be subject to challenge as activities not engaged in for profit. NMTC investments made by way of entities structured with leverage are particularly vulnerable to challenges of their substance based on judicial doctrine.⁵ These potential challenges to NMTC investments translate to investment risk and needlessly complex transaction structures, and would, if applied, frustrate the clear intent of Congress to provide a tax subsidy for business development in low-income and distressed communities.

In order to facilitate its continuing participation in the program, the Bank requests administrative clarification that qualified NMTC investments, structured in a manner that complies with the allocation provisions of Section 704(b), will be respected for federal income tax purposes. In particular, the Bank seeks clarification that it may invest in NMTC transactions where its economic return is expected to come solely from income tax benefits. Such guidance would be consistent with legislative intent, with the logic of Revenue Ruling 2003-20 and with previous guidance accorded to other forms of tax credit investment.⁶ In the alternative, the Bank seeks guidance that its investment in entities qualified to allocate NMTC's will not be subject to challenge from the application of Section 183, in a form similar to that provided the low income housing tax credit program.⁷

¹ Congressional Report, May 11, 2004, S5206

² Jumpstart Our Business Strength (JOBS) Act, S.R. 108-192

³ 12 USC 24

⁴ FASB Interpretation No. 48, Financial Accounting Standards Board, June, 2006

⁵ See, for example, *Frank Lyon Co. v. U.S.*, 435 US 561 (1977), *Knetsch v. U.S.*, 364 US 361 (1960), *Rice's Toyota World v. Commissioner*, 752 F. 2d 89, (4th Cir., 1985), and *Gilman v. Commissioner*, 933 F. 2d 143, (2d Cir. 1991)

⁶ See, for example, Priv. Ltr. Rul. 200609001, (Oct. 24, 2005)

⁷ Treasury Regulation 1.42-4