

NEW MARKETS TAX CREDIT COALITION

September 8, 2011

CC:PA:LPD:PR (REG-101826-11)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklyn Station
Washington, DC 20040

Dear Madam/Sir:

I am writing on behalf of the New Markets Tax Credit Coalition (NMTCC) with comments on the regulations proposed by the Internal Revenue Service (IRS) modifying the New Markets Tax Credit (IRC Section 45D) in an effort to facilitate and encourage investment in non-real estate businesses in low income communities.

The Coalition appreciates and supports the Treasury Department's effort to facilitate NMTC investing in operating businesses. In fact, in a March 2010 letter to then Assistant Secretary for Tax Policy, Michael Mundaca, the Coalition recommended that the IRS provide a special rule, or safe harbor protection, for any community development entity (CDE), specifically organized to make Qualified Low Income Community Investments (QLICs) in operating businesses. We used the term operating businesses to refer to a non-real estate business that makes a good or provides a service. The Coalition's goal in proposing the safe harbor was to address investor concerns about the recapture risk associated with investing in CDEs that provide flexible debt and equity financing to non-real estate businesses.

In that letter, we identified the 7-year term of the NMTC coupled with reinvestment and "substantially all" requirements (IRC 45D -1(c)(5)), as the principal barriers that prevents more NMTC investing in operating businesses. Investors are well aware of the severe recapture penalties that are triggered if a CDE falls short of its "substantially all" requirements at any point during the 7-year compliance period. As a result, investors seek NMTC investment opportunities with CDEs that can guarantee a Qualified Equity Investment (QEI) will remain fully invested in a QLIC for the full 7-year term of the NMTC thus, limiting a CDE's ability to offer the flexible financing products that many operating businesses need and that are difficult to secure through conventional lenders especially in the current lending environment.

To be clear, CDEs are under no statutory or regulatory prohibition that prevents them from making a QLIC in a non-real estate business. In fact, the Federal Register Notice announcing the proposed rule refers to data from the Treasury Department's Community Development Financial Institutions Fund (CDFI Fund) that reports of the \$16 billion in NMTC investments

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made in approximately 3,000 businesses and real estate projects as of 2009, thirty-five percent of the investment dollars went to non-real estate businesses. Similarly, the NMTC Coalition's most recent survey of CDEs found that forty-nine percent of the NMTC investments reported in 2010 were made in non-real estate businesses. However, the CDFI Fund pointed out that many of the NMTC investments categorized as non-real estate transactions according to the CDFI Fund definition, were being used by a non-real estate business to finance some type of "bricks and mortar" real estate related purpose, i.e., to expand or develop real estate for its business as opposed to financing working capital or purchasing equipment.

Since the NMTC was first launched, concerns regarding recapture risk have driven most NMTC investing into real estate or real estate related businesses because of the certainty that the investment would not move out of a NMTC qualified low income census tract, as an operating business might, and real estate financing can be structured as a 7-year interest only transaction, which is not customary for operating businesses.

The Coalition proposed a 'safe harbor' for investments made in CDEs investing in operating businesses because it directly addresses this concern by providing a safety net that investors can rely on if and when a CDE receives a return on investment for some reason it cannot re-invest in another operating business. In order to take advantage of the safe harbor protection, the Coalition recommends that a CDE would have 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 (QLICIs), made in one or more Qualified Active Low Income Community Businesses (QALICBs) as long as the business was established for a purpose other than 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.

If a CDE, including a single purpose CDE can satisfy both of the above described tests an investor would be protected by a safe harbor throughout the 7-year term. This would ease investor concerns about recapture and would generate investor interest in CDEs that offer flexible financing products to operating businesses.

To implement this safe harbor provision, we recommend that the CDFI Fund amend its Allocation Agreement to ensure that any CDE using the safe harbor be required to make a reasonable effort to re-deploy any principal that is returned to the CDE within the 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 its Allocation Agreement, which could include disbarment from receiving further NMTC allocations and/or participating in other CDFI Fund programs. We believe the safe harbor would encourage investors to work with experienced CDEs that had a business plan in place and a track record of lending and/or investing in operating businesses in low income communities.

The safe harbor model would enable a CDE to manage its investments in one or more operating businesses effectively and a CDE would be expected to describe how it planned to do so in its allocation application business strategy and would be held to that plan in its allocation agreement. There are a core group of CDEs, including CDFIs, CDCs, community development venture capital funds and others, with significant experience in financing operating businesses, managing revolving funds and deploying and re-deploying the capital in operating businesses. These CDEs consistently report a strong pipeline of demand from operating businesses seeking flexible capital but they are limited in their ability to finance these businesses using the NMTC for the reasons we have mentioned: investor concern the 7-year term of the NMTC coupled with reinvestment and 'substantially all' requirements

Consider the following example of an operating business that is seeking financing. The business meets all the requirements of a QALICB and has been deemed by a CDE to be a good investment with strong job creation potential, and yet under current IRS rules the CDE is unable to finance the business using the NMTC:

An existing manufacturing business, located in a rural area, is seeking a \$5 million line of credit to finance its expansion into a new line of proprietary health care products. The business needs to purchase several pieces of specialized equipment in order to develop its new product line and has been unable to secure bank financing for the purchase. Conventional banks are reluctant to finance equipment because unlike real estate, an asset that retains its value and may even increases in value over time, equipment is an asset that depreciates quickly.

Unfortunately, under current IRS regulations, a CDE would not finance a line of credit using NMTC capital because it could not guarantee compliance with existing substantially all rules. Due to the nature of the business there would be some points during the 7-year compliance period when 100 percent of the QLICB was deployed in the business to purchase or repair equipment and other times when it was in the best interest of the business to make payments that could move the CDE out of compliance with the 85 percent threshold.

If however, a safe harbor was in place, a CDE could finance a revolving line of credit that would allow the manufacturing business to purchase equipment, and make regular

repayments of interest and principal back into the CDE to replenish the line and allow repeated drawdowns as equipment repairs and/or replacement are needed.

Access to capital is critical to the success of a businesses and it is equally important that the terms and conditions of the capital meet the needs of the business. Unfortunately, while providing fully amortizing loans, repaid in scheduled payments of principal and interest over time, it is customary practice with regard to lending to operating businesses most CDEs do not offer fully amortizing business loans because under current IRS rules amortization is treated as a return of equity to the investor.

Adopting the safe harbor would allow CDEs to offer fully amortizing loans to operating businesses. Whether a CDE established a single purpose to invest in a single operating business, or established a revolving fund to finance a pipeline of businesses, the amortization of loans and/or return of capital would occur within the single purpose CDE or the CDE's fund and as long as the CDE reinvests any returns in a qualified non-real estate business or retains the funds it can guarantee its investor protection through the safe harbor.

A safe harbor would allow a CDE and its investor to negotiate the parameters of the QEI investment using a single set of documents to underwrite loans, investments and manage the portfolio over the 7-year compliance period. As long as the investor receives no return of principal from the portfolio over the 7 -year term they would have a safe harbor against recapture risk.

The investment agreement negotiated between an investor and a CDE would determine the terms and conditions by which a CDE would make QLICs in qualified non-real estate businesses. The Coalition would oppose any effort to have IRS dictate the terms or conditions of a QLICI in a non-real estate business. CDEs structure their NMTC financing products to address the needs of businesses in the low income communities they serve and this flexibility is a critical strength of the NMTC model. In fact, a safe harbor is designed to encourage CDEs to provide flexible financing to operating businesses and regulating the terms of these QLICs would undermined this effort.

In general, the Coalition supports the definition of a "non-real estate qualified active low income community business" as proposed in the rule but we recommend it be modified to allow a CDE to finance the development or rehabilitation of real estate being used by the operating business, including expanding or retrofitting a facility to meet the need of their business.

Our objective is to increase NMTC investments in operating businesses that create growth and jobs in low-income communities. The safe harbor we recommend is designed to encourage and facilitate investing in operating businesses that we see no need to dictate the terms or conditions of the investment as long as the end beneficiary of the CDE financing is an operating business that meets all current requirements of a QALICB.

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Therefore, we propose the following modified definition *non-real estate qualified active low-income community business*:

The term non-real estate qualified active low-income community business, 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 fifty 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."

While the Coalition has reservations about the approach suggested in the proposed rule, we want to reiterate our support of this effort. We do believe that the proposed rule would facilitate investing in CDFIs, which the Coalition supports as a worthwhile goal, but the rule does not necessarily facilitate more CDE lending or investing in non-real estate operating businesses.

For all the reasons cited we encourage the IRS to consider implementing a safe harbor to address investor risk concerns and encourage negotiations between CDEs and investors committed to business lending in low income communities.

I appreciate the opportunity to comments on behalf of the NMTC Coalition and I look forward to working with the IRS on this effort.

Sincerely,



Robert A Rapoza

Attachments (2)

1. Mundaca Letter
2. NMTC Coalition Board of Directors (Directory)