NOVOGRADAC
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CERTIFIED PUBLIC ACCOUNTANTS

September 8, 2011

Internal Revenue Service
CC:PA:LPD:PR (REG-114206-11)
Room 5205
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Advance Notice of Proposed Rulemaking – Proposed Changes to Facilitate and Encourage Investments in Non-Real Estate Businesses in Low-Income Communities

Dear Ladies and Gentlemen:

On behalf of the members of the New Markets Tax Credit ("NMTC") Working Group, we have prepared a response to your request for comments on the advance notice of proposed NMTC regulations issued June 7, 2011. We believe that our suggestions for guidance will help clarify and minimize confusion related to current questions in the NMTC program.

The members of the NMTC Working Group are participants in the NMTC industry who work together to resolve technical NMTC Program issues and create recommendations to make the NMTC Program even more efficient in delivering the most benefit to end users. Our group includes Allocatees, nonprofit and for profit community development entities ("CDEs"), investors, accountants and lawyers.

We commend the Department of Treasury and IRS for its continuing efforts to improve and clarify tax guidance for the NMTC program in order to ensure its continuing success. We believe that specific changes, as requested by this letter, will expand the NMTC program to better serve its intended purpose, bringing capital to communities that have historically had inadequate access to capital, by lessening the current risk to investors due to the uncertainties of the NMTC program.

A. <u>Streamlined Substantiation Requirements for Second Tier CDEs Making Small Loans to Non-Real Estate Businesses.</u>

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 §1.45D-1 could be modified to achieve a similar outcome?**

When trying to determine what changes can be made to improve the NMTC Program, many suggestions can be made about individual aspects of the Program's regulations. Depending on what outcome is desired, certain changes can be made to achieve that outcome. Simplifying the

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substantiation requirements may facilitate more investments, however, we believe that it isn't the substantiation requirements that are causing investors to prefer other types of NMTC investments over those that invest in second tier CDEs. We do not believe that any changes will cause a substantial increase in investments made until a single component of the program is changed that effects all investments – recapture.

Risk of Recapture

When trying to determine what changes can be made to improve the NMTC Program, many suggestions can be made about individual aspects of the Program's regulations. Depending on what outcome is desired, certain changes can be made to achieve that outcome. While we agree that changes need to be made in order to encourage more investments in non-real estate qualified active low-income community businesses ("QALICBs"), we do not believe that any changes will cause a substantial increase in investments made until a single component of the program is changed that affects all investments – "tax credit recapture". By having full recapture risk, plus interest penalties, for the full term of the investment, the NMTC Program has a level of compliance and transaction structuring unrivaled by other tax credit programs. This level of structuring and underwriting ensures that the goals of the NMTC Program are ultimately achieved but at a cost that is incorporated into the overall price of the NMTC and the types of investments that investors are willing to make. A reduction in tax credit recapture risk during the term of the investment would certainly lower the discount of the NMTC applied by investors and broaden the types of investments that tax credit investors are willing to make, including non-real estate QALICBs.

Currently, if $1 of an investor's qualified equity investment is redeemed during the seven year compliance period, many believe full recapture is triggered. It does not matter if this redemption occurs in year one or year six, the result is the same – 100 percent of the new markets tax credits must be recaptured (plus interest) by both the investor who purchased the qualified equity investment from the CDE and by all subsequent holders of that investment, to the extent of the NMTCs allowed and used by each investor.[1] In many other tax credit programs, the level of recapture risk decreases over time. The recapture risk for NMTCs does not decline during the seven year compliance period. With the low-income housing tax credit ("LIHTC"), only the accelerated portion, on a downward sliding scale, is recaptured. If recapture occurs before year 12, only 1/3 of the previously claimed LIHTC is recaptured. During years 12, 13, 14 and 15, 4/15, 3/15, 2/15 and 1/15, respectively, is subject to recapture. The impact of total recapture of the NMTC is amplified because the investor must also pay interest on the underpayment of tax for each prior taxable year, beginning on the due date of the tax return for such prior taxable year.[2]

Recapture risk is a greater concern for investors in CDEs where the investors' qualified equity investment ("QEIs") will be used for non-real estate investments in a QALICB that is an operating business. Operating businesses typically don't need investments with a 7 year term or longer. These operating businesses typically have a need for a much shorter term investment. Also, investments in

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1 IRC §45D(g)(1); Treas. Reg. §1.45D-1(e)(1).
2 IRC §45D(g)(2).

operating businesses may require some control features as opposed to real estate investments that do not generally require control. The risk to the investor is related to the reinvestment and reasonable expectations requirements of the NMTC Program. If an investment is made with a term shorter than seven years, the CDE must be able to reinvest the proceeds of the qualified low-income community investment ("QLICI") within 12 months in order for them to be considered continuously invested for purposes of the substantially all requirement. If they are unable to reinvest all or a portion of the QLICI(s) and fall below the 85% substantially all requirement, recapture may be triggered. In practice, investors have generally favored the simplicity and security of seven-year NMTC investments rather than taking the inherent recapture risks involved with a reinvestment scenario. Prior to the addition of a limited right to cure an investment, investors generally avoided the shorter-term investments solely because of the recapture risk. Today, investors also focus on economic considerations in deciding to invest in shorter-term investments. These considerations include drag on yield when liquidated monies are in temporary investments (i.e., awaiting reinvestment) and the uncertainty on what economic yield might be available on such reinvestment.

Whether recapture is triggered by redemption or failure of the substantially all test, the risk is that a $1 mistake can cause total recapture. If the goal is to promote changes to the program to encourage more investments in operating businesses, we believe changes to the calculation of the amount of recapture triggered by these recapture events needs to be changed to a less draconian approach. We recommend a proportionate calculation rather than total recapture. For example, if $10 of the investor's QEI is redeemed in year 6, only those credits associated with the redeemed amount and previously claimed are subject to recapture plus interest penalties.

Example:

ABC makes a $1 million investment in CDE that in turn invests in XYZ business. ABC receives $50,000 in annual credits in 2011, 2012 and 2013. ABC reduces its tax liability by $50,000 in 2011, 2012 and 2013. In 2014, CDE redeems $100,000, or 10%, of ABC's QEI.

Based upon our recommendation to make recapture proportionate to the amount that caused recapture, ABC would recapture 10% of all credits it received. Therefore, ABC must report recapture tax of $15,000 with interest accruing from 2011 (on $5,000), 2012 (on $5,000) and 2013 (on $5,000).

Using the same set of facts, if a CDE fails the substantially all requirement by $100,000, or 10% of ABC's QEI, the result would be the same.

Without substantive changes to reduce the recapture risk of NMTC transactions, we believe that any changes made to other parts of the regulations will achieve limited results and will not cause investors and CDEs to significantly increase the amount of investments made with non-real estate operating business QALICBs.

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?**

   If the purpose is to encourage more investments in non-real estate businesses, we believe that there should not be a cap. The NMTC Program provides significant flexibility in the types of businesses that it can provide financing to. This flexibility allows a CDE to find projects, regardless of size, that will provide a quantifiable amount of community impact based upon its investment. If the regulations were changed and provided for a cap as suggested above, CDEs would be severely limited in the number of businesses that it could provide financing to. It is difficult to define what exactly a small business is and whether $250,000 is appropriate. We believe that there are many examples of investments with capital needs of $500,000, $1 million, and even $5 million that would be great examples of non-real estate business investments. Without a cap, CDEs will be able to identify a broader range of businesses and focus more on the amount of community impact they deliver rather than on the size of the investments.

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)?**

   Compliance risk and cost is a severely limiting factor in whether an investment is made. We believe that reducing the compliance risk and burden to satisfy any compliance requirements will limit the barriers to certain types of investments, especially those in non-real estate businesses. We believe a non-real estate business that meets the QALICB tests based upon the percentage of its tangible property located in a low-income census tract, similar to a real estate project with no employees, would be an appropriate minimum requirement to take advantage of the simplified substantiation requirements. For example, the current regulations have a bias towards real estate transactions because the gross income, services performed, and tangible property tests for determining whether a business qualifies as a QALICB can all be met if the project's real property is more than 85% located in a qualified census tract. If a non-real estate business had ways to meet multiple requirements by meeting one at a higher rate similar to real estate transactions with no employees, it would lower the barriers to investment. We believe that allowing non-real estate businesses to use the same rule that is currently afforded to businesses without employees, typically real estate entities, that it would lower those barriers to investments in non-real estate businesses that currently exist. However, we do not believe that this change will dramatically affect the number of non-real estate transactions until the issue of recapture risk, as discussed above, has been sufficiently addressed to attract more investors willing to make any type of NMTC investment.

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?**

If the goal is to encourage more investments in non-real estate businesses, we believe that more requirements will discourage more investments rather than encourage them. We believe one of the reasons there aren't more investors in the NMTC program is due to the complexity of the regulations. Increasing the number of limitations on any kind of investment generally won't provide lower barriers to investment. Therefore, we recommend no additional limitations on unaffiliated CDEs or businesses.

B. Encouraging Equity Investments in Non-Real Estate Businesses.

1. **What non-statutory requirements in §1.45D-1 can be revised to encourage CDEs to make equity investments in non-real estate businesses?**

We believe that there are two primary issues affecting the amount of equity investments in non-real estate businesses – recapture risk and the definition of control as it relates to the reasonable expectations test of §1.45D-1(d)(6)(i). In response to Question 1 from section A of the request for comments you will find our comments regarding the risk of recapture and its effects on overall investments in NMTC transactions. You can find our comments regarding the definition of control in our response to the second question below.

2. **If consideration is given to potential changes to the reasonable expectations test of §1.45D-1(d)(6)(i), what modifications would be most effective in encouraging equity investments in non-real estate businesses, while still preserving the purpose of the existing limitations on the reasonable expectations test?**

In a letter to Mr. Michael Mundaca dated August 20, 2010, the NMTC Working Group provided comments on the issues regarding equity QLICIs. For your convenience, we have provided the body of those comments below as we believe the changes we recommended in 2010 are still applicable today. We believe changes in the reasonable expectations test are needed to reduce transaction costs and better facilitate both real estate and non-real estate investments.

> In several comment letters submitted over the years, the NMTC Working Group has recommended changes be made to the CDFI Fund's related party test definition and measurement in order to encourage CDEs to make majority equity investments in qualified active low-income community businesses ("QALICBs"). This year, the CDFI Fund made changes consistent with the NMTC Working Group's recommendations that would allow a CDE to make majority equity interest investments without violating its

allocation agreement so long as it had committed to investing substantially all of its proceeds in entities that were considered unrelated before it invested. This change was a significant step and one that the industry applauds the CDFI Fund for making.

However, it is unlikely that many CDEs will make majority interest equity investments because of an issue related to the reasonable expectations test defined in Treasury Regulation §1.45D-1(d)(6). The Regulations provide that if a CDE:

"…reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business [for the term of the investment…]"

then the QALICB will continue to be deemed a QALICB even if it falls out of compliance at a later time. This provision permits a CDE to avoid suffering a recapture event if the QALICB ceases to qualify as a QALICB during the recapture period for reasons that are outside the control of the CDE.

However, the Regulations further require that if the CDE has or obtains control of the QALICB, it generally must ensure that the entity remains a QALICB for the entire 7-year compliance period and cannot rely on its reasonable expectation at the time the investment is made to avoid a recapture event.

Investors do not want to be subject to strict liability for recapture merely because they acquire a majority equity interest in the QALICB if they do not also have management or voting rights that would allow them to control QALICB status. As a result of the broad definition of "control" under the reasonable expectation test, investors in the current market are unlikely to allow the CDE to acquire a majority equity interest in a QALICB.

If a CDE cannot rely on the reasonable expectation test, investors perceive the compliance risk as too great and most are unwilling to enter into such a transaction. This outcome is unfortunate since equity investments are generally the most patient form of capital and would also reduce the burden of ensuring that the subsidy can remain at the QALICB.

The current definition of control in Treasury Regulation §1.45D-1(d)(6)(ii)(B) states (emphasis added):

> "Control means, with respect to an entity, **direct or indirect ownership (based on value)** or control (based on voting or management rights) of more than 50 percent of the entity. For purposes of the preceding sentence, the term management rights means the power to influence the management policies or investment decisions of the entity."

The problem for equity investors is the imputation of control based on "direct or indirect ownership (based on value)". Currently there is no clear guidance on how to calculate

direct or indirect ownership "based on value". It is unclear to us how value is determined and how it is relevant to whether or not the CDE is controlling the QALICB. We believe that the concept of control should be based solely on the CDE's ability to control the QALICB's status as a QALICB through voting or management rights.

It would also be helpful to clarify the meaning of "control" given the variety of possible equity structures and documentation used in New Markets transactions. The potential for confusion is compounded by the fact that the CDFI Fund has adopted its own definitions regarding "control" in the NMTC arena -- definitions that do not necessarily work well for this purpose.

We believe that the only type of control based on voting or management rights that should be of concern in the context of the reasonable expectation test is control based on rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) allow the CDE to override or block actions by the QALICB when the authority to take such actions is necessary to enable the entity to remain a QALICB. The ability to exercise management or voting control on other issues would not seem to bear on whether the CDE should be allowed to rely on its own reasonable expectation of compliance as a safe harbor.

We note that there are some areas where a CDE's actions could indirectly affect compliance decisions by the QALICB, and one important example would be the right to remove a general partner of a partnership, the managing member of an LLC, or a majority of the directors of a corporation. Removal rights are commonly required by investors in scenarios in which a CDE is making equity investments in a QALICB. We believe that the existence of such rights in the CDE to remove **for cause** a managing member, general partner, or other party or parties with management control should not, by itself, be deemed to confer voting or management control on the CDE. Where removal is limited to "for cause" events (i.e., failure of the general partner, managing member, or majority of directors to comply with their obligations under the organizational documents), the threat of removal would not represent a mechanism for influencing management decisions that is tantamount to direct management control. Moreover, removal provisions typically contemplate the appointment of a substitute managing member, general partner, or directors, rather than entitling the CDE to manage the QALICB itself. In such a case, so long as the CDE does not actually "control" the substitute management, then the CDE could still satisfy the control test as we have recommended it be changed herein.

Accordingly, we recommend that the definition of "Control" contained in Treasury regulations be updated to remove the reference to a value based test and clarify voting and management rights that should be considered. Specifically, we recommend the following change to Treasury Regulation §1.45D-1(d)(6)(ii)(B):

> "Control means, with respect to an entity, **~~direct or indirect ownership (based on value) or~~** control **~~(based on voting or management rights)~~**

~~of more than 50 percent of the entity based on~~ of voting or management rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) to override or block actions by the QALICB that are necessary to enable the entity to remain a QALICB.

(a) The existence of rights in the CDE to remove for cause a managing member of a limited liability company, a general partner of a limited partnership, or majority of directors of a corporation by substituting a new managing member, general partner, or majority of directors with control would not, by itself, be deemed to give the CDE 'control' for purposes of this provision."

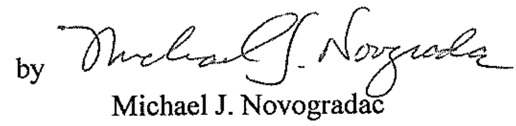
If these changes are adopted, it is likely that equity transactions could be structured in a manner that would attract investors by successfully addressing the issue of control and providing CDE's with the ability to rely on the reasonable expectations test. Without such a change, it is likely that investors will continue to sit on the sidelines when it comes to investing in CDEs that intend to make equity investments and will continue to effectively prevent the most patient form of capital, equity investments, from being made to QALICBs.

Conclusion

We are excited about the positive impact that the NMTC Program is having on the nation's low-income communities and low-income persons and the potential for future success. However, we feel that the program can become even more efficient and deliver more subsidy to the end users within low-income communities, especially to operating business QALICBs, if our recommended changes are made. We appreciate the opportunity to submit our comments on the advance notice of proposed rulemaking regarding investments in non-real estate businesses located in low-income communities. Thank you in advance for your time and consideration.

Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

Yours very truly,
Novogradac & Company LLP

by 
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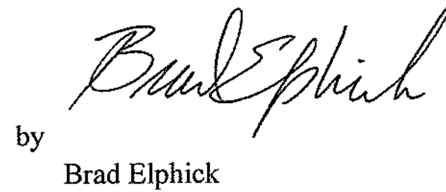
by 
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