

September 8, 2011

Internal Revenue Service
CC:PA:LPD:PR (REG-101826-11)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: 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 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 enhance the efficiency of the NMTC Program in delivering the most amount of benefit to the 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 administrative and 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. Michael Novogradac will also attend the scheduled public hearing to give oral statements on the comments we have below.

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 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

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

² IRC §45D(g)(2).

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. If no decision is made to reduce the overall risk associated with recapture, we respectfully request you consider our comments below to the questions asked in the notice.

Responses to Request for Comments

1. Will the proposed rules allowing a payment from a non-real estate qualified active low-income community business to be invested in a certified CDFI facilitate loans to, or equity investments in, non-real estate businesses? Should the rule take into account whether a loan to the non-real estate business is an amortizing or non-amortizing loan, the loan period, and the loan repayment schedule?

We do not believe these proposed rules will facilitate a significant amount of additional investments in non-real estate businesses. The only substantive change would be a possible increase in the capitalization of CDFIs as a result of the proposed rules. By allowing CDEs only 30 days to make a decision to reinvest in a certified CDFI in order for the original investment to be treated as continuously invested provides for additional complexities to the program and an additional time burden on the CDE

which further increases the risk associated with an investment. Currently, CDEs are allowed 12 months for reinvestment in order to be considered continuously invested. We recommend that the CDE have the ability to invest in a certified CDFI but that it have the ability to do so by the end of the 12 month period that starts from the date of receipt of the payment of, or for, capital, equity, or principal rather than 30 days after the receipt. While the ability to invest in a certified CDFI does provide some additional flexibility to avoid failing the substantially all requirement, it doesn't address the issue investors have regarding 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.

We do not believe the rule as proposed would need to change based upon whether a loan to the non-real estate business is an amortizing or non-amortizing loan or a term of the loan, or based on the loan repayment schedule.

2. Will the proposed rules encourage venture capital investments in non-real estate businesses? If not, how can the proposed rules be modified to accomplish that goal?

As we stated in our discussion regarding recapture risk above, we don't believe that the current proposed rules or any other similarly proposed rules will encourage venture capital investments in non-real estate businesses until changes are made that reduce the risk of recapture and the calculation of the amount of recapture. The rules as proposed do not provide relief that is significantly different than is currently allowed and being used to make venture capital or other similar investments in non-real estate businesses.

3. Is the definition of a non-real estate qualified active low-income community business sufficient for CDEs and investors to rely on? Are the "more than 50 percent gross income" requirement and activity limitation the appropriate ways to define a non-real estate qualified active low-income community business?

Generally, the definition is sufficient. However, it is not uncommon for non-real estate investments to have a portion of the proceeds used for the development of real estate in conjunction with other operating business uses. Based upon the following sentence included in the proposed definition, it may present issues regarding the specific uses of QLICI proceeds:

"The purpose of the capital or equity investment in, or loan to, the non-real estate qualified active low-income community business **must not be connected to** the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate." (emphasis added)

It is unclear as to what "must not be connected to" means. For example, does a non-real estate QALICB, "whose predominant business activity does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate", fail to be a non-real estate QALICB if it has a small portion of "enhancement" expenditures for its existing building? If so, we believe this would not be a sufficient definition and this

portion regarding the purpose of the investment should be removed so that the definition solely relies on the 50 percent gross income requirement of the business activity.

4. Will CDEs be able to determine whether an entity satisfies the requirements to be a non-real estate qualified active low-income community business without incurring unduly burdensome costs?

Costs are generally incurred to ensure that an entity meets the statutory requirements of a QALICB. If the IRS chooses to add another requirement for QALICB determination, it is likely that costs will be similar and will likely increase in such a transaction under the rules as proposed rather than decrease. We do not see those added costs as being particularly significant.

5. Should a payment from a non-real estate qualified active low-income community business be permitted to be invested in entities other than a certified CDFI (or qualified low-income community investments)?

For the reasons stated above, we do not believe this would significantly change the number of investments in non-real estate QALICBs. However, we would agree that if the regulations proposed are adopted that providing options in addition to certified CDFIs would provide additional flexibility and reduce the concern regarding eligible investments.

6. Should a qualified equity investment made before the effective date of the final regulations be eligible for designation as a non-real estate qualified equity investment?

We believe that any new regulations should generally allow those affected by the changes to have the option to elect to retroactively take advantage of the new flexibility afforded by the changes. Therefore, we recommend that a qualified equity investment made before the effective date of the final regulations be eligible for designation as a non-real estate qualified equity investment at the election of the CDE but should not be required to do so.


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 changes regarding recapture are made. We appreciate the opportunity to submit our comments on the 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.


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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,
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by 
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