

May 9, 2011

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and

Ms. Donna Gambrell
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**Re: The Urban Institute Report – “Evaluating Community and Economic Development Programs:
A Literature Review to Inform Evaluation of the New Markets Tax Credit Program”**

Dear Ladies and Gentlemen:

As participants in the New Markets Tax Credit (“NMTC”) Working Group, we, the undersigned, have joined together to provide comments regarding The Urban Institute Report – “Evaluating Community and Economic Development Programs: A Literature Review to Inform Evaluation of the New Markets Tax Credit Program” (the “Report”). 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 efficient 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 Urban Institute and the CDFI Fund for the ongoing commitment to evaluate the NMTC Program. We have provided our comments below to clarify some of the points that were made in the report for your consideration as you continue the process of evaluating the NMTC Program. We hope that you will reach out to us in the future as you prepare more analyses of the NMTC Program.

Corporate or individual investors

In the discussion regarding the value of the NMTC on page 7 of the Report, you attribute the diminished value of the credit to the fact that an investor has to pay capital gains taxes at the end of the credit period. In footnote 5, the NMTC is further compared to the Low-Income Housing Tax Credit (“LIHTC”). We agree that the NMTC has diminished value. We recommend that it be clarified that the reason for this diminished value is due to several factors, not just the capital gains factor or the lack of taxable losses from the underlying investment as outlined in the Report. We believe the main reason the present value of the credits is discounted to 25 to 30 percent of an investor’s total investment is due to a consideration of the time value of money. As was noted in the Report, the NMTCs are claimed over a period of six years and a day¹ and the investor cannot receive any of its capital back until after seven years². A typical investor would not be willing to pay a \$1 today for a \$1 of benefit it will receive six years from today. If you were to perform a simple net present value calculation of the credits received over the seven year compliance period using a modest 7% discount rate, the reduction in value of the tax credits is nearly 24%. That means that \$1 million of NMTCs claimed over six years and a day is only worth \$761,831 in today’s dollars or just more than 76 cents per dollar of tax credit.

In addition to the discount for the time value of money, the requirement that the taxpayer’s basis in the investment be reduced by the amount of the tax credit³ is another factor. This reduction in the taxpayer’s basis is similar to the requirements of the Historic Rehabilitation Tax Credit and Renewable Energy Tax Credits. This reduction in the taxpayer’s basis in its investment generally causes the taxpayer to recognize a taxable gain, which generates a tax cost, to the investor at the end of its investment term, generally just after the end of the tax credit period. This basis reduction is unlike what is required for LIHTC property which is not reduced by the amount of the LIHTC claimed.⁴

An additional consideration includes tax credit recapture risk. By having full recapture risk, plus interest penalties, 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 achieved but at a cost that is incorporated into the overall price of the NMTC. A reduction in tax credit recapture risk would certainly lower the discount of the NMTC applied by investors.

Finally, the assertion that NMTC investors cannot claim operating expenses – including management fees and depreciation on assets – in addition to the tax credits is not due to any regulations of the NMTC Program. If the CDE is a pass-through entity such as a partnership or LLC taxed as a partnership, the investor will receive its share of the CDE’s taxable losses and income. Most CDEs are structured as pass-through entities with the investor obtaining a 99.99% ownership interest in return for its qualified equity investment. Generally, the underlying project, whether real estate or an operating business, receives loans from a CDE rather than equity investments. Since the CDE is not making an equity investment, it will not be allocated any of the project’s taxable losses or income that are allocated to owners of the project. Therefore, there are no allocations of taxable losses or income to pass-through to the NMTC investor. However, if the CDE were to make an equity investment, it would be allocated items of taxable loss or income in accordance with its interest in the project and subsequently passed through to the NMTC investor if the CDE is a pass-through entity. Therefore, there is no prohibition

¹ IRC §45D(a)(3)

² IRC §45D(g)(3)(C)

³ IRC §45D(h)

⁴ General Explanation, TRA ’86, page 173.

against NMTC investors from being allocated losses from the underlying property but it is rarely structured in such a way.

Lastly, we note that the NMTC investment community is dominated by corporate investors and the top marginal tax rate for corporations for capital gains is the same as ordinary income, namely 35%.

Recipients of the investments

On pages 7 and 8, footnote 6 describes the qualifications of a qualified active low-income community business (“QALICB”) as defined in IRC §45D(d)(2)(A). We believe that it would be more accurate to begin footnote 6 with “In general...”. There are several additional qualifications excluded in footnote 6 that allow a project to meet the definition of a QALICB including, but not limited to portions of a business⁵ and the exceptions to the gross income and services performed tests.⁶

Financial health

On page 35 of the Report, the financial health of CDEs is discussed. Generally, CDEs that receive an allocation of NMTC authority establish subsidiary CDEs on a project-by-project basis to address the structuring, compliance and asset management issues that are common within the NMTC Program. These subsidiary CDEs are generally designed to have a limited life of slightly more than seven years, slightly exceeding the compliance period of the NMTC Program. At the end of the compliance period, most investors anticipate withdrawing from the transaction and therefore liquidating the CDE. The financial health of the subsidiary CDE is limited to its specific investments that are typically to a single project. Due to its limited life and its limited investments, the financial health of the subsidiary CDE can be sufficiently structured as there are generally few factors that will affect its ability to meet operating and lending expenses over the life of the subsidiary CDE.

Leveraging of Program dollars for other dollars

On page 65 of the Report, the effect of twinning the NMTC with other credits is discussed. In particular, the twinning of historic and renewable energy tax credits is mentioned. Twinning credits has proven to be a great way to provide additional sources to a project that qualifies for multiple credits. By twinning two credits, developers are able to increase the amount of credits generated which in turn increases the amount of tax credit equity generated. An investor will typically price the credits in a fashion similar to if they hadn’t been twinned. Therefore the investor’s yield in its tax credit investment generally remains unchanged and the true benefit is the additional subsidy that is available to the project.

Pricing efficiency of credits

In the discussion regarding the pricing efficiency of NMTCs, we agree with the factors that were pointed out as contributing to the discount in pricing that you see in the current market. However, we suggest that the central pricing issue actually revolves around when an investor makes their capital

⁵ IRC §45D(d)(2)(c)

⁶ Treas. Reg. 1.45D-1(d)(4)

contributions compared to when they receive the tax benefits they paid for, as well as suffer tax detriments associated with the basis reduction discussed earlier. The 39% NMTC is not claimed in its entirety at the time the investor makes an equity investment in the CDE but rather the NMTCs are claimed over a period of six years and a day⁷ and the investor cannot receive a return of any portion of its original capital until after seven years⁸. This is one reason the present value of the credits is discounted to 75 to 80 cents per dollar of tax credit in consideration of the time value of money, as was discussed in greater detail in our comments on the corporate and individual investors section.

In addition to the discount in value of NMTCs due to the time value of money, a required reduction of the investor's qualified equity investments equal to the amount of NMTCs⁹ claimed also increases the discount of the NMTCs. Generally, if an investor pays less than a \$1 per NMTC, they will have to recognize a taxable gain when they exit the partnership. For example, if an investor pays \$0.80 per credit and purchases \$1,000,000 in NMTCs, they will make total capital contributions of \$800,000. After seven years and all required basis reductions have been taken, the investor's capital account would be negative \$200,000 (\$1,000,000 - \$800,000). If you assumed no other increases or decreases in the investor's capital account other than the NMTC basis reduction, the investor would have to recognize taxable gain upon liquidation of its ownership interest equal to \$200,000, the amount the capital account was negative. The recognition of taxable gain is a tax cost to the investor and further reduces the value of the NMTC.

Finally, by having full recapture risk, plus interest penalties, the NMTC Program has a level of compliance and transaction structuring unrivaled by other tax credit programs. In many other tax credit programs, the level of recapture risk decreases over time. The recapture risk for NMTCs remains the same throughout the entire seven year compliance period. A higher level of structuring and underwriting ensures that the goals of the NMTC Program are achieved due to the shift in risk of project performance from the government to the taxpayer. With any shifting of risk to an investor, you should expect that pricing would decrease as a result. We recommend that these central factors be included in the discussion on the pricing efficiency of the NMTCs.

In evaluating the pricing efficiency of a tax credit program the report references five potential bases for comparison on page 74. These five bases include:

1. Perfection, where each tax credit dollar would translate into one dollar of investment;
2. A government grant and the costs associated with direct allocation of funds;
3. Private capital that has been induced by regulation to invest in community or economic development projects;
4. Other tax credit programs; or
5. The same program over time.

We recommend that you include some considerations involved in using each of these comparative approaches. We agree with the Report that in order to properly assess a program's efficiency, an

⁷ IRC §45D(a)(3)

⁸ IRC §45D(g)(3)(C)

⁹ IRC §45D(h)

evaluation should not be limited to just one of these bases for comparison. We have provided the following considerations and believe that these should be included at a minimum.

Perfection

When comparing a tax credit program to the perfect scenario in which there is no reduction in the value of the credit and investors are willing to invest a dollar for every dollar of tax credit received, the comparison should evaluate the central pricing issue we described above, the time value of money. The further away in time a benefit is recognized by an investor in comparison to when the risk is recognized, the further away the credit will be from perfection. In addition to this central issue of timing, other factors, including those that were listed on pages 72 and 73 should also be considered.

Government grant

When comparing a tax credit program to a government grant program the comparison should evaluate the cost of such a program as well as the transfer of risk from the private sector to the government. A tax credit program that encourages private sector investors to make investments they may not have made otherwise requires a relationship between public and private sector investment resources. This relationship with the private sector encourages an extreme amount of transaction scrutiny by the investors due to the risk of performance and tax credit recapture, which would be lost with a cash grant program. For example, by having full recapture risk, plus interest and penalties, the NMTC Program has a level of compliance and transaction structuring unrivaled by other tax credit programs to mitigate the risk of recapture since the risk doesn't decrease over time during the compliance period as it does in other similar tax credit programs. This level of structuring and asset management ensures that the goals of the NMTC Program are achieved because of the risk that the private sector is taking on. The compliance factor may be lost with a cash grant program and would likely lead to the funding of transactions that generated a higher default and loss rate, and therefore less community benefits. Also the government's risk of realizing repayment of any portion of the grant if a recapture event were to occur dramatically increases. In a tax credit program, enforcement of recapture penalties is directed at the private sector investors while a government grant program generally enforces recapture with the project level grant recipients. The grant recipients generally aren't as well capitalized as a private sector investor and likely will be unable to repay the grant and any recapture penalties. Additionally, the cost to the government compared to the benefit received should be evaluated. In a government grant program, the cost to the federal government occurs at the time the grant is made. In comparison, a tax credit program has tax credits, which are foregone revenue to the federal government, that are claimed over a longer period, six years and a day in the case of NMTCs. It has also been our experience that most of the transactions that used Section 1602 or 1603 grants didn't combine the grants with any other tax credits and were able to attract very little private investment in addition to the cash grants. The difficulty in combining different grant programs with other tax credits makes the grants one of the only available financing sources for these types of projects. We believe this would be the case if the NMTC Program is converted to a cash grant program.

Private capital

When comparing a tax credit program to private capital that has been induced by regulations there may be few comparisons that can actually be made that allow for a fair evaluation. In a tax credit program the consequences for failure to comply with the program's regulations can be quantified. Generally, private capital investments that have been induced by regulations to invest in community or economic development projects have few consequences that can be quantified for failing to comply that can be compared to compliance failure in tax credit programs.

Other tax credit programs

When comparing a tax credit program to other tax credit programs adjustments should be made for the dissimilarities in order to make a proper evaluation. Factors to consider should include, but not be limited to, the timing of when investors expect to make their cash investments, when benefits are expected to be received, the risk, term and cost of tax credit recapture, and basis reduction requirements and the complexity of compliance. For example, if you were to evaluate the NMTC and the historic rehabilitation tax credit, it would be important to note these differences. Historic tax credits are earned by the taxpayer when the qualified rehabilitation expenditures are placed in service instead of over seven years like the NMTC and the compliance period is five years for the historic tax credit as compared to seven for the NMTC. Furthermore, the historic tax credit recapture risk is reduced by 20% a year and there is no interest added to any recapture amount. NMTC recapture risk remains the same until the end of seven years and an interest factor is added to any recapture amount. Both credits are similar in that they require a 100% basis adjustment for the tax credit. In the compliance area, NMTC transactions have annual federal compliance and reporting requirements with the CDFI Fund, whereas historic tax credits transactions do not have comparable requirements.

The same program over time

When comparing a tax credit program to itself over time, the central issue to evaluate is likely to be the economic changes over that time period. For example, over time an investor's appetite may change due to current economic conditions that affect its profitability. During a period in which an investor experiences lower profits and therefore less tax liability, it makes sense that their appetite for tax credits would also decrease. The same may be true in the opposite direction during times of economic prosperity. Also, many tax credit programs are modified over time. For example, if the NMTC Program was changed in the future to allow it to offset alternative minimum tax, it would be difficult to compare it to today's NMTC Program without considering this economic change.

Other considerations

We agree that it is prudent to analyze investor rates of return in addition to the five bases of comparison described above. In order to make such an analysis, it is important that a comparable, risk adjusted, rate of return be used to make the comparison. As we have described throughout our comments, an important consideration that an investor makes in determining its pricing per credit is the overall risk of the transaction. Therefore, a comparable risk-adjusted yield must be determined. Investor yields from other tax credit investments may be a good basis for comparison since there are many similarities between investments. However, the differences between the programs have to be taken into account when making such a yield comparison.

Conclusion

We applaud the CDFI Fund and the Urban Institute in evaluating the NMTC Program. Addressing technical matters, including inefficiencies of the NMTC Program, has been the sole purpose of the NMTC Working Group and it is why the NMTC Working Group's members are dedicated to that goal. Since 2006, the NMTC Working Group has responded to requests from Treasury, the IRS, and the CDFI Fund with recommendations to improve the NMTC Program's ability to deliver significant community impact to this nation's low-income communities. Many of these comment letters provide suggestions to improve very specific aspects of the program that would improve the overall efficiency of the NMTC. All of these recommendations can be found in the Comment Letters page on www.nmtcworkinggroup.com.

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 believe that the program can become even more efficient and deliver more subsidy to the end users within 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,

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