

May 15, 2006

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2006-36)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2006-36 Public Comment Invited on Recommendations for 2006-2007 Guidance
Priority List

Dear Sirs:

As participants in the New Markets Tax Credit ("NMTC") industry, we, the undersigned, have joined together to request that the Department of Treasury and Internal Revenue Service (the "IRS") consider our recommendations regarding the guidance priority list for 2006-2007. We believe that our suggestions for guidance will help clarify and eliminate confusion related to current questions in the NMTC program. In many cases, we have already submitted letters in regards to these issues requesting additional guidance and suggesting sample language. By providing guidance on these issues, we believe that the NMTC Program will be able to better serve its intended purpose, providing equity and loan investments to Qualified Active Low-Income Community Businesses ("QALICBs"), by lessening the current risk to investors due to the uncertainties of the NMTC program. 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.

Partnership Allocations (Internal Revenue Code Section 704(b))

It is currently unclear as to how a partnership allocates NMTCs among its partners. Guidance on this issue would be very helpful, particularly to Community Development Entities (CDEs) seeking to make venture capital investments.

Redemption

In a letter dated April 24, 2006, we submitted comments and suggested language regarding the Treasury Regulations on redemption (Treasury Regulation Section 1.45D-1(e)(3)). We have attached a copy of that letter for your convenience.

Reinvestment Rules for Equity Investments

We plan to submit comments on suggested changes to the NMTC Treasury Regulations as they apply to equity investments in QALICBs. It is currently unclear as to how to determine if a distribution from a QALICB to a CDE is required to be reinvested. Additional guidance is requested.

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Reasonable Expectations Test

Treasury Regulations contain a “reasonable expectations” test. Under this test, a CDE can treat a QALICB as a QALICB for the duration of the CDE’s investment in the QALICB if the CDE had a reasonable expectation, at the time the investment was made, that the businesses would remain in compliance as a QALICB for the term of the investment and the CDE does not control the QALICB. Definitionally, it is clear that the reasonable expectations test applies to the general tests, e.g. sales, property and services. However, there are several areas where the statutory language of the Treasury Regulations is less clear, including:

1. For CDEs investing in other CDEs, that the Investee CDE is a qualified CDE,
2. Portion of a business rule,
3. Satisfying the “Active” business requirement,
4. Satisfying the rental of real property rules, and
5. Not being one of the excluded businesses (intangibles, “sin” businesses, and farming).


Clarifying guidance that the reasonable expectations test applies to each of the above would be very useful.

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. We appreciate the opportunity to submit our suggestions for issues that should be included on the 2006-2007 Guidance Priority List. We believe that further guidance on these issues is essential to sustain and increase the impact of the NMTC Program on 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 and Company LLP


Michael J. Novogradac

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Owen P. Gray

cc: Paul Handleman
Eric Solomon
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April 24, 2006

Mr. Paul Handleman
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Re: New Markets Tax Credit Regulation on Redemption (Reg. 1.45D-1(e)(3))

Dear Paul:

As participants in the New Markets Tax Credit ("NMTC") industry, we, the undersigned, have joined together to request that the Internal Revenue Service (the "IRS") consider our recommendations regarding amendments to the Treasury Regulation on redemption ("Regulation"). We believe that our suggested changes will lessen the unnecessary administrative burden for Community Development Entities ("CDEs") and lessen the undue risk of recapture faced by investors in CDEs. By lessening the administrative burden of CDEs, more of the NMTC subsidy can be made available to qualified businesses. Similarly, by lessening the undue risk of recapture to investors, more equity capital can be raised and invested in qualified businesses. We commend the Department of Treasury for its continuing efforts to improve and clarify tax guidance for the NMTC program in order to ensure its continuing success.

Since the IRS is working on guidance regarding targeted populations, we believe that the IRS has the opportunity to include these suggested changes in that guidance. If the IRS decides against this approach, then we ask that the IRS consider issuing other guidance clarifying the matters contained in this letter.

For your convenience, we have summarized our comments below:

C Corporation filing consolidated return

If a CDE is taxed as a C corporation and is included in a consolidated return, then it will likely make cash payments to its parent, the qualified equity investment ("QEI") holder, to fund the CDE's portion of the consolidated group of corporations' income tax liability. Under Regulation 1.45D-1(e)(3)(i), a C corporation's distributions to its parent

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are limited to earnings and profits. Earnings and profits are reduced by federal income taxes. If a C corporation CDE distributed all its earnings and profits to its parent, and made a payment to its parent for its allocable share of income taxes, there is concern that the payment to the parent would be treated as a distribution in excess of earnings and profits. We have suggested language to clarify that this is not the result.

Timing of distributions

Regulation Section 1.45D-1(e)(3)(iii) provides a safe-harbor for CDEs that are considered a partnership for Federal tax purposes. The Regulation specifically states:

“ . . . a pro rata cash distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year will not be treated as a redemption for purposes of paragraph (e)(2)(iii) of this section if the distribution does not exceed the CDE's operating income for the taxable year.”

The Regulation then defines Operating Income.¹ However, the Regulation implies that the distribution must be made in the same taxable year to which the Operating Income is attributed. By requiring that the distribution be made in the same year, CDEs are required to estimate Operating Income before the end of the taxable year. This is because in the normal course of business, a CDE will not have its books and records for a given month closed and adjusted until after the end of the month.

For example, the books and records of a calendar year CDE may not be closed and adjusted until January 15th. Additionally, the tax returns will not be completed in most cases until some time in March. As a result, the only way a CDE can distribute its Operating Income before the end of the taxable year is if the CDE estimates its Operating Income for the given year. If the CDE miscalculates its estimate of Operating Income and distributes cash in excess of Operating Income, then investors in the CDE could potentially suffer recapture.

¹ For purposes of calculating operating income, Reg. 1.45D-1(e)(3)(iii) defines operating income as:

- (A) The CDE's taxable income as determined under section 703, except that—
 - (1) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; and
 - (2) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;
- (B) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;
- (C) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k);
- (D) Start-up expenditures amortized under section 195; and
- (E) Organizational expenses amortized under section 709.

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In order for the CDE to accurately determine Operating Income as defined in the Regulation, the CDE must wait until after year-end to calculate Operating Income. There are several examples throughout the Internal Revenue Code (“Code”) that allow an entity to treat a distribution as having been made in a given taxable year if it makes the distribution within a certain amount of time after the end of a given taxable year. For example, Code Section 855 allows a regulated investment company to treat a distribution as having been made in a given taxable year if it declares the dividend prior to the due date for the filing of the tax return, including any extensions, and distributes the dividend within 12 months after the taxable year.² Code Section 857(b)(9) allows a real estate investment trust to treat a distribution as having been made on December 31 of a given taxable year if the distribution is made by January 31 of the following taxable year.³

We recommend that the Regulation be clarified to allow CDEs, solely for purposes of determining if a recapture event has occurred, to treat distributions made by the due date (including extensions) of a CDE’s federal income tax return to be treated as made in the prior taxable year. We have provided sample language for your consideration.

² Code Section 855(a) provides the following rule for distributions after close of taxable year:

(a) General rule.

For purposes of this chapter, if a regulated investment company—

- (1) declares a dividend prior to the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and
- (2) distributes the amount of such dividend to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration,

the amount so declared and distributed shall, to the extent the company elects in such return in accordance with regulations prescribed by the Secretary, be considered as having been paid during such taxable year, except as provided in subsections (b), (c) and (d).

³ Code Section 857(b)(9) allows dividends to be paid in the following year but deemed paid in the year they were declared:

(9) Time certain dividends taken into account.

For purposes of this title, any dividend declared by a real estate investment trust in October, November, or December of any calendar year and payable to shareholders of record on a specified date in such a month shall be deemed—

- (A) to have been received by each shareholder on December 31 of such calendar year, and
- (B) to have been paid by such trust on December 31 of such calendar year (or, if earlier, as provided in section 858).

The preceding sentence shall apply only if such dividend is actually paid by the company during January of the following calendar year.

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Distributions made for prior year(s)

In a given taxable year, a CDE may not want to or may not be able to distribute all of its Operating Income to its investors. The Regulation currently does not allow the CDE that is taxed as a partnership for federal tax purposes to carry this undistributed Operating Income forward to future years. If, however, the CDE is taxed as a corporation it is permitted to make distributions out of accumulated earnings and profits. It seems inequitable that corporations may make distributions out of its accumulated earnings and profits but partnerships are only permitted to make distributions out of current year Operating Income.

There are numerous examples of the inequities of this rule. For example, a CDE makes a 3 year loan that requires a balloon payment at the end of year 3 for the amount of principal and accrued interest. The CDE has accrued the interest income over the three years but has not received any current cash payments of interest. At the end of year three, the CDE receives cash for the repayment of the loan it made and corresponding accrued interest. However, because the taxable year in which the loan was repaid will only reflect the interest income for that year in its Operating Income calculation as the Regulation is currently interpreted, about two-thirds of the cash will be trapped at the CDE, unable to be distributed. With a carry-forward of undistributed Operating Income from prior years, the CDE would be able to distribute cash received when accrued interest is paid.

In an effort to create symmetry between the rules for corporations and partnerships as it relates to the Regulation, we ask that a CDE be allowed to make distributions from Operating Income in the same manner that a C corporation can make a distribution from earnings and profits. Code Section 316 defines a dividend as being a distribution out of accumulated earnings and profits or from current earnings and profits without regard to the accumulated earnings and profits at the time the distribution was made.⁴ We ask that entities taxed as partnerships be allowed to make distributions from Operating Income in the same manner. By creating this symmetry between corporations and partnerships, the burden on partnership CDEs to avoid redemption when distributing Operating Income without jeopardizing the NMTCs will be alleviated. We have provided sample language for your consideration.

⁴ Code Section 316(a) defines a dividend for purpose of distributions by a C corporation as follows:

(a) General rule.

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

- (1) out of its earnings and profits accumulated after February 28, 1913, or
- (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

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Tax-exempt income

We believe that Operating Income includes tax-exempt income. However, the current wording does not specifically state that it should be included. We recommend an added reference to specifically include tax-exempt income in Operating Income in order to avoid any confusion.

Capital gains

Some CDEs are making short-term venture capital investments in qualified businesses. If these investments are redeemed or otherwise sold, the CDE must reinvest the lesser of the proceeds received or the original cost basis. Amounts received in excess of the original cost basis do not need to be reinvested. However, the definition of Operating Income excludes capital gains. As such, while profits do not need to be reinvested by the CDE they cannot be distributed to investors without risking a recapture event. We recommend that capital gains be included in Operating Income.

Add-back of lower-tier depreciation

We believe that it is currently clear that depreciation and amortization expense attributable to an equity investment should be added back to operating income. Reg. Sec. 1.704-1(b)(1)(vii) treats the allocation of a loss as an allocation of each component thereof. Therefore, if a CDE is allocated a loss from a QALICB, that loss may include a pro rata share of the depreciation deductions of the QALICB which would be eligible for add-back. We believe it would be useful to specifically state that this is the rule.

We have provided sample language for your consideration. Our suggestions also include an update of paragraph (e)(3)(iii)(D) to include a reference to the recently enacted Hurricane Katrina first year depreciation rules contained in Section 1400N(d).

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. We appreciate the opportunity to submit our suggestions on the NMTC Regulation regarding redemption. Thank you in advance for your time and consideration.

Mr. Paul Handleman
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April 24, 2006

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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Enclosure

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Proposed Amendments to New Markets Tax Credit Regulations
Treasury Regulation Section 1.45D-1
Pursuant to I.R.C. § 45D(g)(3)(C)
Revisions in Red, Underlined Typeface

(e) Recapture.

(1) In general. If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, then the tax imposed by Chapter 1 of the Internal Revenue Code for the taxable year in which the recapture event occurs is increased by the credit recapture amount under section 45D(g)(2). A recapture event under paragraph (e)(2) of this section requires recapture of credits allowed to the taxpayer who purchased the equity investment from the CDE at its original issue and to all subsequent holders of that investment.

(2) Recapture event. There is a recapture event with respect to an equity investment in a CDE if—

- (i) The entity ceases to be a CDE;
- (ii) The proceeds of the investment cease to be used in a manner that satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section; or
- (iii) The investment is redeemed or otherwise cashed out by the CDE.

(3) Redemption.

(i) Equity investment in a C corporation. For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is treated as a C corporation for Federal tax purposes is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment is treated as cashed out when section 301(c)(2) or section 301(c)(3) applies to amounts received by the equity holder. An equity investment is not treated as cashed out when only section 301(c)(1) applies to amounts received by the equity holder. Solely for purposes of subsection (e) of this section, a CDE that is included in a consolidated return shall treat cash payments made to its parent corporation or any members of the consolidated group as a payment of income taxes by the CDE to the extent of the CDE's allocable share of income taxes.

(ii) Equity investment in an S corporation. For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is an S corporation is redeemed when section 302(a) applies to amounts received

by the equity holder. An equity investment in an S corporation is treated as cashed out when a distribution to a shareholder described in section 1368(a) exceeds the accumulated adjustments account determined under §1.1368-2 and any accumulated earnings and profits of the S corporation.

(iii) Capital interest in a partnership. In the case of an equity investment that is a capital interest in a CDE that is a partnership for Federal tax purposes, a pro rata cash distribution by the CDE to its partners based on each partner's capital or profits interest in the CDE during the taxable year will not be treated as a redemption for purposes of paragraph (e)(2)(iii) of this section if either the distribution does not exceed the CDE's operating income for the taxable year or the distribution and all prior distributions does not exceed the CDE's cumulative operating income for all years. In addition, a non-pro rata de minimis cash distribution by a CDE to a partner or partners during the taxable year will not be treated as a redemption. A non-pro rata de minimis cash distribution may not exceed the lesser of (A) 5 percent of the greater of (1) the CDE's operating income for that taxable year or (2) the CDE's cumulative operating income for all years less all prior distributions or (B) 10 percent of the partner's capital interest in the CDE. For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, operating income is the sum of:

(A) The CDE's taxable income as determined under section 703, except that—

(1) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; ~~and~~

~~(2) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;~~

(B) Income exempt from tax;

(C) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;

(D) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k) and 1400N(d);

(E) Start-up expenditures amortized under section 195; and

(E) Organizational expenses amortized under section 709.

(iv) Solely for purposes of calculating a redemption under paragraph (e)(3) of this section, cash distributions made by the due date (including extensions) of a CDE's federal income tax return shall, at the election of the CDE, be treated as made in the prior taxable year.

(v) For purposes of calculating operating income under paragraph (e)(3)(iii) of this section, Reg. Sec. 1.704-1(b)(1)(vii) applies to treat the allocation of net or "bottom line" taxable income or loss as an allocation of each component thereof.