

REG-149404-07

# NEW MARKETS TAX CREDIT COALITION

November 10, 2008

LEGAL PROCESSING DIVISION  
PUBLICATION & REGULATIONS  
BRANCH

NOV 13 2008

Internal Revenue Service  
Attn: CC:PA:LPD:PR (REG-149404-07)  
Room 5203  
PO Box 7604  
Ben Franklin Station  
Washington, DC 20044

Re: Amendments to New Markets Tax Credit Regulations

Dear Sir or Madam:

I am writing on behalf of the New Markets Tax Credit (NMTC) Coalition with comments on the IRS proposed amendments to the New Markets Tax Credit regulations (§1.45D-1T) as posted in the Federal Register on August 11, 2008.

In addition to submitting comments on the proposed amendments, the Coalition is taking this opportunity to make recommendations on several NMTC regulatory issues not addressed by the proposed amendment. This letter also includes a series of recommendations regarding the target population allowance authorized in IRC Section 45D(a)(2). While the Coalition plans to submit comments on the notice of proposed rulemaking issues in September on targeted populations we also felt it was important to include comments on the guidance in this comprehensive NMTC letter as well.

The Coalition looks forward to working with the IRS to craft regulations that serve to strengthen and clarify the intent of the NMTC program.

## **I. Comment on Proposed IRS amendments**

### **1. Redemption Safe Harbor for Partnership CDEs**

The proposed amendment attempts to clarify how a Community Development Entity (CDE), organized as a partnership, can make pro-rata cash distributions to its partners without violating NMTC redemption rules. This issue has been a concern for the Coalition and has been raised in previous letters to Treasury and the IRS, most recently in 2004.

The amendment provides that, in the case of an equity investment that is a capital interest in a CDE that is a partnership for federal tax purposes, the CDE can issue a pro-rata cash distribution to its partners based on each partner's capital interest in the CDE during the taxable year. That distribution will not be treated as a redemption of principal for purposes of §1.45D-1(e)(2)(iii) if the distribution does not exceed the sum of the CDE's operating income for the taxable year and the CDE's undistributed operating income (if any) for the prior taxable year.

The Coalition recommends that the IRS amendment be modified to ensure that distributions of QLICI loan interest payments and loan loss reserve proceeds are considered as operating income, provided that interest is due with respect to a leverage loan.

## **2. Termination of a Partnership CDE**

The Coalition supports the proposed rule that clarifies recapture is not triggered in cases in which a CDE is a partnership and the sale of a QEI causes the termination of that partnership as defined in IRC Section 708(b) which defines when and how a partnership is terminated

## **3. Reasonable Expectations Test Applied to CDEs**

The Coalition supports the amendment that applies the reasonable expectations test to CDEs making investments in other CDEs. However, we recommend that the amendment be expanded to ensure that the reasonable expectations protection is applied to pass-through CDEs in order to give investors added assurance with regard to the recapture risk associated with a CDE losing its CDE status.

When a CDE makes a QLICI in the form of a loan or equity investment in a QALICB, it is permitted to claim the benefit of the reasonable expectation safe harbor with respect to the continued qualification of the recipient as a QALICB over the seven-year compliance period. However, when a CDE (the "first CDE") makes a QLICI in the form of a loan or equity investment in another CDE (the "second CDE"), there is no safe harbor in place with respect to the CDE status of the second CDE that would serve to protect that loan or investment should the second CDE lose its CDE status during the compliance period. If the second CDE were to lose its CDE status at any time during the compliance period the NMTC loan or investment would cease to be considered a QLICI in compliance. Investors will continue to resist investing in CDEs that plan to loan or invest in pass-through CDEs unless the IRS can ensure investors that these transactions enjoy the protection on the reasonable expectations safe harbor.

In order to address this concern, we recommend that the following language be added to NMTC regulations Section 1.45D-1(d)(1)(iv):

For purposes of paragraph (d)(1)(iv) of this section, a CDE (the "second CDE") receiving a loan or equity investment from a CDE (the "first CDE") is treated as a CDE for the duration of the first CDE's investment in the entity if the first CDE reasonably expects, at the time the first CDE makes the capital or equity investment in, or loan to, the second CDE, that the second CDE will satisfy the requirements to be a qualified community development entity throughout the entire period of the investment or loan. In the event that further, successive loans or investments are made through additional CDE(s) as provided in paragraph (d)(iv)(2) or (3) of this section, such additional CDE(s) will be treated as CDE(s) for the duration of the first CDE's investment if the first CDE reasonably expects, at the time the first CDE makes the capital or equity investment, that such successive CDE(s) will satisfy the requirements to be a qualified community development entity throughout the entire period of the investment or loan.

## **II. Additional NMTC Coalition Recommendations**

### **1. Amend QALICB Tests for Target Population**

In September 2008 IRS issued a Notice of proposed rulemaking relating to how an entity serving certain targeted populations under section 45(D)(e)(2) can meet the requirements to be a QALICB. Prior to that Notice, in 2006 the IRS issued Notice 2006-60 which proposed that in order for a business to qualify as a QALICB for a target population it would be required to have:

- a) at least 50 percent of its gross income derived from sales, rentals, services and other transactions with individuals who are low income;
- b) at least 40 percent of its employees are low income; or
- c) at least 50 percent of the entity is owned by individuals who are low income.

While the Coalition generally supports the targeted populations thresholds proposed by the IRS, we have several recommendations.

First, the Coalition recommends that the ownership test be amended to accommodate non profit businesses that are not individually owned. The Coalition recommends that a non-profit business be required to document that at least 20 percent of its board, with a minimum of two board members, are low-income individuals or represent a low income target population. The CDE certification process requires that at least 20 percent of a CDE's board represent a low income community in order to ensure accountability to the low income community and we believe the same threshold test should be applied to ensure that a non-profit QALICB is accountable to a low income community.

Second, the Coalition recommends that the rules for target population accommodate start-up or expanding businesses. Current NMTC regulations, Section 1.45D(d)(4)(iv), accommodate the needs of start-up businesses in meeting the 'active conduct' test by requiring that a CDE, at the time it makes a QLICI, reasonably expects that the entity will generate revenues within three years after the date the QLICI is made. While we believe Notice 2006-60 allows for a QALICB benefiting a targeted population to take advantage of the 'reasonable expectation' period as provided in current regulations, we urge the IRS to clarify this point for the sake of CDEs and investors.

Finally, the Coalition recommends that the IRS and CDFI Fund consider accepting documentation of an individual's participation in other federal programs targeted specifically to low-income individuals and families as a proxy to document that the individual is low income for purposes of the NMTC. This would significantly ease the burden of compliance for CDEs and the administrative burden for the CDFI Fund. The following programs are solely targeted to low-income individuals and families and could be used to document an individual's target population eligibility: USDA School Lunch Program and Food Stamp Program, HHS-funded Community Health Centers, Medicaid, Child Care and Development Block Grants, and the Worker Opportunity Tax Credit. It would be up to the CDE to document how a QALICB satisfied the targeted populations test.

Similarly, the Coalition recommends that the IRS issue guidance to clarify that a QALICB can satisfy the requirement that at least 50 percent of its gross income is derived from sales, rentals, services or other transactions with low income persons by showing that at least 50 percent of the payments coming into the QALICB are coming from federal, state or local programs that exclusively assist low-income individuals.

For example, if a CDE invests in a federally-qualified, non-profit community health center and the center, as the QALICB, can document that at least 50 percent of its patients are below the poverty line based on the fact that at least 60 percent of the QALICB's gross income is derived from Medicaid payments, that should be sufficient because the third party payer system is available only to low income individuals. The Coalition requests IRS clarification and guidance to clarify whether in such a situation a QALICS could rely on its documented history of securing party Medicaid payments to show that at least 50 percent of its gross income is derived from services with individuals who are low income.

## **2. Facilitate CDE Lending to Non-Real Estate QALICBs**

The Coalition has advocated for a series of regulatory changes designed to accommodate CDE lending to non-real estate businesses. Currently most CDE lenders structure loans as 7-year, interest only notes with a balloon payment after year seven in order to alleviate investor concerns regarding the redeployment of repaid principal and maintain compliance with the “substantially all” requirement. While this 7-year, interest only loan structure satisfied investor concerns, it limits the ability of a CDE to respond to the financing needs of its business borrowers. The 7-year term of the Credit does not coincide with the amortization schedules used for equipment and working capital loans to small businesses. Many businesses, as a result, cannot repay or refinance Credit-financed loans with a balloon payment after the seventh year. Therefore, the Coalition supports allowing CDEs to offer more flexible debt products while addressing investor concerns.

Specifically, the Coalition recommends that a CDE be allowed to establish a sinking fund that would permit a CDE to direct principal repayments into a designated account without having the accumulating funds count against the CDE’s “substantially all” threshold. This new fund consisting of principle repayments would become an asset of the borrower, though the creditor would still have access to that money, and it would not increase the cost to the government. The sinking fund account could be held by the CDE or the IRS could require that the sinking fund account be held by a third party certified CDFI Bank.

## **3. Define Related Entity**

The Coalition recommends that the IRS issue a definition of ‘related entity’ before the 2009 NMTC allocation applications are submitted to the CDFI Fund in order to clear up what the Coalition believes is a misinterpretation of the related entity language in the NMTC authorizing statute.

While the NMTC statute (Section 45D(f)(2)) grants Treasury the authority to offer priority points to a CDE that intends to invest a substantial portion of its investments in QALICBs that are unrelated to the CDE the IRS NMTC regulations do not include a definition of related entity. The only definition of the ‘related entity’ is the one provided by the CDFI Fund in its annual allocation application and supporting materials. The CDFI Fund defines an entity that is related to the CDE as an entity that will hold a majority equity interest in the business after the CDE makes a QLICI in the business.

The Coalition disagrees with this definition because the test should be based on the equity interest that CDE has in the QALICB before and not after the QLICI is made. Since an allocation applicant can only secure priority points if commits that substantially all of its investments will be in unrelated entities, this definition serves to discourage CDEs from making equity investments into QALICBs.

In essence, the CDFI Fund’s current definition of the related entity test has forced CDEs to choose between making equity investments in QALICBs or securing priority points in the highly competitive NMTC allocation application process.

We would also argue that the CDFI interpretation is at odds with related party principals included in the Internal Revenue Code which would look to the relationship between the CDE and QALICB based on the ownership of each at the time the QLICI is made, not based on the CDE’s own interest after the QLICI is made.

Therefore, the Coalition urges the IRS to issue a definition of related entity that before the 2009 allocation applications are submitted to ensure that CDEs can effectively use the NMTC to make patient equity capital available to QALICBs.

#### **4. Facilitate CDE Venture Capital Investing**

The Coalition has issued numerous recommendations designed to alleviate some of the barriers that discourage CDEs from engaging in venture capital investing. The current NMTC rules define ‘Financial Counseling and other Services’ as advice provided by the CDE relating to the organization or operation of a trade or business. While the Coalition feels that the services of a venture capital fund manager would fall under this definition, investors will need additional clarification before they feel comfortable investing in a CDE that would count such an activity as a QLICI.

The Coalition recognizes that venture capital is a high-touch industry, with fund managers sitting on boards and taking part in the management decisions of the investee. Investors commonly pay a 2.5 percent management fee to the fund management to make and manage investments. One way to encourage more venture capital investing with the NMTC would be to clarify that fees provided to a venture capital fund manager, including management fees, could be considered to be ‘Financial Counseling and other Services’ and thereby qualify as a QLICI.

#### **5. Exempt NMTC Transactions from True Debt Analysis**

CDEs have expressed concern, particularly during this time of fast-declining real estate values, that the current true debt analysis is misleading and creating an impediment to closing deals in low income communities where the appraised value of a property is frequently far below the true development costs. Therefore the Coalition is recommending that the IRS exclude NMTC transaction from the true debt, or bona fide debt, analysis.

Many CDEs are finding that the appraised value of properties have been impacted by the market drop and real estate is appraising for less now than what it was just months ago. This is especially the case in low-income communities where NMTC transactions occur because values in these areas are markedly depressed.

CDE are increasingly finding that the sum of the QLICI loans to a real estate QALICB will exceed the appraised value of the assets being financed and tax counsel for the investors are taking the position that some or all of the QLICI cannot be considered true debt.

For example, assume a CDE is looking to finance a project costing \$10 million with 2 separate QLICIs, a \$7 million A Note and a \$3 million subordinated B Note. Assume that the property appraises for only \$8 million because of an economic downturn causing market values across the area, particularly in low income communities, to decrease. Tax counsel for the NMTC investor is likely to claim that the B Note is not true debt because it is not supported by the appraised value of the property, cannot be backed up by collateral, and this claim forces the CDE to craft documents that conform to the true debt analysis, which leads to a protracted negotiation with tax counsel and adds significant time and considerable cost in legal and accounting fees to a project. The additional transaction cost leads to a reduction in the benefit flowing to the QALICB and the community.

There are two ways the IRS could remedy this problem and the Coalition is requesting that the IRS move to adopt at least one of the following recommendations.

1. The IRS could alleviate the true debt constraint by issuing guidance requiring that the ‘related party’ test be applied to a CDE before a QLICI is made. This would allow CDEs to make equity

investments more readily available to QALICB and would help CDEs to fill the appraisal gap in real estate projects by loosening restrictions on CDE equity investing.

2. The IRS could exempt NMTC projects from the true debt, or bone fide debt, analysis. Exempting the transaction from true debt analysis will permit the NMTC program to more efficiently meet the program goal by make more equity and equity-like financing available to QALICBs and allowing more of the benefit to flow to and stay with the QALICB and the community.

We urge the IRS to adopt of on these recommendations.. Both will result in more equity investments being made in QALICBs and both will result in the reduction of cost in terms of NMTC transactions.

## **6. Clarify NMTC Exemption from IRC Section 183 and Economic Substance**

The Coalition continues to recommend that the NMTC be treated like the Low Income Housing Tax Credit and the Historic Tax Credit as it relates to IRC Section 183, Activities Not Engaged in for Profit, as well as the economic substance doctrine. The NMTC was created with the explicit goal of generating equity investment in low income communities where the incentive of a federal tax credit subsidy was needed because of the real or perceived economic risk associated with investing in low income communities. Therefore applying any type of economic substance test to the NMTC flies in the face of the program's intent.

IRC Section 183 is intended to curtail abusive tax shelters by requiring that equity investors enter into business transactions with the expectation that they will secure a profit. Similarly, the purpose of the economic substance doctrine is to curtail the use of abusive tax shelters that have no economic substance or business purpose other than reducing the federal tax liability of the taxpayer. The NMTC should be exempt from both of these provisions because Congress authorized the NMTC in order to encourage investments in low income communities that without the benefit of a federal tax credit have a difficult time attracting investment capital.

Section 183 presents a problem for investors involved in a leveraged transaction that may be largely driven by the Credit and less by the economics of the deal. Though Section 183 applies only to the activities of individuals and S Corporations, the Coalition is requesting that the IRS clarify that section 183 not be applied to NMTC transactions. The IRS issued a notice clarifying that Section 183 not be applied to the LIHTC and the Coalition is requesting that the same notice be issued for the NMTC.

The Coalition recognizes that the economic substance doctrine has not yet been codified but nonetheless many investors are requiring CDEs to verify the economic substance of a QLICB in order to finalize an investment agreement and this required verification adds time and cost to the NMTC transaction by forcing CDEs to project 20-year build out scenarios or use a set payment amount in order to clear the economic substance hurdle.

If and when the economic substance doctrine is signed into law and codified, it is not the intent of Congress to have the test applied to NMTC transactions. In 2004 the Senate Finance Committee made this clear in the report filed on the Jumpstart Our Business Strength Act (Report 108-192) which included language to codify economic substance. The report explicitly states, "if tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority it is not intended that the tax benefit be disallowed if the only reason for the disallowance is that the transaction fails to meet the economic substance doctrine as defined in this provision." The Low Income Housing Tax Credit and Historic Rehabilitation Tax Credit were mentioned in a report footnote as duly exempt from the economic substance doctrine and

NMTC would be granted exemption for the same reasons. To clarify this point during the 2004 debate on the bill, Senator Jay Rockefeller engaged Senator Max Baucus, then Ranking Member of the Senate Finance Committee, in a colloquy on the Senate floor where Baucus stated, “It is our intent that the NMTC be treated like the LIHTC and the HRTC and protected as a congressionally mandated tax benefit.”

### **7. Clarify What Constitutes a Tenant Excluded Businesses**

The Coalition requests guidance on NMTC Regulation Section 1.45D-1(d)(5)(ii) that states “a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent a lessee of the real property is described in paragraph (d)(5)(iii)(B) of this section.” This disqualifies a CDE investment from being considered a QLICI if the lessee is a business that is engaged in an activity on the so called ‘sin list’ which includes casinos, massage parlors, and golf courses.

The Coalition requests clarification as to whether a CDE is only prohibited from leasing to a business that is engaged exclusively (or primarily) in a prohibited business or whether a CDE is prohibited from leasing to a business that is engaged in any level of disqualified business activity.

For example, consider a CDE that finances the development of commercial office building that leases space to a state job training agency and the state operates a lottery and allows gambling at casinos in its jurisdiction. The state agency housed in the commercial office building is not involved in a disallowed business activity and yet it is affiliated with a state government that sanctions one of more disallowed business activities. It is not clear if the leasing to such a state agency would disqualify the office building from being able to receive a QLICI.

The Coalition recommends that the IRS clarify that a QLICI is disqualified if the lessee is “exclusively or primarily engaged in one of the prohibited businesses listed in paragraph (d)(5)(iii)(B).” In addition, we recommend that the ‘portions of a business’ allowance be applied in a case where a lessee would meet all of the QALICB tests if separately incorporated.

As the regulations are written, the reasonable expectation safe harbor applies only to a CDE’s expectation about QALICB status. But a tenant’s engagement in a prohibited business impacts QLICI status directly, without reference to QALICB status. The Coalition therefore recommends that the regulation be amended to read: “For purposes of this paragraph (d)(5)(ii), a QLICI will not be disqualified if the CDE reasonably expects, at the time it makes the capital or equity investment or loan to a business engaged in the rental of real property, that lessees will not be engaged in the businesses described in paragraph (d)(5)(iii)(B) of this section.”

### **III. Coalition Comments Regarding the NMTC and Housing**

Over the last year members of the Coalition board have engaged in several discussions aimed at developing a model by which the NMTC could be used to finance the development or rehabilitation of low-income housing and/or assist homeowners facing possible foreclosure. The Coalition continues to explore the potential of the NMTC in this capacity and is in an ongoing conversation as the housing crisis continues and the NMTC Coalition learns more about the type of financing tools that are needed and most appropriate in this situation.

There is one housing proposal the Coalition would like to encourage the IRS to consider and this model would allow a CDE to use its NMTC allocation to finance a “home aggregator”, a qualified active low income community business (QALICB) engaged in the purchase and sale of single-family homes. The homes may or may not be occupied at the time of purchase (and/or

sale). In the case of occupied properties, the QALICB home aggregator would purchase the home from the owner, thereby retiring the existing mortgage on the property, (i.e. the costly sub-prime loan) and then sell the property back to the family while providing a new fixed rate, 100 percent loan to value, 80/20 regularly amortizing mortgage.

For low-income families seeking a loan on their first home, the QALICB home aggregator would simply purchase the home on behalf of the family and immediately sell the home to the family with the favorable NMTC facilitated financing.

The first-position conforming 80 percent loan would be financed by a conventional lender and sold on the conventional secondary market to Fannie Mae or Freddie Mac. The 20 percent second loan would be financed from NMTC proceeds and would actually be a 20% seller carry back from the QALICB home aggregator. The QALICB would own the home for a short period of time before selling it.

While the model works best if the 80 percent first mortgage originator is also the NMTC investor, it still works if the two parties are different. The combined 80/20 interest rate loan to the borrower is projected to be between 6.5 - 7.5 percent, fixed for 30 years. The end borrower/homeowner would benefit from a more favorable mortgage on the property, one that would allow them to avoid foreclosure and/or allow individual wealth building.

In order to move this proposal forward, the IRS would need to clarify that a home aggregator business would qualify as a QALICB and to do so it would need to satisfy all five of the QALICB threshold tests.

The Coalition does not anticipate that an aggregator business would have a problem meeting the first four QALICB tests: the 50 gross income test; the 40 percent tangible property test, the 40 percent services test, or the less than 5 percent collectibles test. We make this claim assuming that the home aggregator's business office would be located in qualified NMTC census tracts and all of the properties purchased, held, and sold would be in low-income census tracts. None of the home aggregator's assets are likely to be collectibles so the fourth test would be met.

The question is whether a home aggregator business could satisfy the fifth test requiring that less than 5 percent of the QALICB's average of the aggregate unadjusted bases of the property be attributable to nonqualified financial property and we are requesting clarification on this point and on the IRS's interpretation of Section 1397C (e) which defines "nonqualified financial property" as debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property, with the exception of reasonable amounts of working capital held in cash, cash equivalents, or debt or accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory.

The Coalition recommends that since the home aggregator business would be in the business of purchasing and selling single-family homes, those home properties should be treated as business inventory and therefore be exempt from the "non qualified financial property" test. As part of its normal course of business, the home aggregator would be selling its inventory in exchange for 2<sup>nd</sup> position notes receivable which it would hold for the remaining seven year term of the NMTC program.

In instances where the home aggregator is forced to rent the housing it acquires, perhaps due to markets circumstances, we request that the aggregator QALICB be exempt from NMTC Regulation Section 1.45D-1(d)(5)(ii) that prohibits a QALICB from engaging in the rental of

residential property. In order to facilitate use of the NMTC to finance this housing model, a QLICB would need this flexibility. The QALICB, either by renting or selling the housing inventory, would be working to see that previously 'at risk' properties in low income communities remain occupied..

I appreciate the opportunity to submit these comments on behalf of the NMTC Coalition and I look forward to working with the IRS in the ongoing effort to strengthen and refine the NMTC program.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert A. Rapoza". The signature is fluid and cursive, with the first name being the most prominent.

Robert A. Rapoza