

March 13, 2009

Internal Revenue Service
CC:PA:LPD:PR (REG-149404-07)
Courier's Desk
1111 Constitution Avenue, NW
Ben Franklin Station
Washington, D.C. 20224

Re: New Markets Tax Credit Treasury Regulations Project – Clarifications

Dear Ladies and Gentleman:

In response to your request, we are submitting clarification of comments we sent on behalf of the New Markets Tax Credit ("NMTC") Working Group in a letter dated November 7, 2008. We have revised our recommendations to further address issues that are being raised in light of the current economic crisis. We are specifically providing clarification to our Working Capital and Redemption – Special Exceptions comments and have added a further recommendation regarding qualified low-income community ("QLICI") reinvestment requirements. The proposed amendments address the impact on a CDE's operating income and reinvestment requirements when a qualified active low-income community business ("QALICB") is in default or incurs losses during periods of economic distress consistent with the program's intent to maintain the community development entity's ("CDE") investment in the QALICB during the 7-year tax credit period. We believe that our suggestions for guidance will help clarify and minimize confusion related to current questions in the NMTC program. We appreciated the opportunity to submit comments originally and the opportunity to speak at the public hearing on this matter. We look forward to continuing the open dialogue regarding these issues and any others with the NMTC program.

1. Loan Loss Reserves.

The first proposal addresses the ability of the Community Development Entity (CDE) to make distributions funded by loan loss reserves held by the CDE if the Project Borrower (QALICB) is not making current interest payments. Interest payments made by the QALICB are used by the CDE to pay operating expenses and to make distributions to the Investment Fund/Investor (Fund). The distributions are used by the Fund to pay interest due with respect to a Leverage Loan (or the economic equivalent return on an equity investment) and pay operating expenses. Under the existing regulations, if a CDE has cash reserves set aside for loan losses it cannot distribute such funds if the interest income due from the QALICB to the CDE cannot be accrued or if it is uncertain as to its ability to accrue the interest income. This will result in a payment default on its leveraged loan by the Fund. The request is to clarify that a CDE can use loan loss reserves for their intended purpose in the event of a payment default by a QALICB without regard to the accrual of the interest income for federal income tax purposes. The proposed amendment will allow the CDE to provide patient capital to the QALICB and avoid enforcement action during periods of financial distress.

The proposed modification to the Operating Income Safe Harbor is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(e)(3)(iii):

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 –

(3) Interest income with respect to a loan that is a qualified low-income community investment that is not accrued for federal income tax purposes in connection with a payment default shall be included in the CDE’s taxable income up to an amount equal to the CDE’s loan loss reserve maintained in compliance with paragraph (d)(3) of this section.

(iv) Example. – The application of paragraph (e)(3)(iii)(A) is illustrated by the following example:

Example. (i) X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. Y acquires a qualified equity investment of \$10 million in X. X uses the proceeds of Y’s qualified equity investment to establish a \$500,000 loan loss reserve held by X and to make a \$9,500,000 loan that is a qualified low-income community investment to B. B is a qualified active low-income community business. In the year ended December 31, 2008, B is unable to make required interest payments of \$600,000. X does not accrue the unpaid interest as taxable income for federal income tax purposes. X can include \$500,000 of unpaid interest in *operating income* and distribute up to \$500,000 from the loan loss reserve to Y.

2. Losses

Under the existing operating income safe harbor, losses realized from equity investments in QALICBs taxed as partnerships adversely impact a CDE’s operating income during periods of economic distress. For example, if a QALICB is incurring losses due to delays in lease-up or vacancies of a commercial rental building, the CDE partner will be allocated losses that may prevent distributions by the CDE of interest payments received from the QALICB in compliance with the safe harbor. If the QALICB is taxed as a corporation, such losses would not impact the CDE’s operating income. The amendment proposed facilitates equity investments by the CDE and allows the CDE to provide patient capital to the QALICB, in particular during periods of economic distress. The proposed amendment provides that losses allocated to the CDE with respect to equity investments in QALICBs taxed as partnerships do not reduce operating income to the extent such losses exceed the cumulative taxable income allocated to the CDE with respect to the equity investment.

In addition, in combined historic and new markets tax credit transactions, the CDE may be the sole owner of the operator of a rental real estate property leased from the QALICB (a disregarded entity for federal tax purposes), and may recognize losses during start up operations and periods of economic distress, for example due to rental vacancies or delays in lease-up. Such expenses incurred by the CDE will reduce the CDE’s operating income and may prevent distributions by the CDE in compliance with the operating income safe harbor. The proposed amendment below provides that losses recognized by the CDE with respect to equity investments

in disregarded entities do not reduce operating income to the extent such losses exceed the CDE's cumulative taxable income recognized by the CDE with respect to the equity investment.

The proposed amendment to the definition of "operating income" is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(e)(3)(iii):

For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, "operating income" is the sum of:

(F) losses (excluding deductions included in operating income pursuant to paragraph (e)(3)(iii) without regard to this paragraph (e)(3)(iii)(F)), but only to the extent that such losses are realized by the CDE from an equity investment in an entity that is either a partnership or disregarded entity for federal income tax purposes, and such losses exceed the CDE's cumulative taxable income realized from such equity investment.

(iv) Example. – The application of paragraph (e)(3)(iii)(F) is illustrated by the following examples:

Example. (i) X is a calendar year partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On January 15, 2008, Y acquires a qualified equity investment in X. On January 15, 2008, X uses the proceeds of Y's equity investment to make qualified low-income community investments that consist of a loan and an equity investment in B. X has a 49% interest in all partnership items of B. B is a qualified active low-income community business and a partnership for federal income tax purposes. B is required to make \$250,000 in annual interest payments to X. For the year ended December 31, 2008, B realizes net tax losses of \$400,000 (including \$250,000 of interest expense and \$150,000 of other operating expenses). B uses \$400,000 of loan proceeds held in a working capital reserve to pay the operating expenses. For the year ended December 31, 2008, X's interest income is \$250,000 and X's losses allocated from B are \$196,000 (49% of \$400,000). Under paragraph (e)(3)(iii)(F) of this section, \$196,000 would be added to X's *operating income* for the year ended December 31, 2008, since such losses exceed X's cumulative taxable income realized from its equity investment in B.

3. CDE Expenses – QLICI Defaults

A CDE may incur unanticipated expenses if a QALICB is in default, for example, in connection with restructuring a QLICI or exercising remedies. These unanticipated, extraordinary expenses may reduce the CDE's operating income such that the CDE cannot make distributions in compliance with the operating income safe harbor. The proposed amendment below allows the CDE to add back expenses incurred in connection with QLICI defaults.

The proposed amendment to the definition of "operating income" is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(e)(3)(iii):

For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, "operating income" is the sum of:

(G) losses (excluding deductions included in operating income pursuant to paragraph (e)(3)(iii) without regard to this paragraph (e)(3)(iii)(G)), but only to the extent that such losses are realized by the CDE with respect to servicing a qualified low-income community investment if the qualified active low-income community business is in default or is experiencing financial difficulties that are reasonably likely to cause a default with respect to the qualified low-income community investment.

(iv) Example. – The application of paragraph (e)(3)(iii)(G) is illustrated by the following example:

Example. X is a calendar year partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On January 15, 2008, Y, a calendar year taxpayer, acquires a qualified equity investment in X. On January 15, 2008, X uses the proceeds of Y's equity investment to make qualified low-income community investments that consist of a loan and an equity investment in B. X has a 49% interest in all partnership items of B. B is a qualified active low-income community business. During 2008, B fails to perform as required under agreements entered into with X. As a result of such failures to perform (i.e., defaults), for the year ended December 31, 2008, X incurs \$30,000 of attorneys' fees and travel expenses related to enforcement and/or restructuring of its qualified low-income community investments in B. X uses funds held in a loan loss reserve in compliance with paragraph (d)(3) of this section to pay the additional expenses incurred due to B's defaults. Under paragraph (e)(3)(iii)(G) of this section, to the extent X's additional operating expenses due to B's defaults are deductible, up to \$30,000 would be added to X's *operating income* for the taxable year ended December 31, 2008.

4. QLICI Reinvestment - CDE expenses

As discussed above, a CDE may incur unanticipated expenses related to the restructuring of a QLICI that is in default or a QALICB that is experiencing financial difficulties that are reasonably likely to cause a default. Above, we proposed an amendment to allow a CDE to add back these extraordinary expenses in the calculation of operating income. We further recommend that the amount of proceeds received by a CDE in payment of, or for, capital, equity or principal that must be reinvested be reduced by these expenses since they are directly attributable and are only incurred when there is a troubled QLICI.

The proposed amendment to the reinvestment requirement is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(d)(2)(i):

(d)(2)(i) In general. Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE **(net any expenses realized by the CDE with respect to servicing a qualified low-income community investment if the qualified active low-income community business is in default or is experiencing financial difficulties that are reasonably likely to cause a default with respect to the qualified low-income community investment)** in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least

equal to such original cost basis, then an amount equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(iv) Examples. – The application of paragraph (d)(2)(i) is illustrated by the following example:

Example 2. On April 1, 2003, A, B, and C each pay \$100,000 to acquire a capital interest in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X treats the 3 partnership interests as one qualified equity investment under paragraph (c)(6) of this section. In August 2003, X uses the \$300,000 to make a qualified low-income community investment under paragraph (d)(1) of this section. In August 2005, the qualified low-income community investment is defaulted on. X pays legal fees of \$20,000 in restructuring the defaulted loan. The original \$300,000 qualified low-income community investment is redeemed for \$250,000. In February 2006, X reinvests \$230,000 of the \$250,000 in a second qualified low-income community investment and uses the remaining \$20,000 for the legal fees incurred as a result of the defaulted loan. Under paragraph (d)(2)(i) of this section, \$300,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment because the \$20,000 used to pay costs in connection with restructuring or exercising remedies for the defaulted qualified low-income community investment are not required to be reinvested.

5. Working Capital

In our previous comments, we recommended that the reasonable working capital regulations be amended to allow proceeds to be expended for construction of real property within a 24 month period after the date a qualified low-income community investment (“QLICI”) is made, rather than just 12 months. Our recommendation was based upon common industry practice that when an investor makes a qualified equity investment (“QEI”) in a community development entity (“CDE”), it will generally require those funds be nearly simultaneously invested or loaned to a qualified project in the form of a QLICI. While a CDE has the ability to hold onto the QEI proceeds up to 12 months after receiving them before substantially all of the proceeds must be invested, it is not common practice for QEI investors to allow CDEs to do so. Investors believe that the risk associated with their investments increases the longer their proceeds remain uninvested. For this reason, we requested that the time period that the qualified active low-income community business (“QALICB”) could hold the QLICI proceeds be extended


to 24 months since 12 months was proving to be too short for many construction projects. If the 12 month period isn't changed, CDEs will be forced to make QLICs in tranches in order to avoid having cash at the QALICB for periods of more than 12 months. Since, QLICs will need to be made in tranches, investors will generally prefer to make their QEIs in corresponding tranches to avoid having the QEI proceeds remain uninvested. This creates an unnecessary and expensive burden on both the CDE and the QALICB. In nearly every case this decreases the amount of proceeds that makes it to the qualified project due to the increased transaction costs.

Conclusion

We commend the Department of Treasury and Internal Revenue Service for its continuing efforts to improve and clarify tax guidance for the NMTC program in order to ensure its continuing success. 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 the program has to be an economic stimulus in our low-income communities. We appreciate the opportunity to submit our clarifications for these issues regarding the NMTC regulations. 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,
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along with the undersigned

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