NOVOGRADAC & COMPANY LLP
CERTIFIED PUBLIC ACCOUNTANTS

May 1, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2013-22 Public Comment Invited on Recommendations for 2013-2014 Guidance Priority List

Dear Ladies and Gentlemen:

On behalf of the members of the New Markets Tax Credit ("NMTC") Working Group, we submit the following comments, considerations, and recommendations regarding existing NMTC rules and regulations, which we believe will increase the effectiveness and efficiency of the NMTC Program. The members of the NMTC Working Group are participants in the NMTC industry who work together to help resolve technical NMTC Program issues and provide recommendations to make the NMTC Program even more efficient in delivering benefits to qualified businesses located in low-income communities around the country. Our group includes over 50 organizations that are allocatees, nonprofit and for-profit community development entities ("CDEs"), consultants, investors, accountants and lawyers.

We appreciate the opportunity to comment on ways to further enhance the good being done by the NMTC Program, and we also appreciate the level of commitment, dedication and outreach that has been shown and continues to be shown by the CDFI Fund, the Internal Revenue Service ("IRS") and the Treasury's Office of Tax Policy in implementing and managing the NMTC Program. The CDFI Fund, IRS and Treasury have proven to be capable managers of the NMTC Program. This is evidenced by the tremendous success the NMTC Program has enjoyed since its inception in 2000. Low-income communities across the country have benefitted from targeted investments of more than $26 billion. We applaud the various offices within Treasury that have worked with all those involved in these transactions to ensure that those dollars get into highly distressed communities as efficiently as possible.

Since the program's inception, the knowledge, understanding and experience among participants in the NMTC Program has been continuously rising, as has the demand and competition for the NMTC among participants in the NMTC Program, including investors, lenders, CDEs and qualified businesses. The interaction of these and other factors has led to ever greater efficiencies and effectiveness of the NMTC Program in delivering much needed subsidy to qualified businesses.[1] These factors have also helped direct a greater portion of the NMTC Program to the nation's most distressed low-income communities and to qualified businesses generating even greater community impacts.

[1] See "Reports Indicate that NMTC Program Improves with Age," Novogradac Journal of Tax Credits, July 2011, Volume II, Issue VII.

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We commend the IRS for requesting items to be included on its annual Guidance Priority List. We believe that one of the most effective ways to further improve the efficiency of the NMTC Program requires a statutory change – that is to make the credit permanent or, at a minimum, provide a long-term extension. The current trend Congress has exhibited of granting a short-term extension creates uncertainty in the industry. Uncertainty in any aspect, especially as it relates to the future of funding for the NMTC Program, limits the number of investors and potential CDEs willing to participate, and also limits the level of long-term investment that existing investors and CDEs are willing to make. Willingness by investors to participate in the NMTC Program would also be greatly enhanced if a long-term or permanent extension of the NMTC included a provision that would allow the NMTC to offset the alternative minimum tax (AMT).[2] A long-term extension of the NMTC with an AMT offset provision would put the NMTC Program on par with Low-Income Housing Tax Credits, Historic Tax Credits and certain Renewable Energy Tax Credits, and would increase the demand by investors for the NMTC. An increase in demand by investors would lead to an even greater amount of subsidy reaching qualified businesses. Additionally, if the NMTC Program were made permanent or received a long-term extension, CDEs and other NMTC Program participants would dedicate more resources to the NMTC Program and generate even greater efficiencies. Due to the economic downturn, the financing of qualified businesses has become increasingly complicated, requiring industry participants to become progressively more creative in transaction structuring while simultaneously ensuring that as much subsidy from the NMTCs as possible reaches qualified active low-income community businesses ("QALICBs").

We believe that the following comments, considerations, and recommendations regarding existing NMTC rules and regulations, if pursued and adopted, will increase the effectiveness and efficiency of the NMTC Program. That said, we believe one regulatory change rises above all others in its potential to positively impact the NMTC Program – the manner in which tax credit recapture is determined. By imposing the risk of full recapture, plus interest and penalties, for the full term of the investment for all potential causes of recapture, the NMTC Program has created a level of compliance analysis and transaction structuring unrivaled by other tax credit programs. A reduction in tax credit recapture risk during the term of the investment would lower overall transaction costs and help facilitate the financing of specific types of businesses that tax credit investors are reluctant to make currently.

The following comments, considerations, and recommendations specifically relate to regulatory changes. Because many of the proposed revisions to the regulations clarify policies that many industry participants have thought were already implicit in the regulations, we believe it would be helpful if the proposed changes, at the option of the taxpayer, could be relied on for periods prior to their effective date. Otherwise, CDEs will receive no additional comfort that transactions structured before the effective date will be allowed to rely on any of the clarifications and guidance provided in the proposed regulations.

For your convenience, the recommendations have been prioritized in Exhibit A and are what we believe to be the order of highest priority. However, we agree that each recommendation should be considered to generate and sustain the greatest possible community impact. Our comments reflect the work of over 50 member organizations participating on numerous conference calls and countless drafting sessions over several years. We trust you will find our comments useful and instructive. Many of our comments have been previously submitted in response to other requests for public comment. All of the NMTC Working Group's comments regarding these issues, as well as many others, can be found on our website at www.nmtcworkinggroup.com. We would be happy to meet with you to discuss our comments in further detail.

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[2] For further discussion of AMT implications, see §2.16 of Novogradac & Company New Markets Tax Credit Handbook, 2011.

We appreciate the opportunity to submit our suggestions for issues that should be included on the 2013-2014 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. With further guidance, we believe that the NMTC can be an even more effective tool in restoring economic growth throughout the country. 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. 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

by

Brad Elphick

cc: Paul Handleman
Robert Ibanez

Exhibit A
NMTC Working Group
2013-2014 Guidance Priority List

Regulatory Changes

1. **Provide proportionate recapture to provide a reduction in tax credit recapture risk during the term of the investment**

   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.[3] 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.[4]

   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

[3] IRC §45D(g)(1); Treas. Reg. §1.45D-1(e)(1).
[4] IRC §45D(g)(2).

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 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.

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. We recommend that the CDFI Fund not deviate from the current statutory mandate of priority points.

2. Redemption Safe Harbor for Partnership CDEs

In a letter dated April 24, 2006, we submitted comments and suggested language for the Treasury Regulation on redemption (Treasury Regulation § 1.45D-1(e)(3)) regarding the timing of distributions and distributions made for prior years' accumulated profits. The NMTC Working Group requests that the suggested language offered in our previous letter be further considered. We still believe that our suggested changes will lessen the unnecessary administrative burden for CDEs as well as the undue risk of recapture faced by investors in CDEs. By lessening the administrative burden to 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 efforts in proposing changes to the regulations. However, we still request that our recommendations be considered as an alternative to the proposed changes in the regulations. For your convenience, we are resubmitting our comments below from our previous letter with certain changes made to incorporate the proposed changes in the Regulations. We have also provided the additional follow-up clarifications to this sample language that were sent in the letter dated March 13, 2009 for your consideration in Exhibit C.

Final 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."

a. Timing of distributions

The Final Regulation then defines Operating Income.[5] However, the Final Regulation implies that the distribution must be made in the same taxable year to which the Operating Income is attributed. By requiring the distribution to be made in the same year, CDEs are required to estimate Operating Income before the end of the taxable year rather than rely on its books and records which are typically closed and adjusted after year end. Even with the changes in the proposed regulations that allow distribution of the current taxable year's Operating Income and the prior taxable year's undistributed Operating Income this remains an issue for the CDE.

For example, the books and records of a calendar year CDE may not be closed and adjusted until January 15. Additionally, the tax returns will not be completed in most cases until sometime 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.

[5] 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) Tax-exempt income under section 103;
(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 any other depreciation and amortization deductions under the IRC;
(E) Start-up expenditures amortized under section 195; and
(F) Organizational expenses amortized under section 709.

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 ("IRC") 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, IRC 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.[6] IRC 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.[7]

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 attached as Exhibit B.

b. 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. The Proposed Regulation allows a CDE to distribute undistributed

[6] IRC 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) .

[7] IRC 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.

operating income from the prior taxable year only. 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 accumulated earnings and profits from all prior taxable years but entities taxed as partnerships are only permitted to make distributions out of current year Operating Income and undistributed Operating Income from the prior taxable year.

There are numerous examples of the inequities of this rule. For example, a CDE makes a three 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 3, 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.

Another example relates to a CDE that decides to hold its interest income received in the earlier years of its NMTC investment period in a reserve account, to hedge against future potential loan losses or unanticipated operating expenses. As the CDE's operations stabilize, the CDE may be in a position to release some of these prior earnings and provide a return to its investors. However, under the current and proposed regulations, the CDE would be unable to pay distributions to its partners for its undistributed Operating Income, except for amounts related to the current and immediate prior year.

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. IRC 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.[8] 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.

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[8] IRC 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.

If the proposed regulations are not changed to incorporate our previous comments regarding the inclusion of all prior taxable years' undistributed Operating Income and the timing of when distributions can be made, we recommend that the regulations clarify the calculation of how distributions are applied to undistributed Operating Income. It is currently unclear as to which year's Operating Income would be deemed to be distributed first. For example, a CDE has $100 of Operating Income for the current taxable year and $100 of undistributed Operating Income for the prior taxable year for a total of $200 that could be distributed based upon the safe harbor provision in the proposed regulations. If the CDE has $120 of cash that it intends to distribute pro rata to its partners, would the $120 distribution be applied first to the prior year's undistributed Operating Income of $100 with the remaining $20 applied to the current year's Operating Income, thereby leaving $80 of undistributed current taxable year Operating Income (which would be available for distribution in the following taxable year)? Or, would the $120 distribution first be applied to the entire current taxable year's Operating Income and next only $20 attributable to the undistributed Operating Income from the prior taxable year (thus leaving $80 of prior year Operating Income not available for distribution and no amount of current year Operating Income available for distribution in the following taxable year)? We believe that the CDE should be allowed to use the former approach using a first-in first-out (FIFO) methodology. Otherwise, $80 of undistributed Operating Income will be unavailable to the CDE for distribution during the next taxable year.

c. Catch-up period

We recommend that CDEs be allowed to apply these rules retroactively to allow them to "catch-up" their distributions. Without guidance on this issue, many CDEs chose not to make distributions due to the severe risk of recapture. If this guidance had existed, they would have made distributions in prior taxable years. If our recommendation to allow CDEs to distribute the cumulative amount of all prior taxable years' undistributed Operating Income is not incorporated into the final changes, we recommend that guidance be provided to allow CDEs with undistributed Operating Income from any prior taxable year to distribute their undistributed Operating Income. For all taxable years following the year in which the guidance is finalized, the CDE would only be able to distribute the sum of the current taxable year Operating Income and the undistributed Operating Income from the prior taxable year as provided in the Proposed Regulation. For example, a CDE began generating $100 of Operating Income beginning taxable year 2006 and $100 every year thereafter through 2009 for a total of $400 of Operating Income. However, to date, the CDE hadn't distributed its Operating Income each year due to the lack of guidance in the regulations. If the proposed regulations are finalized March 15, 2009, the CDE would then be able to "catch-up" its distributions by distributing the entire $400 during 2009. In 2010 and each year thereafter, under the safe harbor provision, the CDE would be able to distribute the sum of its current taxable year's Operating Income and prior taxable year undistributed Operating Income.

d. Definition of Operating Income – capital gains

We commend Treasury for adopting our comments related to the inclusion of tax-exempt income and the CDE's allocable share of depreciation and amortization in the calculation of Operating Income. However, the inclusion of capital gains was not addressed in the proposed regulations. Some CDEs are making venture capital investments in qualified businesses. A goal of the NMTC program is for CDEs to provide equity capital (the most patient form of capital) to businesses located in distressed communities. 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.

Additional Comments Regarding the Proposed Redemption Regulations

e. Special exceptions

The amendment to the Regulations to allow distributions in a succeeding year of undistributed operating income from a prior year is useful given the difficulty of determining the actual operating income before year-end. The amendment does not address, however, the situations in which a CDE receives QLICI loan interest payments or equity distributions sufficient to make projected distributions which exceed the operating income safe harbor due to unanticipated losses incurred by the CDE or the QALICB.

> Example #1: CDE makes loans to a QALICB. The QALICB defaults on its interest payments due to the CDE, and, as a result of this default, the CDE may incur additional expenses (or may be uncertain as to its ability to accrue the interest income). The CDE has a loan loss reserve set aside equal to 5% of the QEI, and uses the funds in the loan loss reserve to make distributions pro rata in accordance with the financial projections at closing. The distributions are in the amounts required for the Investment Fund (a) to pay interest due with respect to a Leverage Loan (or the economic return on an equity investment) made to the Investment Fund to fund a portion of the QEI and (b) to pay the Investment Fund's projected operating expenses.
>
> Example #2: CDE makes a loan and an equity investment in a QALICB. The equity investment generates unanticipated losses which are not funded by the CDE. The unanticipated losses may be funded by project reserves, QALICB affiliate contributions or loans, or third party financing. The CDE receives the projected cash flow from the QLICI loan (or equity investment) and makes distributions pro rata to its members in accordance with the financial projections provided at closing. The distributions are in the amounts required for the Investment Fund (a) to pay interest due with respect to a Leverage Loan (or the economic return on an equity investment) made to the Investment Fund to fund a portion of the QEI and (b) to pay the Investment Fund's projected operating expenses.

The legislative history and the Final Treasury Regulations state that there is a recapture event if the investment is redeemed or "otherwise cashed out." The distributions described above in Examples #1 and #2 do not constitute a "cashing out" of the QEI since they are funded by loan loss reserve funds set aside for use in the event of defaults on QLICI loan payments or QLICI loan interest payments (or a return on an equity investment). The distributions are in amounts required to pay Leverage Loan debt service (or the economic return on an equity investment) and operating expenses of the Investment Fund.

The request is to modify the safe harbor (i) to define "operating income" to include QLICI loan interest payments without regard to whether the income should be accrued for federal

income tax purposes up to the amount of the loan loss reserve held by the CDE and (ii) to add back the tax deductions incurred by the qualified active low-income community business or the CDE that do not reduce the CDE's operating cash flow. We have provided sample language for your consideration attached with this comment letter.

f. Allocation among multiple QEIs

In the event that multiple qualified low-income community investments ("QLICIs"), are made into the same qualified active low-income community business ("QALICB") (e.g. installments of historic tax credit equity or advances of a construction loan), there is uncertainty as to how payments of or for capital, equity or principal received by the CDE should be attributed to those QLICIs. Under Treasury Regulation Section 1.45D-1(e)(2)(ii) there is a recapture event with respect to a QEI if "the proceeds of the investment cease to be used in a manner that satisfies the substantially all requirement." It is not clear under this Regulation how the "proceeds of the investment" are defined. This is particularly relevant where (i) multiple QLICIs are made to a single borrower over a period of time, and (ii) these QLICIs are funded from multiple QEIs. In this situation, it is not clear whether the borrower would be deemed to have repaid the QLICI made with the first QEI, the last QEI or repaid QLICIs made proportionally from each QEI.

Similar uncertainty exists under Section 1.45D-1(e)(2)(iii) where multiple QEIs are made into one CDE over a period of time. In this case, there is uncertainty as to how distributions from the CDE which constitute a return of capital will be attributed among those QEIs for purposes of the redemption test for QEIs. For example, consider the case where multiple QEIs have funded a single QLICI. Cash is paid to the CDE by the borrower and that cash is distributed to the investor as a return of capital. Which QEI has been redeemed? This is particularly relevant where the first of a series of QEIs has reached its seventh anniversary but later QEIs have not.

We believe in both cases CDEs should be permitted to elect to use any reasonable method to treat proceeds from a repaid QLICI as applicable to the QEIs made into that CDE. Further, the Regulation should state that the use of a FIFO method, a LIFO method or a pro-rata allocation method should be allowed if consistently applied.

g. 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 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.

3. Non-Real Estate Businesses

In a letter dated September 8, 2011, to the Internal Revenue Service in response to a request for comments on the notice of proposed NMTC regulations issued June 7, 2011, the NMTC Working Group provided comments on (i) whether the definition of a "non-real estate

QALICB" is sufficient for CDEs and investors to rely on and (ii) whether the "more than 50% gross income" requirement and activity limitation are the appropriate ways to define a non-real estate QALICB. For your convenience, we have provided the body of those comments below, because we believe the changes we recommended in 2011 are still applicable today.

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. The following sentence in the proposed definition may present issues regarding certain 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 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? We believe this limitation is not appropriate or consistent with the overall purpose of this definition, and that the language regarding the purpose of the investment should be removed, so that the definition solely relies on the 50% gross income requirement of the business activity.

4. Working Capital

Treasury Regulation § 1.45D-1(d)(4)(i)(E)(2) provides that working capital includes any proceeds that will be expended for construction of real property within 12 months after the date the investment or loan is made. While this provision takes into account the timing difference in which investment or loan proceeds are made to a construction project and then expended, it doesn't allow for a reasonable amount of time for the funds to be expended based upon the length of typical construction timelines. Historically, the construction period for NMTC projects is rarely 12 months or less. We believe that the regulation should be modified to 24 months to allow for a more reasonable construction period. We recommend that the regulation be amended with a provision such as the following to Treasury Regulation § 1.45D-1(d)(4)(i)(E)(2):

> (2) Construction of real property. For purposes of paragraph (d)(4)(i)(E)(1)(i) of this section, the proceeds of a capital or equity investment or loan by a CDE that will be expended for construction of real property within **24** months after the date the investment or loan is made are treated as a reasonable amount of working capital.

Further regulatory clarification around the "non-qualified financial property" limitation, particularly in regard to what is (and is not) "reasonable working capital," would be very helpful. Aside from extending the safe harbor period for QLICI and non-QLICI funds held for construction (which we understand is under consideration by the IRS), more basic guidance is needed. Neither the IRC nor the regulations (under Section 45D or elsewhere) provide any definition of "working capital," much less "reasonable working capital." The analysis and structuring that are currently required to deal with these issues leads to higher transaction costs, and it creates a serious impediment to many kinds of financing, particularly for operating

businesses, which typically need to retain and manage funds in a wide range of amounts for a wide variety of purposes. With no guidance to help define reasonable working capital, investors and CDEs are often unwilling to take the risk of having to simply guess whether a particular amount of capital held for a particular type of business fits within this limitation.

5. Aggregation of QEIs

Treasury Regulation §1.45D-1(c)(6) provides, "A CDE may treat any qualified equity investments issued on the same day as one qualified equity investment. If a CDE aggregates equity investments under this paragraph (c)(6), the rules in this section shall be construed in a manner consistent with that treatment." Under this provision, a CDE can receive multiple investments on the same day and treat them as a single QEI. However, if a CDE receives a single investment, it cannot elect to treat that single investment as more than one QEI.

It is not uncommon for a CDE to receive a QEI intended for a particular QLICI, but then for unexpected reasons, the CDE is unable to close the QLICI that the QEI was originally intended for. The CDE must then identify and close other QLICIs, the amounts of which may not correspond to the original QEI amount. This subjects the CDE and its investors to compliance risks associated with multiple QLICIs, the failure of any of which could result in recapture of NMTCs for the entire QEI.

We believe CDEs should be permitted to make an election to designate a single investment made on a particular date as one or more QEIs made on that date, so long as such election is made on or before the "substantially all" testing date selected for such QEIs (within the initial 12-month investment period). On the other hand, a CDE could accomplish exactly the same result if, instead of designating the initial investment as a single $1,000,000 QEI, it received 10 separate wire transfers of $100,000 each and registered 10 QEIs on the same date.[9] The only difference is that this latter approach represents a substantial reporting and administrative burden for the CDE and CDFI Fund. If the designation must be made within the limited period described above, this would give CDEs flexibility in getting their funds invested initially, without affecting compliance measurements over the long term.

In addition to the above, when for unexpected reasons the CDE is unable to close the QLICI that the QEI was originally intended for it is also not uncommon for an Allocatee to want to move a QEI from one sub-CDE to another sub-CDE. However, Allocatees are concerned that if the one sub-CDE seeks to transfer its QEI to the other sub-CDE with the same investor in each sub-CDE, the IRS would treat the transfer as a redemption triggering recapture of the tax credits associated with the QEI in the transferring sub-CDE.

For example, Sub-CDE 1 received a QEI of $10,000,000. Sub-CDE 1 is a subsidiary of Allocatee ABC. Sub-CDE 1 was created to be used solely for debt QLICIs. Sub-CDE 2 is another subsidiary of Allocatee ABC and is used solely for equity QLICIs. For internal bookkeeping purposes, the Allocatee will not do both equity and debt QLICIs out of the same subsidiary CDE. The initial QEI in Sub-CDE 1 was for the purpose of funding a debt QLICI for a particular transaction. However, the transaction has failed to close and Allocatee ABC would like to use the proceeds of the QEI for equity QLICIs that are available to be funded through Sub-CDE 2. By moving the QEI from Sub-CDE 1 to Sub-CDE 2, Allocatee ABC is not seeking to re-start the 12-month substantially-all test. If Allocatee ABC cannot transfer the QEI from Sub-CDE 1 to Sub-CDE 2, then recapture may result if a replacement

[9] We note that some CDEs may even opt to segregate the QEIs into even smaller denominations, such as 100 QEIs at $10,000 each, to further minimize recapture risk.

debt QLICI cannot be identified in time to satisfy the substantially-all requirement, and $10,000,000 of NMTC-advantaged money will not reach low-income communities.

We believe CDEs should be permitted to transfer QEIs from one subsidiary CDE to another subsidiary CDE without triggering a redemption either to avoid a violation of the substantially-all requirement or for administrative purposes, provided that the 12-month period for satisfying the substantially-all requirement does not expire as to the transferred QEI(s).

6. De Minimis Rule

Under Treasury Regulation §1.45D-1(d)(5)(iii)(B), a qualified business for a CDE excludes several types of business. The regulation specifically provides:

> (B) Certain other trades or businesses. The term qualified business does not include any trade or business consisting of the operations of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

In IRC Section 1400N, certain tax benefits, including an expansion of available new markets tax credits, were made available to investments made to Gulf Opportunity Zone (GO Zone) properties. In Section 1400N(p)(3)(A)(i), "qualified Gulf Opportunity Zone Property" specifically excluded "any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises" and such property was not eligible for GO Zone tax benefits. Although applicable only for purposes of Section 1400N(p)(3)(A)(i), in Internal Revenue Bulletin 2006-33, Notice 2006-77, the IRS provided the following guidance: "a taxpayer's trade or business that has less than 10% of its total gross receipts derived from massages, tanning services, or a hot tub facility is not treated as, respectively, a massage parlor, suntan facility, or a hot tub facility." For purposes of this guidance, "only gross receipts from the taxpayer's trade or business activity that includes the massages, tanning services, or hot tub facility are taken into account."

We recommend that Treasury Regulation §1.45D-1(d)(5)(iii)(B) be revised to incorporate the following language:

> (B) Certain other trades or businesses. The term qualified business does not include any trade or business, (i) **from which more than 10 percent of its total gross receipts are derived from,** the operations of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or (ii) consisting of any store the principal business of which is the sale of alcoholic beverages for consumption off premises. **In determining whether this 10 percent test is satisfied, only gross receipts from the taxpayer's trade or business activity that includes operations of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, are taken into account.**

We note that this is consistent with the Internal Revenue Bulletin 2006-33, Notice 2006-77, in which the IRS provided similar guidance for properties considered in the GO Zone. We recommend that the additional language mentioned above be added to the Treasury Regulation

§1.45D-1(d)(5)(iii)(B) and be applicable to all new markets tax credit properties (not just GO Zone properties).

7. Tenant Excluded Businesses

Treasury Regulation § 1.45D-1(d)(5)(ii) provides that "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 provision takes the approach of disqualifying a CDE's investment as a QLICI "to the extent a lessee . . .is" one of the prohibited businesses listed in paragraph (d)(5)(iii)(B).

First, this approach attempts to connect a specific quantity (a portion of the QLICI) to the existence of a business operation that is not in any way quantified. It is unclear whether a lessee must be engaged exclusively (or primarily) in a prohibited business, or whether the lessee's engagement in any such business activity triggers this provision.

We recommend that the regulations clarify that, in order to disqualify a QLICI, the lessee must be "exclusively or primarily engaged in one of the prohibited businesses listed in paragraph (d)(5)(iii)(B)." It would present a considerable burden on CDEs and investors if incidental activities by lessees could trigger disqualification.

An example of such incidental activities would be a hotel that includes a day spa that offers massage services and includes a sun tanning booth. The primary business of the hotel is to provide lodging and convention facilities as evidenced by the amount of square footage dedicated to these purposes and the income generated from these activities. The massage services and sun tanning booth generate an extremely small portion of the hotel's overall income. It is not entirely clear if the massage services and sun tanning booth disqualify the hotel project from being able to receive a QLICI.

It is also unclear how to determine how much of the QLICI would be disqualified if, and to what extent, a lessee is engaged in any such business. This might be done based upon the proportion of square footage of the space of the "offending" lessee bears to the total rentable space in the property. Another approach could be based upon the proportion that the amount of the lessee's space devoted to the prohibited activity bears to the total rentable space in the property. Or it might be done according to the proportion of the costs spent on the lessee's space (or portion of that space devoted to the prohibited activity), relative to the total cost of the project. Or it could be done on the basis of the amount of income generated by the lessee's space (or portion of that space devoted to the prohibited activity), relative to the total income generated by the project.

We recommend that the regulations provide guidance on how to quantify the lessee's activity. We believe the square footage of the lessee's space relative to other rentable space in the project would be the most reasonable approach. Square footage is readily determinable in real estate businesses and would not be subject to nearly as much uncertainty or manipulation as attempting to apportion costs or income between the lessee's space or operations and the project as a whole. However, we also believe that a taxpayer should be able to select any other method that is reasonable.

Another concern about how the regulations are currently written is how the current approach by-passes the entire QALICB analysis, and in so doing, has the effect (presumably unintended)

of by-passing the "reasonable expectation" safe harbor. 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. We recommend that the regulation be amended with a provision such as the following:

> 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.

8. Definition of Control

In several comment letters submitted over the years, the NMTC Working Group has recommended changes be made to the CDFI Fund's related party test definition and measurement in order to encourage CDEs to make majority equity investments in qualified active low-income community businesses ("QALICBs"). The CDFI Fund made changes consistent with the NMTC Working Group's recommendations that would allow a CDE to make majority equity interest investments without violating its allocation agreement so long as it had committed to investing substantially all of its proceeds in entities that were considered unrelated before it invested. This change was a significant step and one that the industry applauds the CDFI Fund for making.

However, it is unlikely that many CDEs will make majority interest equity investments because of an issue related to the reasonable expectations test defined in Treasury Regulation §1.45D-1(d)(6). The Regulations provide that if a CDE:

> "…reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business [for the term of the investment…]"

then the QALICB will continue to be deemed a QALICB even if it falls out of compliance at a later time. This provision permits a CDE to avoid suffering a recapture event if the QALICB ceases to qualify as a QALICB during the recapture period for reasons that are outside the control of the CDE.

However, the Regulations further require that if the CDE has or obtains control of the QALICB, it generally must ensure that the entity remains a QALICB for the entire 7-year compliance period and cannot rely on its reasonable expectation at the time the investment is made to avoid a recapture event.

Investors do not want to be subject to strict liability for recapture merely because they acquire a majority equity interest in the QALICB if they do not also have management or voting rights that would allow them to control QALICB status. As a result of the broad definition of "control" under the reasonable expectation test, investors in the current market are unlikely to allow the CDE to acquire a majority equity interest in a QALICB.

If a CDE cannot rely on the reasonable expectation test, investors perceive the compliance risk as too great and most are unwilling to enter into such a transaction. This outcome is

unfortunate since equity investments are generally the most patient form of capital and would also reduce the burden of ensuring that the subsidy can remain at the QALICB.

The current definition of control in Treasury Regulation §1.45D-1(d)(6)(ii)(B) states (emphasis added):

> "Control means, with respect to an entity, **direct or indirect ownership (based on value)** or control (based on voting or management rights) of more than 50 percent of the entity. For purposes of the preceding sentence, the term management rights means the power to influence the management policies or investment decisions of the entity."

The problem for equity investors is the imputation of control based on "direct or indirect ownership (based on value)". Currently there is no clear guidance on how to calculate direct or indirect ownership "based on value". It is unclear to us how value is determined and how it is relevant to whether or not the CDE is controlling the QALICB. We believe that the concept of control should be based solely on the CDE's ability to control the QALICB's status as a QALICB through voting or management rights.

It would also be helpful to clarify the meaning of "control" given the variety of possible equity structures and documentation used in New Markets transactions. The potential for confusion is compounded by the fact that the CDFI Fund has adopted its own definitions regarding "control" in the NMTC arena -- definitions that do not necessarily work well for this purpose.

We believe that the only type of control based on voting or management rights that should be of concern in the context of the reasonable expectation test is control based on rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) allow the CDE to override or block actions by the QALICB when the authority to take such actions is necessary to enable the entity to remain a QALICB. The ability to exercise management or voting control on other issues would not seem to bear on whether the CDE should be allowed to rely on its own reasonable expectation of compliance as a safe harbor.

We note that there are some areas where a CDE's actions could indirectly affect compliance decisions by the QALICB, and one important example would be the right to remove a general partner of a partnership, the managing member of an LLC, or a majority of the directors of a corporation. Removal rights are commonly required by investors in scenarios in which a CDE is making equity investments in a QALICB. We believe that the existence of such rights in the CDE to remove **for cause** a managing member, general partner, or other party or parties with management control should not, by itself, be deemed to confer voting or management control on the CDE. Where removal is limited to "for cause" events (i.e., failure of the general partner, managing member, or majority of directors to comply with their obligations under the organizational documents), the threat of removal would not represent a mechanism for influencing management decisions that is tantamount to direct management control. Moreover, removal provisions typically contemplate the appointment of a substitute managing member, general partner, or directors, rather than entitling the CDE to manage the QALICB itself. In such a case, so long as the CDE does not actually "control" the substitute management, then the CDE could still satisfy the control test as we have recommended it be changed herein.

Accordingly, we recommend that the definition of "Control" contained in Treasury regulations be updated to remove the reference to a value based test and clarify voting and management

rights that should be considered. Specifically, we recommend the following change to Treasury Regulation §1.45D-1(d)(6)(ii)(B):

> "Control means, with respect to an entity, ~~**direct or indirect ownership (based on value) or**~~ control ~~**(based on voting or management rights) of more than 50 percent of the entity based on**~~ **of voting or management rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) to override or block actions by the QALICB that are necessary to enable the entity to remain a QALICB.**
>
> > **(a) The existence of rights in the CDE to remove for cause a managing member of a limited liability company, a general partner of a limited partnership, or majority of directors of a corporation by substituting a new managing member, general partner, or majority of directors with control would not, by itself, be deemed to give the CDE 'control' for purposes of this provision."**

If these changes are adopted, it is likely that equity transactions could be structured in a manner that would attract investors by successfully addressing the issue of control and providing CDE's with the ability to rely on the reasonable expectations test. Without such a change, it is likely that investors will continue to sit on the sidelines when it comes to investing in CDEs that intend to make equity investments and will continue to effectively prevent the most patient form of capital, equity investments, from being made to QALICBs.

9. Reinvestment Rule for Equity Investments

Many CDEs have made and many more would like to make QLICIs in the form of equity, as opposed to debt. However, the Regulation does not define when an amount received by a CDE from a QALICB with respect to an equity investment is payment of, or for, capital or equity. The Regulation does specify that if the amount is determined to be a return <u>of</u> capital rather than a return <u>on</u> capital, then it must be reinvested within 12 months from the date of receipt in order to be treated as continuously invested. Without guidance on determining whether a distribution received with respect to a QLICI must be reinvested in another QLICI, CDEs often choose not to receive any distributions with respect to their equity investments in QALICBs in order to avoid any possibility of failing the reinvestment and substantially all requirements. Since CDEs generally have operating expense funding needs, CDEs are forced to either fund cash reserves or split their QLICI into a debt portion, with current pay interest, and an equity portion. These solutions add administrative complexities and transaction costs that reduce the efficiency of the NMTC program.

We believe there should be symmetry between the rules for determining if a cash distribution received by a CDE from a QALICB on its equity investment in the QALICB must be reinvested with the rules for determining if a cash distribution received by an investor in a CDE is a redemption. We believe that symmetry is necessary since the issue in both cases is the return of a capital investment versus return on a capital investment. For redemption purposes, the determination of whether capital has been redeemed is made in order to determine if a recapture event has occurred. If one dollar of capital has been redeemed, recapture is deemed to have occurred. For QLICI reinvestment purposes, the determination between a return of capital versus a return on capital is made in order to determine whether the CDE is meeting the substantially all requirement. If capital has been received from an equity investment in a

QALICB and not reinvested within twelve months, then the dollar amount treated as meeting the substantially all requirement is reduced by one. While the reason for making the determinations is different, we believe the underlying principles of return "on" investment versus return "of" investment are the same for both, and the method for determining which occurred should similarly be the same. We believe that this can be achieved by providing a cross reference in (d)(2)(i) to (e)(3). Just as distributions that are made by a CDE are not considered redemptions if they either don't exceed accumulated earnings and profits or operating income, a QALICB would be allowed to make distributions in a similar manner without the distributions being deemed a return of capital for reinvestment determination purposes.

> Example: CDE A makes an equity investment in a partnership. The investment is a qualified low-income community investment in a qualified active low-income community business. The qualified business makes a distribution to CDE A. The distribution will not be considered a return of capital for reinvestment consideration if either the distribution does not exceed the partnership's operating income (as defined in the regulations pursuant to Reg. 1.45D-1(e)(3)) for the taxable year) or the distribution and all prior distributions do not exceed the partnership's cumulative operating income for all years. (Note: This example assumes that the suggested language from our recommendations regarding the Redemption regulations will be incorporated.)

10. Reasonable Expectations

We believe the added language that is designed to protect CDEs who make QLICIs in other CDEs leaves uncertainty regarding whose reasonable expectation about the QALICB's status can be relied upon. The proposed revisions make it clear that, if a CDE (the "first CDE") makes a QLICI in another CDE (the "second CDE"), and then the second CDE makes a loan to a QALICB, the first CDE can rely on the reasonable expectation test. However, the wording of the revised regulation at least suggests that it is the first CDE that must have that reasonable expectation.

One of the advantages of enabling CDEs to invest in other CDEs is that it enables the first CDE to support and expand the activities and operations of the second CDE. Naturally, the second CDE will be operating in those markets and dealing with those QALICBs with which it is most familiar and will have the primary contact with prospective QALICBs. Accordingly, the second CDE will generally be responsible to the first CDE for determining that the QALICBs to whom the second CDE lends meet and are expected to meet the necessary qualifications.

However, if it is the first CDE that must have a reasonable expectation of continued QALICB status, then it seems that the first CDE would have to perform much of the qualification underwriting and analysis on QALICB status. This underwriting and analysis is probably more efficiently performed by the second CDE and would likely be done by the second CDE anyway as part of its efforts to screen eligible loans. This effectively requires both CDEs to do the same underwriting, which is unnecessarily duplicative, inefficient, and costly.

It should be clear that the first CDE can rely on the reasonable expectation test if either the first CDE or the second CDE has a reasonable expectation of ongoing QALICB status.

11. Economic Substance Doctrine

In the Health Care and Education Affordability Reconciliation Act of 2010 (the "Act"), the economic substance doctrine was codified in Section 7701(o) of the IRC of 1986, as amended effective for transactions entered into after March 30, 2010. In a technical explanation prepared by the Joint Committee on Taxation ("JCT") explaining revenue provisions of the Act, footnote 344[10] clarified that the codification of the economic substance doctrine is not intended to disallow tax benefits in a transaction that achieves the basic purpose or plan for which the tax benefit was designed by Congress. The NMTC community, as well as other tax credit communities, applaud the explanatory guidance provided by this footnote since it recognizes and is consistent with Congress' legislative intent in codifying the economic substance doctrine as well as Congress' legislative intent in enacting tax credits that provide incentives for investment in affordable rental housing, historic properties, underserved economic areas, and renewable energy resources.

We request that Treasury provide guidance that it will follow the documented legislative intent included in footnote 344. While we believe that case law and historical Treasury guidance is generally consistent with the interpretation provided in footnote 344, we also believe that industry participants and practitioners can more readily rely on written guidance from Treasury expressing Treasury's agreement with the explanatory statements provided in footnote 344. Such guidance from Treasury would receive greater deference by a court interpreting the economic substance statute than the JCT explanatory footnote.

12. Partnership Allocations (IRC section 704(b))

It is currently unclear as to how a partnership allocates NMTCs among its partners. Internal Revenue Code ("IRC") §45D and §704(b) provide no specific reference on how the NMTC should be allocated among partners in a partnership. The NMTC is a unique credit that doesn't generate a readily identifiable expense similar to other credits like the low-income housing tax credit, which subsidizes construction costs that generate depreciation expense. In the absence of current specific guidelines, we believe that NMTCs should be allocated among the partners in a partnership in a manner that is most consistent with the existing §704(b) partnership allocation regulations. Therefore, the NMTC should be allocated in the same manner as the NMTC basis reduction which in turn should be allocated in the manner agreed to by the partners of the partnership and that is consistent with the partnership allocation safe harbor rules under existing Treasury Regulations. Guidance on this issue would be very helpful, particularly to CDEs seeking to make venture capital investments.

13. Program Related Investments and NMTC Transactions

We recommend changes to the Regulations related to Program Related Investments that will decrease transaction costs discussed in detail below. In a letter to Ms. Emily S. McMahon, Acting Assistant Secretary (Tax Policy), dated April 10, 2012, the NMTC Working Group made recommendations regarding guidance under §4944 Treasury Regulation § 53.4944-3 and on Program Related Investments. We have provided our comments below to recommend new language be added to the regulations for §4944 to provide a safe harbor for investments in NMTC transactions.

[10] Joint Committee on Taxation Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010, " as Amended, in Combination with the "Patient Protection and Affordable Care Act", JCX-18-10, March 21, 2010, page 152.

We request that Treasury provide a program-related investments safe harbor for private foundations that make loans to or equity investments in an entity that makes a qualified equity investment, as defined in §45D(b)(1). For purposes of determining the amount of NMTC allowable under IRC § 45D, the amount of the QEI made by a limited liability company ("LLC") classified as a partnership includes cash from a nonrecourse[11] or recourse[12] loan to the LLC that the LLC invests as equity in a qualified community development entity. It has been our experience that private foundations are generally hesitant to make a loan to or equity investment in an entity that will use the proceeds to make a QEI because under the regulations related to program-related investments under Treasury Regulation § 53.4944-3, it is unclear if such an investment would meet the requirements. We believe that the intent of the NMTC Program to provide below-market rate investments to qualified businesses in low-income communities meets the intent of the exceptions provided for program-related investments that don't jeopardize the carrying out of exempt purposes of a private foundation as described in Treasury Regulation § 53.4944-3. Therefore, we recommend that the following safe harbor be added to Treasury Regulation § 53.4944-3(a)(2)(i):

> **(A) A loan to or equity investment in an entity that makes a qualified equity investment in accordance with section 45D(b)(1) shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B).**

We also recommend a similar safe harbor be added to Treasury Regulation § 53.4944-3(a)(2)(iii):

> **(A) A loan to or an equity investment in an entity that makes a qualified equity investment in accordance with section 45D(b)(1) shall be deemed to not have as a significant purpose the production of income or the appreciation of property.**

We believe that such guidance will give private foundations the comfort necessary to make direct investments in an entity that will use the investment to make a QEI. Without such guidance, private foundations are likely to avoid NMTC transactions or incur additional structuring costs to make the investment, diluting the overall benefit that can be passed on to qualified businesses located in low-income communities.

> Example (11). X is a business enterprise that operates in a low-income community and is considered a qualified active low-income community business as defined in section 45D(d)(2). Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to Z, an investment fund created to make qualified equity investments in accordance with section 45D in A, a qualified community development entity (CDE) as defined in section 45D(c). The loan made by Y to Z bears an interest rate below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan to Z is to encourage the economic development of low-income communities and/or serve low-income persons and low-income communities through Z's investment in a CDE, an investment that will generate new markets tax credits as defined in section 45D. The loan from Y to Z has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have

[11] Revenue Ruling 2003-20.
[12] Revenue Ruling 2010-17.

been made but for such relationship between the loan, its use by Z to make a qualified equity investment in A, A's use of substantially all of the proceeds from Z to make qualified low-income community investments, and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Below is example one from the § 53.4944-3 regulations for comparison to our example above:

Example (1). X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

14. Investments Prior to Receipt of Allocation Agreement

Under Treasury Regulation § 1.45D-1(c)(3), subject to specified conditions, an investor may make an equity investment in a CDE prior to the CDE's receipt of its executed allocation agreement, and such investment is treated as a qualified equity investment as of the effective date of the allocation agreement. It is unclear, however, how this provision applies to subsidiary CDEs that must receive a sub-allocation in order for the investment to constitute a valid qualified equity investment.

Many (if not most) QEIs are made through subsidiary CDEs, and commonly, the parties to the allocation agreement will include, in addition to the CDE that received the allocation award, one or more subsidiary allocatees. Under CDFI Fund procedures, the fact that an allocation agreement has been executed by a subsidiary CDE is not, by itself, sufficient to effect a sub-allocation to such subsidiary CDE (the sub-allocation must be logged into the CDFI Fund's system), and an investment cannot be a QEI unless and until the subsidiary CDE has received a valid sub-allocation.

We believe this can be addressed by a minor modification to Treasury Regulation § 1.45D-1(c)(3)(iv) so that it reads as follows:

(iv) Initial investment date. If an equity investment is designated as a qualified equity investment in accordance with paragraph (c)(3)(ii) of this section, the investment is treated as initially made **(A)** on the effective date of the allocation agreement between the CDE and the Secretary**, or (B) in the case of an investment in a CDE receiving a sub-allocation, the date (on or following the effective date of such allocation agreement) on which such sub-allocation is effective for purposes of such allocation agreement.**

In addition, we note that it would be appropriate for Treasury Regulation § 1.45D-1(c)(3) to make clear that the entity receiving the equity investment prior to the execution of the allocation agreement must be a CDE at the time the equity investment is received. Currently, Treasury Regulation § 1.45D-1(c)(3) does not explicitly provide that the entity receiving the equity investment must be a CDE when the equity investment is received.

15. Equity Investments in Other CDEs

Treasury Regulation §1.45D-1(c)(4)(i)(B) provides that the term qualified equity investment does not include "Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2)." We believe this provision can inhibit investments in other CDEs in ways that were not intended by this provision.

Some allocatees obtain their allocations in their parent companies, though they will generally utilize their allocations by making sub-allocations to one or more subsidiary CDEs. At the same time, the parent company that received an allocation may have non-NMTC investment activities unrelated to those they undertake using their NMTC allocation.

We believe the intent of the above regulation is to preclude one investment from generating NMTCs twice (once when a QEI is made in the first CDE, and then a second time if the first CDE makes an equity investment in a second CDE with an allocation who designates that investment as a QEI). That concern, as well as our concern described above, can still be addressed if the above regulation is modified to read, "Any equity investment by a CDE **(the "primary CDE")** in another CDE **(the "second CDE")**, if the **primary** CDE making the investment has received an allocation under section 45D(f)(2) **and is using funds from any QEI to make the equity investment in the second CDE.**"

As an alternative, the regulation could be changed to exclude investments from a CDE with an allocation into another CDE only after the primary CDE has issued a QEI. That would allow a parent CDE who has sub-allocated all of its allocation to subsidiary CDEs to make equity investments since it won't be issuing QEIs. This alternative can be enacted by modifying the above regulation to read, "Any equity investment by a CDE **(the "primary CDE")** in another CDE **(the "second CDE")**, if the **primary** CDE making the investment has received an allocation under section 45D(f)(2) **and has issued one or more QEIs for the full amount of its allocation.**"

16. Safe Harbor for Investments in Other CDEs

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 makes a QLICI in the form of a loan or equity investment in another CDE, there is no safe harbor with respect to CDE status, so as to protect that loan or investment as a QLICI should the recipient CDE cease to be a CDE during the compliance period.

Thus, the loss by the recipient CDE of its CDE status at any time during the compliance period would mean that the loan or investment would cease to constitute a QLICI. There are many scenarios in which there are no practical ways for this to be cured -- the proceeds of the loan or investment will have, in turn, been used to make loans or investments in QALICBs (as required by the regulations) and will not easily be recoverable from the non-qualifying intermediary CDE.

This has significantly impeded the use of NMTCs to invest in other CDEs. Generally, only the strongest and most sophisticated CDFIs have been able to raise capital under this program since only those institutions can provide enough comfort to investors that they will remain CDEs (or will be able to repay the investments should that status change) throughout the compliance period.

We believe that there should be a "reasonable expectation" safe harbor applicable to CDE status (presumably in Treasury Regulation § 1.45D-1(d)(1)(iv)) similar to that provided for QALICBs, which might read as follows:

> 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 "primary CDE") is treated as a CDE for the duration of the primary CDE's investment in the entity if the primary CDE reasonably expects, at the time the primary 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.

17. Nonqualified Financial Property – Hedges

The NMTC program is designed to stimulate capital investment in low-income communities. The GAO Report to Congressional Committees regarding the New Markets Tax Credit Program dated January 30, 2004 stated that "[a]ccess to credit and investment capital is essential for creating and retaining jobs, developing affordable housing, revitalizing neighborhoods, and promoting the development of small businesses."

Based on the purpose of the NMTC program to incentivize economic development in low-income communities, we believe that hedges entered into in the ordinary course of the QALICB's trade or business to manage risks of operations should not constitute nonqualified financial property. For example, an ethanol plant routinely enters into options, futures contracts and forward contracts in connection with the purchase of corn and natural gas required for the production of ethanol and in connection with the sale of ethanol. Another example is a food manufacturing facility which may use hedges to minimize the impact of price fluctuations of the core ingredients.

In order to address this concern, Treasury Regulation Section 1.45D-1(d)(4)(i)(E)(1) should be clarified by adding the following exclusion to the definition of nonqualified financial property: (iii) option contracts, futures contracts, forward contracts and similar property that a taxpayer acquires in the normal course of the taxpayer's trade or business primarily to manage risk of price changes with respect to ordinary property that is held or to be held by the taxpayer as the applicable terms are defined pursuant to Treasury Regulation Sections 1.1221-2(c) and (d).

Treasury Regulation Sections 1.122-2(c) and (d) provide definitions for "normal course", "ordinary property" and "managing risk" in connection with defining hedging transactions that do not result in capital assets.

We believe this clarification will enhance the efficiency and the impact of the NMTC program by eliminating uncertainty regarding the proper treatment of such hedging transactions and allowing borrowers to use standard market practices in managing operational risks.

18. Trade or Businesses Involving Intangibles

Treasury Regulation § 1.45D-1(d)(5)(iii)(A) provides that a "qualified business does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license." We request Treasury provide clarification, possibly through the use of examples or by referencing a specific section elsewhere in the Internal Revenue Code, that clarifies the meaning of "developing or holding intangibles for sale or license." Further clarification is needed to avoid any confusion about the type of intangibles referenced in this exclusion. Specifically, is there a difference between intangibles created as a result of the nature of the business?

We believe the key to the interpretation and application of this exclusion lies in the words "development or holding of intangibles for sale or license." While the businesses of many companies involve intangibles, the above exclusion is intended to apply only to businesses that create the intangibles internally and then grant to their customers (though either sale or license) the right to use those intangibles. The exclusion should not apply where the intangibles arise out of contracts or transactions between the business and its customers.

We note that there are regulations under Section 367 of the Code, involving situations where a person is transferring or licensing an intangible to a foreign person, which draw a distinction between an "operating intangible" which is an integral part of a business, versus an intangible that is typically transferred for consideration and dependent on use by the transferee. A similar approach may be called for here.

In any case, we believe it would be helpful to clarify Treasury Regulation §1.45D-1(d)(5)(iii) through examples in the Regulations that illustrate the distinction made above. For example, assume a business enters into service contracts with its customers to provide cleaning services for commercial buildings, pursuant to which the customers agree to make fixed payments over the terms of the contracts. Although the service contracts may be intangible assets in the hands of the business, they are created by the transactions between the business and its customer that are integral to the nature of the business. It is not created by the business and then sold or licensed to others. We believe this would be a situation where the business would not be disqualified.

In contrast, assume instead that the business is primarily involved in developing a brand name, associated trademarks, and a set of operating procedures for "XYZ Commercial Cleaners", which it then sells or licenses to third party operators of cleaning companies under agreements that entitle such operators to use the brand name, trademarks, and operating procedures so developed. The business receives fees for granting such rights, which might be based in whole or in part on the sales of the cleaning companies. We believe this may be a situation where the business would be disqualified, because the intangible assets (in the form of trade names, trademarks, and other intellectual property) are first created by the business and then transferred to others for consideration.

Without further clarification of the meaning within the regulation regarding intangibles, industry participants may be reluctant to invest in transactions involving businesses that have intangibles, regardless of the nature of the intangibles or how they are involved in the business.

19. Control as Impacted by Enforcement

Treasury Regulation § 1.45D-1(d)(6) contain the "reasonable expectation" safe harbor for QALICB status and goes on to provide that this safe harbor is not available if and when the CDE obtains "control" of the qualified business. Treasury Regulation § 1.45D-1(d)(6)(ii)(C) provides an exception which protects a CDE's ability to rely on the reasonable expectation safe harbor where the CDE obtains control due to financial difficulties of the QALICB.

One of the requirements for this exception is that the CDE must dispose of the entire amount of the investment or loan and reinvest the amount received in such disposition in a qualified low-income community investment within a 12-month period following acquisition of control. We believe that this does not provide CDEs with an adequate time period to deal with troubled investments.

For example, in the context of a real estate loan, it is common for lenders to acquire properties through foreclosure and hold them for a period of time prior to disposition. This enables the lender to recover as much of its loan as possible, by (i) avoiding the "distress sale" atmosphere of a foreclosure sale, (ii) enabling the lender to take steps to repair or improve the property prior to sale, and/or (iii) enabling the lender to sell the property at a time and manner of the lender's choosing.

CDEs that face troubled loans need the flexibility to recover the most value for their investments. A CDE that forecloses on a real estate loan could acquire the property through an entity that it forms, and in which the CDE would own all, or nearly all, of the equity interests. Although the CDE's equity interests could still constitute a QLICI, the CDE would "control" the entity because of its ownership. The requirement that the CDE *both* dispose of the property and re-invest the proceeds within 12 months is a severe constraint on the CDE's ability to maximize its recovery. The regulations generally allow CDEs 12 months to reinvest, which recognizes the difficulty a CDE can face in finding, negotiating, and closing replacement QLICIs of the proper size and on acceptable terms.

However, under Treasury Regulation § 1.45D-1(d)(6)(ii)(C)(3)(ii), the CDE is penalized if it controls the property or the business for any significant period of time, because every day it continues to control the property or business reduces the time it has to dispose of it, if it wishes to continue to rely on the reasonable expectation safe harbor. We believe it should be sufficient if the CDE disposes of the investment within 12 months from when it acquires control. Once it does so, reinvestment would be governed by the general 12-month reinvestment period, during which there would be no question of "control" anyway because the CDE will be holding cash for re-investment in other QLICIs. We recommend that the regulation be amended with a provision such as the following to Treasury Regulation § 1.45D-1(d)(6)(ii)(C)(3)(ii):

> The CDE sells or causes to be redeemed the entire amount of the investment or loan described in paragraph (d)(6)(ii)(C)(1) of this section **within a 12-month period** from the date on which it first acquired control and, by the end of the 12-month period applicable to reinvestment of the proceeds of such sale or redemption under paragraph (d)(2) of this section, reinvests the amount received in respect of the sale or redemption in a qualified low-income community investment under paragraph (d)(1) of this section . For this purpose, the amount treated as continuously invested in a qualified low-income community investments is determined under paragraphs (d)(2)(i) and (ii) of this section.

20. Non-Qualified Financial Property – Entity Ownership

Many businesses choose to own divisions of the company as separate legal entities, for liability or other reasons. Under the existing "nonqualified financial property" restrictions, shares of stock and membership or partnership interests are included in the definition. We recommend excluding these items from the definition where the entities are under common control.

As such, Treasury Regulation Section 1.45D-1(d)(4)(i)(E) should be further supplemented by adding the following exclusion: **(iv) shares of stock in wholly owned subsidiaries of the entity or partnership interests in partnerships which are under common control.**

This clarification will be particularly beneficial to investments in operating businesses.

21. Portions of the Business Requirements

The "portions of the business" provisions of the regulations (Treasury Regulation §1.45D-1(d)(4)(iii)) have become a very useful tool in structuring investments. In order to make use of these provisions, (i) a "complete and separate set of books and records" must be maintained with respect to the applicable portion of the business, and (ii) the proceeds of the CDE's loan or investment are treated as a QLICI only to the extent that such proceeds are used in such portion of the business.

The regulations currently do not provide any definition of "complete and separate set of books and records." Presumably, one of the intended benefits of making this test available is to encourage companies with varied and complex operations to locate businesses in low-income communities, without requiring that they set up and maintain separate legal entities. In addition to the costs of formation and organization that having to use separate entities would entail, companies are also often required to conform to complex, inter-company accounting rules that are both expensive and burdensome.

We believe that the purposes of the program and of the "portions of the business" regulations are met if the separate books and records are sufficient in content and detail to enable the company to demonstrate that the portion of the business would meet the tests constituting a QALICB if the business had been separately incorporated. We suggest that Treasury Regulation § 1.45D-1(d)(4)(iii)(A) be modified to add the following clarification:

> For purposes of this paragraph (d)(4)(iii), the books and records required to be maintained with respect to a trade or business that is treated as a portion of a business hereunder will be deemed sufficiently complete and separate if they are sufficient to demonstrate that such trade or business would meet the requirements of subparagraphs (d)(4) and (d)(5) hereof if such trade or business had been separately incorporated.

To go a step further than this and require that the books and records must be equivalent in all respects to that which the company would be required to maintain if the portion of the business had been separately incorporated, would defeat one of the main benefits of using this approach.

It is also not clear when the proceeds of a CDE's loan or investment are deemed to be (or not to be) used in the trade or business that constitutes the portion of the business. In particular, (i) a company might advance funds for the benefit of such trade or business (e.g., the development of a new store in a low-income community) prior to the date when the CDE's loan or investment closes, or (ii) a company might have an established, company-wide purchasing

program under which it acquires goods or services, some of which are used for the benefit of the designated portion of the business.

If a CDE's loan or investment is applied to reimburse the company for actual costs it has advanced for materials, supplies, goods, or services actually used in the designated portion of the business, then such proceeds should be deemed to have been used in the portions of the business. We suggest that Treasury Regulation § 1.45D-1(d)(4)(iii) be modified to state:

> For purposes of this paragraph (d)(4)(iii), to the extent that the proceeds of a CDE's loan or investment are applied to either pay or reimburse the costs of materials, supplies, goods, or services used in or for the portion of the business, they will be deemed used in the trade or business that constitutes the portion of the business.

Exhibit B
NMTC Working Group
2013-2014 Guidance Priority List

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 do- 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;~~

(2) 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.

(B) Tax-exempt income under section 103;

(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 any other depreciation and amortization deductions under the Code

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

(F) Organizational expenses amortized under section 709; and

(G) Deductions under Section 162, with respect to expenses incurred by the CDE or the qualified active low-income community business in excess of operating revenues, and

(1) If incurred by the CDE, such expenses are funded by (a) the CDE's loan loss reserve maintained in compliance with paragraph (d)(3) of this section or (b) reserves or financing not funded by qualified equity investments provided to the CDE; or

(2) If incurred by the qualified active low-income community business, such expenses are funded by (a) reserves held by the qualified active low-income community business, or (b) financing provided to the qualified active low-income community business (other than qualified low-income community investments made by the CDE).

(3) Examples. – The application of paragraph (e)(3)(iii)(G) is illustrated by the following examples:

Example 1. (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 in X. X uses the proceeds of Y's qualified equity investment to make qualified low-income community investments that consist of a loan and an equity investment in B. B is a qualified active low-income community business. X makes the equity investment in B through A which is a wholly-owned subsidiary of X and a disregarded entity for federal income tax purposes. X is a calendar year taxpayer.

(ii) B rents a building to A. A's required annual lease payments of $400,000 are sufficient to cover the annual debt service payments of $350,000 due by B with respect to the loan QLICI and to pay B's operating expenses of $50,000.

(iii) For the year ended December 31, 2008, A has tax losses from operations of $150,000 and is only able to make lease payments of $250,000 to B. B makes the debt service payment of $350,000 to X and pays its operating expenses utilizing $150,000 of reserves held by B. For the year ended December 31, 2008, X's interest income is $350,000 and tax losses from its investment in A are $150,000. Under paragraph (e)(3)(iii)(G)(ii) of this section, $150,000 would be added to X's *operating income* for the year ended December 31, 2008.

Example 2. The facts are the same as in *Example 1* except that A borrows $150,000 from a lender and uses the loan proceeds to make the $400,000 lease payment to B. B makes the debt service payment of $350,000 to X. Under paragraph (e)(3)(iii)(G)(ii) of this section, $150,000 would be added to X's *operating income* for the taxable year ended December 31, 2008.

(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.

Exhibit B
NMTC Working Group
2013-2014 Guidance Priority List

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

(2) Payments of, or for, capital, equity or principal.

(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 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. **For purposes of determining if a distribution from an equity investment is a payment of, or for, capital or equity, rules similar to the rules for determining whether a redemption occurred in accordance with paragraph (e)(3) shall apply as appropriate given the type of entity making the distribution to the CDE.** 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.

Example: CDE A makes an equity investment in a partnership. The investment is a qualified low-income community investment in a qualified active low-income community business. The qualified business makes a distribution to CDE A. The distribution will not be considered a return of capital for reinvestment consideration if either the distribution does not exceed the partnership's operating income (as defined in the regulations pursuant to Reg. 1.45D-1(e)(3)) for the taxable year) or the distribution and all prior distributions do not exceed the partnership's cumulative operating income for all years.

Exhibit C

NOVOGRADAC
& COMPANY LLP
CERTIFIED PUBLIC ACCOUNTANTS

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.

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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 startup 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. <u>QLICI Reinvestment - CDE expenses</u>

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:

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

(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 **<u>(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)</u>** 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 QLICIs in tranches in order to avoid having cash at the QALICB for periods of more than 12 months. Since, QLICIs 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,
Novogradac and Company LLP

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