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Sent: Friday, May 16, 2003 3:31 PM
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Tony Brown (Brown, Tony);
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Subject: NMTC Outstanding Issues Comment

Attached please find a letter on behalf of the New Markets Tax Credit Coalition (Coalition) to continue our dialogue with the Treasury Department on a number of outstanding policy and regulatory issues related to the New Markets Tax Credit (NMTC)

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New Markets Tax Credit Coalition (NMTCC)

May 16, 2003

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Eric Solomon:

I am writing on behalf of the New Markets Tax Credit Coalition (Coalition) to continue our dialogue with the Treasury Department on a number of outstanding policy and regulatory issues related to the New Markets Tax Credit (NMTC). We appreciate all that the staff at Tax Policy, the Internal Revenue Service (IRS), and the Community Development Financial Institutions (CDFI) Fund has done to get the NMTC program launched and the first \$2.5 billion in NMTC allocations awarded.

There are a number of issues, including a defined cure period and raising the control threshold, on which we have commented before and on which you probably don't require much additional explanation - other than to say they continue to be priority items for the Coalition. Some of the Coalition's outstanding policy questions, including the implementation of the Qualified Low-Income Community Business tests, are issues that need to be addressed in the near future in order for Allocatees and investors to move ahead in implementing the NMTC program.

We look forward to meeting with you and your colleagues on May 20th and discussing some of these issues further.

Issue 1: Control

On the issue of control, the Coalition supports the reasonable expectation test as included in the temporary regulation as it provides a valuable safeguard for Community Development Entities (CDEs) and their investors. However, the temporary regulation defines "control" as direct or indirect ownership or control of 33 percent or more of an entity (Section 45D(d)6(ii)), which we believe is far too low. Thirty-three percent ownership does not provide control and is not generally considered to be the threshold used in accounting to define control.

The Coalition recommends that the threshold for control be set at 60% management voting control (whether through holding membership, partnership or stock interest(s)), which clearly ensures that a CDE has a controlling interest in the company and therefore can be held to a higher standard in terms of keeping the business in compliance.

Issue 2: Cure Period

The Coalition has requested that a defined cure period, of at least one year, be provided in regulations governing the NMTC. We are concerned with the precedent set by the Allocation Agreement that establishes a 60-day cure period, which we believe, is far too short. Allocatees, and their investors, need concrete assurance that they will have sufficient time to remedy a problem, which in some cases may mean working with a business or a CDE borrower, before recapture is triggered.

While the temporary rule provides CDEs with the option of applying for a waiver or requesting a time extension to remedy a Qualified Low-Income Community Investment that falls out of compliance (Section 45D(g)(2) B), no guidance is given on when and under what circumstances a waiver or time extension would be granted. Therefore the provision offers limited assurance to CDEs or potential investors. Instituting a one-year cure period would provide investors as well as CDEs with certainty on what happens in the face of non-compliance.

The Coalition recommends that a one-year cure period be provided in the regulations and that only after that period has expired would a CDE need to apply for a waiver.

We submitted a letter in February in which we listed several circumstances where the lack of a defined cure period present a real problem for Allocatees, Qualified Low-Income Community Businesses, and investors.

Issue 3: Allowable Activities for Lower Tier CDEs

There are CDEs that will operate as intermediaries by either investing in or loaning to other CDEs and/or by purchasing loans from other CDEs. This is an important subset of CDEs through which non-allocatee CDEs can benefit from the NMTC program.

By statute, CDEs can use Qualified Equity Investments to invest in or lend to Qualified Low-Income Community Businesses, invest in or lend to CDEs, purchase loans from CDEs, or provide financial counseling and other services to Qualified Low-Income Community Businesses. The statute is silent on what a lower tier CDE can do with funds it receives via an investment or loan from an upper tier CDE. However the temporary regulations restrict the activities of a lower tier CDE to investing in or lending to Qualified Low-Income Community Businesses or providing financial counseling and other services to such businesses (Section 45D(d)(1)(iv) A). Under the temporary regulation lower tier CDEs cannot purchase loans from CDEs or invest in or lend to CDEs.

The Coalition does not see that any policy objective is achieved by thus limiting the activity of lower tier CDEs. The limitation does however hinder the activity of CDE intermediaries, including several members of the NMTC Coalition steering committee, that intend to use the credit to help non-allocatee CDEs access capital.

For example, the National Community Investments Fund (NCIF), which plans to apply for an allocation in this second round, has reasons relating to bank regulatory requirements for wanting to be able to lend to bank holding company CDEs (tier 2 CDEs) and have them be able to downstream loan proceeds to their bank subsidiary CDEs (tier 3 CDEs). This activity is not allowed under the current temporary regulation.

The "substantially all" requirement is in place to ensure that at least 85% of a CDEs Qualified Equity Investment has been put into Qualified Low-Income Community Investments within 12 months no matter how many CDEs a Qualified Low-Income Community Investment flows through.

Issue 4: Multiple Loan Sales

Related to the issue of allowable activities for lower tier CDEs, the Coalition seeks clarification on whether the purchase of loans is limited to a single purchase transaction, or whether a chain of purchase transactions among several CDEs is allowed. The Coalition believes that such a chain of purchase transactions is clearly within the legislative intent and reflects the reality of practices used within established capital markets. We do not see any opportunity for abuse, as long as each entity in the chain of transactions is a CDE and Qualified Equity Investments are deployed for Qualified Low Income Community Investments. Such transfers should be allowed particularly if transfers of the loans subsequent to the purchase of the loan from a lower tier CDE are solely among entities related to the first tier CDE that will hold the Qualified Low Income Community Investment loans.

For example, based on the market experience of the Community Reinvestment Fund (CRF)(CRF is the sponsor of the National New Markets Tax Credit Fund Inc., a current Allocatee), in the packaging of loans for sale to investors, it is a common practice to isolate a pool of loans that are pledged to a particular group of investors in a qualified special purpose entity (usually an LLC). This is done, in part, to assure investors that, if financial problems emerge elsewhere in the parent company, the loans they are counting on for repayment of their investment are not subject to actions by creditors of the parent company.

In order to utilize this same proven technique to attract capital to NMTC investments, CRF(which is a CDE) anticipates purchasing Qualified Low-income Community Investment loans from lower tier CDEs and then transferring those loans to its Business Loan Conduit LLC(anticipated to be a sub-allocatee).

We would appreciate clarification on whether Treasury would allow a chain of purchase transactions among multiple CDEs.

Issue 5: Warehouse Line of Credit

Throughout the consumer and commercial mortgage lending industry, lenders utilize warehouse lines of credit to make and hold pools of loans that they assemble for securitization or sale to secondary market purchasers. The use of a warehouse line makes the process more efficient for both the

originator of the loans and the secondary market purchaser because it dramatically reduces the number of transactions that must take place between the parties. This device is increasingly used in the Low Income Housing Tax Credit industry to assemble pools of projects prior to seeking investor capital pay-ins.

Because the use of warehouse lines is so common in the pooling of real estate assets, the Community Reinvestments Fund (CRF) and other CDEs have assumed that it would be possible to use a warehouse line of credit to assemble loans in advance of calling for capital from qualified equity investors. The Qualified Equity Investment would be used as the permanent source of funding for the Qualified Low-Income Community Investment. Since the investor cannot claim tax credits until the equity investment is actually made in the CDE, the use of a warehouse line actually results in a later triggering of the credits, which is, presumably, a more conservative use of the credits.

The Coalition requests that Treasury clarify the ability of CDE to use a warehouse line of credit as we have described.

Issue 6: Related Entity Test

The Coalition urges Treasury to reconsider its interpretation of the related entity test.

Making a "capital or equity investment in, or loan to, any qualified active low-income community business" is a Qualified Low-Income Community Investment authorized by the NMTC statute 45D(d)1A. The word "capital" was included in the law specifically to ensure that CDE Allocatees could invest in businesses that they owned in part or in whole. Since the statute intended CDEs to make investments in businesses they own, we caution the Fund not to use the related business entity test to discourage such capital investments.

We contend that the related entity test was included in the authorizing statute to address the issue of an investor that has a controlling interest in a CDE and plans to direct the CDE to make Qualified Low-Income Community Investments in a business or businesses in which they hold a majority equity interest. In such a situation, the investor would be controlling the investments decisions and directing the Allocatee to invest in businesses related to the investor.

The Coalition recommends that in determining whether a CDE is investing in a related business the CDFI Fund look at the operating agreement between the equity investor and the CDE rather than merely considering the relationship between the CDE and the Qualified Low-Income Community Business. If the CDE's operating agreement or partnership agreement stipulates that the equity investor has final decision making power over all investment decisions then the relationship between the equity investor and the Qualified Low -Income Community Business is what determines whether or not the investment is in a related entity.

So for example, a CDE Allocatee makes an investment in a grocery store that is owned and managed by a non-profit CDC affiliated with the CDE. A single investor holds 90% of the equity in the CDE Allocatee and the operating agreement between the CDE Allocatee and the equity investor grants the investor final say over all investment decisions made by the CDE Allocatee. The Coalition suggests that investing in the CDC's grocery store would not be considered investing in a related entity. However, we suggest that it would be considered an investment in a related entity had the CDE Allocatee chosen to invest in a business owned in full or in part by the equity investor.

Issue 7: Allocatees investing in other CDE Allocatees

The Coalition questions why an Allocatee should be prohibited from making an equity investment in another CDE. We do not see what public policy purpose is served by the inclusion of this restriction in the temporary regulation (26 C.R.F. 1.45D-1T (c)(4)(i) (B)) and in the Allocation Agreement (Section 3.3(f)). While there is a clear prohibition against any single Allocatee claiming more credits than awarded, we would appreciate some explanation as to the reasoning behind this prohibition.

Issue 8: Implementing the Qualified Active Low-Income Community Business Test

The Coalition recommends that the Treasury Department provide additional guidance on how the Qualified Active Low-income Community Business tests can be applied to specific businesses. We request clarification on the following issues:

A. It is common for some businesses, such as real estate development businesses, to take the form of a limited partnership or limited liability company with few or no employees. In such situations the general partner or the managing member operates the business on behalf of the LP or LLC. As such, it may be technically impractical or irrelevant to apply the services test to such a business. The Coalition recommends that the regulations clarify that a business in the form of a partnership or LLC with few or no employees and operated by a managing partner or managing member, respectively, will satisfy the employment services test if the managing partner or managing member satisfies the test.

B. The regulations require that a Qualified Low-Income Community Business must demonstrate that at least 50% of its business' total gross income is "derived from the active conduct of a qualified business... within any low-income community." The Coalition is concerned that this may present a problem for CDE portfolio companies (where the CDE elects not to use 50% of either tangible property or services to meet the gross income test) that manufacture goods for sale outside low-income areas or provide services outside these areas, especially as companies grow and expand geographically over the seven-year duration of tax credit investments. Therefore, the Coalition recommends that "derived from the active conduct" be defined to mean that the activity originate in a business located in a low-income community. For example, we recommend that a business meet the test if the product they produce is manufactured in the low-income community or the service workers they employ are dispatched from within a low-income community.

C. Section 45D(d)(2)(C) states that "the term 'qualified active low-income community business' includes any trades or businesses which would qualify as a qualified active low-income community business if such trades or businesses were separately incorporated."

In order to help Treasury ensure that only legitimate uses of this "separately incorporated" clause are used, we suggest that CDEs be required to submit substantial documentation to support their contention that a trade or business would qualify as a qualified active low-income business if it was separately incorporated.

The test used to identify a Qualified Low-Income Community Business, including the gross income, tangible property, and services test, must be satisfied by the "separately incorporated" business entity as though it was a stand-alone entity.

The Coalition has previously submitted several examples of how CDEs plan to utilize this provision and we have made recommendations as to the type of documentation that could be submitted to verify compliance. We would be happy to share these again with the Treasury staff if that would be helpful.

Issue 9: Implementation of the Reasonable Expectations Test

The Coalition was pleased to see the "reasonable expectations" provision included in the temporary rule. In our comments on the Advanced Notice of Proposed Rulemaking (ANPR) submitted in June of 2001, the Coalition recommended that compliance be determined at the time a CDE makes a Qualified Low-Income Community Investment and we feel the "reasonable expectations" language suggests that this is the case if a CDE can demonstrate that they acted in good faith at the time the loan or investments was made.

For example, a CDE makes a 7-year investment in a Qualified Active Low-Income Community Business. Before making the investment, the CDE documents that the business has a 10-year lease on its building and a track record of conducting business in the qualified low-income community. However, after 4 years the business moves and is no longer based in a qualified census tract. We suggest that in this situation the CDE and its investors are protected by the reasonable expectations test and therefore recapture is not triggered.

Without a defined cure period and in the face of stringent recapture penalties, the reasonable expectations test provides a critical safeguard against recapture to both Allocatees and investors.

Issue 10: Exempting NMTC from IRC Section 183

Internal Revenue Code (IRC) Section 183 requires that equity investors seeking tax deductions enter into their investments with the presumption that they will earn a profit for the duration of the term of their investment. In order to avoid classification as an abusive tax credit transaction, Section 183 requires that equity investor must then demonstrate that they entered into the investments transaction with the expectation of profit.

This cite is problematic for Allocatees that plan to take advantage of leverage by financing an investments partnership with both equity and non-recourse debt to finance the purchase of Qualified Equity Investment in a CDE. In such a leverage scenario, some investors will be approaching the transaction with no expectation of return other than the tax credit, which would put them in violation of Section 183.

The IRS has acknowledged the problem that Section 183 creates for the Low Income Housing Tax Credit and has issued Reg. 1.42-4 to ensure that the LIHTC is held harmless.

The Coalition recommends that the NMTC be treated like the Low Income Housing Tax Credit(LIHTC) as it relates to Section 183. Such a ruling would be consistent with Revenue Ruling 2003-20 issued by the Treasury Department in January of this year permitting the use of leverage.

Issue 11: Standardized Reporting

The Coalition has recommended that Treasury develop standardized reporting forms that CDEs can submit annually as part of their tax return. In addition, we have recommended that Treasury develop standardized forms that CDEs can use in collecting compliance information (such as gross income, tangible assets and services provided) from Qualified Low-Income Community Businesses. While CDEs would be required to conduct their own due diligence and certify that all information submitted is accurate, having a standardized Treasury form will ease the reporting burden on CDEs and simplify reporting to Treasury.

The Coalition is interested in working with Treasury and assisting in the development of such documents and reporting tools. We have discussed these issues with you and your colleagues in the past and we believe the input of community development practitioners would be of great value in developing standardized reporting tools.

Let me close by saying thank you again to the NMTC team at the Treasury Department for all the work thus far to ensure that this new program is launched effectively and we appreciate this opportunity to continue working with you on this important program.

Sincerely,

Robert A Rapoza
Cc: Tony Brown