IRS Comment Letters
Shorebank Corp. Comment on Proposed Regulations (REG-119436-01) Regarding New Markets Tax Credit

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Mr. Jeffrey C. Berg
Acting Director
Community Development Financial Institutions Fund
U.S. Department of the Treasury
601 13th Street, NW
Suite 200 South,
Washington, DC 20005

Dear Mr. Berg:

Shorebank Corporation is pleased to provide comment on the CDFI Fund's Guidelines on the New Markets Tax Credit (NMTC).

Shorebank Corporation, a certified Community Development Financial Institution, is the nation's oldest and largest development bank holding company. The model for development banks and many nonbank CDFIs, Shorebank's mission is to increase opportunities in underinvested communities such as those targeted by NMTC. Organized in 1973 with a $41 million bank, Shorebank's assets reached $1.1 billion at year-end, 2000. The corporation has bank and nonbank CDFI operations in underserved markets in Chicago, Detroit, Cleveland, and in rural communities of the Upper Peninsula of Michigan and the Pacific Northwest.

Since inception, Shorebank has invested over $1 billion in its priority communities or minority-owned companies. Loans outstanding in 2000 grew by more than $101 million, a highly efficient deployment of $107 million in deposit growth. This included the origination of $51 million in 341 small business financings and an additional $13 million in community organization and church financings, most of which would qualify for NMTC in 2000 alone. Within Shorebank's largest and oldest bank subsidiary, ShoreBank (formerly South Shore Bank), loss rates have been on a par with banks nationally--.37% over the last five years.

Shorebank has an almost 30-year history of raising equity from the private sector to support its market-driven community development model. At year-end 2000, Shorebank's total equity stood at over $76 million. This record, along with Shorebank Corporation's consolidated earnings for 2000 of $1.8 million, demonstrate the viability of market-driven investment in underserved urban and rural markets and form the context for Shorebank's comments on the NMTC Guidelines.

In general, we believe that the process for allocating and tracking NMTC allocations must focus on the intent of the statute to leverage private sector investment in businesses operating in distressed communities. Unlike the CDFI Fund's Core Program, where there is an upfront 1 : 1 match of Federal to private sector dollars, the NMTC program requires more private sector investment up front and phases in government subsidy over time. Investors bear considerable risk in making NMTC investments. They will look to the CDFI Fund for an allocation and monitoring process that imposes minimal delays and reporting burdens while facilitating the flow of their capital into qualified businesses in distressed areas.

Our responses to the CDFI Fund's specific questions follow:

1 IRC 45D(f)(2) requires that in making allocations of NMTCs, priority be given to (a) any applicant that has a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities or (b) any applicant which intends to satisfy the Substantially All Test by making Qualified Low-Income Community Investments (QLIIs) in one or more businesses in which persons unrelated to the CDE hold a majority equity interest.

(a) How should the Fund implement this policy? For instance, should the Fund incorporate preference points into the scoring? Should the Fund make awards to organizations that are deemed competitive and meet one or both of these criteria before providing an allocation to any other applicant?

These provisions are designed to ensure that NMTC allocations flow to institutions that have proven effectiveness in investing in low income communities or will proactively seek a range of independent, qualified low income community investments in which to invest. The intended benefit in either case is the flow of capital to a range of qualified opportunities in low income communities. Applications should receive preference points for these criteria and the CDFI Fund should make awards to competitive organizations that meet one or both before providing an allocation to any other applicant.

(b) What specific factors should the Fund consider when evaluating whether an applicant meets the requirements for priority treatment?

The CDFI Fund should gauge track record by looking at: years in operation, average annual volume of transactions in qualifying communities (aggregate, including all subsidiaries and affiliates), pipeline for reinvesting proceeds of intended new Qualified Equity Investments (QEI), and financial counseling and other services provided in combination with financing. Some information suggesting the degree to which the type of financing provided by the CDE has otherwise been unavailable would also be useful.

The CDFI Fund should gauge intention to Make QLIIs in One or More Businesses in Which Persons Unrelated to CDE Hold Majority Equity Interest by looking at: pipeline (including contact names for spot reference checking) and qualifications of staff to generate and meet demand for a significant volume of QLIIs. Historical track record should also be considered here. Finally, this evaluation should take into account whether the applicant may invest QEI proceeds into one or more subsidiaries that intend to meet the "substantially all" test by making QLIIs in one or more businesses in which persons unrelated to the CDE hold a majority equity interest.

(c) Should more weight be given to one priority category over the other and should an applicant be allowed to receive preference points under both priority categories.

More weight should not be given to one priority category over the other. However, applicants should not be allowed to receive preference points under both priority categories. Community Development Corporations (CDCs) and CDFIs routinely take majority equity positions in real estate projects they are developing in low-income communities. In fact, in many cities CDC ownership is a key factor in receiving additional state and local subsidies for the project. Real estate focused CDEs that are sponsored by CDCs and CDFIs would presumably be given preference points on the basis of their track record. To give preference points under both priority categories, however, would in effect give priority to loan funds and venture capital funds over CDC-sponsored real estate developers. Since real estate development appears to be a key activity envisioned by the drafters of the NMTC statute, it should not be penalized by allowing preference points trader both priority categories.

2. Should there be limits as to the amount of a NMTC allocation that may be awarded to an applicant in a calendar year?

It is in the interests of practitioners of community development that there be sufficient demand for the tax credits by qualified CDE applicants. Experience with other tax credit programs such as the Low Income Housing Tax Credit also suggests that investors prefer working with entities that can generate a substantial volume of QLIIs. Therefore, in the early years of the program, we do not recommend limits on the annual amount of NMTC allocation for any applicant. Early market experience will indicate whether limits are needed to ensure that the credits flow to a range of CDE types and markets.

3. During the evaluation process of NMTC applications, the Fund will request that applicants provide information on their track records for providing capital or technical assistance to Low-Income Communities and disadvantaged businesses and the effect that such investment/technical assistance has had on such Low-Income Communities or businesses. Applicants may also be required to describe the social underwriting criteria that they will use when deciding which companies to invest in. lf an applicants receives a NMTC allocation, it will be required to report to the Fund on the ways in which Qualified Equity Investments are used to benefit Low Income Communities.

(a) *What indicators should the Fund assess when evaluating the community development impact of an applicant's prior activities or the social underwriting criteria of its loan policies ?*

The most objective measures would be: a) number and dollar amount of loans or investments made to borrowers operating in low income communities as defined in the statute, and b) underwriting criteria or marketing outreach that result in CDE making loans or investments that would not be readily available through other financing entities.

(b) On what basis should the Fund judge how "successfully" capital or technical assistance has been provided?

The success of capital investment and technical assistance efforts should be evaluated on the basis of broad economic development objectives as follow.

For capital investment:
· Number and dollar amount of investments or loans funded.
· Asset growth of investees.
· Sales growth of investees.
· Number of turnarounds that stayed in business for credit allowance period.
· Number of start-ups that stayed in business for credit allowance period.
· Net jobs created or maintained through financed businesses in low income neighborhoods.
· Square feet of commercial space developed in low income neighborhoods.

For technical assistance-
· Number of clients served at facilities developed
· Objectives achieved by clients served (i.e., increased profitability or sales)

(c) What information should the Fund request from allocation recipients as indicators for evaluating the effectiveness of the NMTC Program (e.g., number of jobs created or retained, increases in revenues or businesses receiving Qualified Low-income Community Investments, rates of return to investors from Qualified Equity Investments, or number of clients served at facilities developed) ?

The same indicators as for Co), above.

In addition to the questions above, Shorebank has the following concerns regarding the process outlined in the CDFI Fund's Guidance:

Allocation Application and Allocation Agreement Procedures. The Application process for tax credit allocations requires the CDE to supply a Comprehensive Investment Plan that provides historical information and a minimum five-year investment strategy. Upon receiving notice of an award of allocation, a CDE must enter into an Allocation Agreement with the CDFI Fund. Investors and CDFI practitioners are concerned that both the Application and Allocation Agreement processes will be onerous and substantially delay the availability of the tax credits to spur new investment. In addition, there are investor concerns that a CDE's violation of an Allocation Agreement might trigger recapture, even where there is no bad faith. Investors and CDFI practitioners have expressed concern that there might not be a uniform standard of recapture risk, if recapture were to result from violations of individualized Allocation Agreements. Finally, there is concern that Allocation Agreements might constrain a CDE's flexibility to adjust its business plan or geographic focus as needed to be successful over time.

Recommendations:

Eliminate the Allocation Agreement and incorporate necessary reporting requirements from CDEs in the Notice of Allocation Availability and in the application itself, so that nothing remains to be negotiated after a CDE receives a tax credit allocation.

If there must be an Allocation Agreement, create a boilerplate document that focuses on the mechanics of tax credit allocation and reporting, rather than financial, development impact, business or geographic targets. (The matter of overriding concern with respect to NMTC, the CDE's obligation to meet the "substantially all" test, should be addressed in agreements with investors and in an annual compliance statement to the IRS.) Create a process that ensures that a CDE does not trigger recapture through violation of its Allocation Agreement, unless there is bad faith.

Ensure that the time from filing an Application to completing an Allocation Agreement and receiving NMTC allocations is less than one year.

Allow a streamlined application process for CDEs that have already submitted a Comprehensive Investment Plan for a similar NMTC business model, or a relevant Comprehensive Business Plan under any other CDFI Fund program.

Availability of Bank Enterprise Award monies for a) bank investments into CDEs, and b) Qualified Low Income Community Investments by banks that are CDEs. There is precedent in the combination of Low Income Housing Tax Credits and Historic Preservation Tax Credits for the use of two sets of Federal resources simultaneously to accomplish a community development purpose. The markets served by QLIIs under NMTC have long deferred investment and credit needs. Meeting these needs will most rapidly and reliably be accomplished by allowing the BEA incentive along with NMTC.

Recommendation: Bank investments into CDEs, and QLIIs by banks that are CDEs, should be eligible for Bank Enterprise Awards.

Availability of Business Trusts as qualifying CDE structure.

We request clarification that business trusts that are taxable as partnerships can be used as a CDE vehicle. These are commonly used in securitization programs, and are an important vehicle for attracting conventional investors to low-income communities.

Recommendation: Business trusts that are taxable as partnerships should be an eligible CDE form.

Directly Serving Low Income Communities. Shorebank supports the New Market Tax Credit Coalition position that the final guidance specify that a CDE can satisfy the 'primary mission test' by either directly or indirectly serving low-income communities.

Community Accountability. Shorebank supports the New Markets Tax Credit Coalition position that community accountability should be able to be met by having representatives of the "target market" on their governing board or use other approaches, such as an advisory board, focus group or community meetings, and that the guidance definition of "representative of low-income community" be expanded to include people whose primary job or activity is serving or working in such areas, such as a pastor, business owner or CDC director, who may live elsewhere, but is representative of the community and aware its needs. NCIF further agrees that CDEs should he treated as meeting the accountability test if a majority of their governing or advisory board (if they employ such an approach) meets the "representative test."

Please feel free to contact me at 773-420-4960 if you have any questions on these comments.

Sincerely,
/s/
George Surgeon
Chief Financial Officer

cc: IRS
Eric Solomon, Senior Advisor for Tax Policy, U.S. Department of Treasury