IRS Comment Letters
New Markets Group Comment on Proposed Regulations
(REG-119436-01) Regarding New Markets Tax Credit
Document Date: June 29, 2001

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Room 5226
Internal Revenue Service
P.O.B. 7604 Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

The New Markets Group is pleased to have the opportunity to comment on the IRS' Advance Notice of Proposed Rulemaking (ANPR) on the New Markets Tax Credit (NMTC).

The New Markets Group consists of six of the largest trade associations and intermediaries within the Community Development Financial Institutions (CDFI) industry. As such, our members and we collectively manage billions of dollars of assets that are devoted to supporting development in low-income communities. The members of the New Markets Group are: Community Development Venture Capital Alliance, The Enterprise Foundation, National Community Capital Association, National Community Investment Fund, National Congress for Community Economic Development and The Retail Initiative, Inc.

Since the NMTC represents a major new opportunity to expand the amount of capital available to low-income communities, we have joined in an informal alliance that is seeking to expand the potential pool of NMTC investors. We believe that if these communities and the NMTC are to realize their full potential, the tax credit will have to appeal to a broad range of investors, including those that may be new to the community development field.

We will be providing comments on the ANPR individually and as members of other coalitions, particularly the New Markets Tax Credit Coalition. Our goal with this letter is not to replicate those comments. Instead our focus here is to summarize investors' needs and expectations with respect to the NMTC. These investors have a broad range of investment options, and NMTC investments are merely one alternative in a competitive landscape. The New Markets Group strongly reaffirms the comments provided by the New Markets Tax Credit Coalition, since we believe that many of the positions of that Coalition directly address the investor concerns highlighted in this letter.

These comments are based on interviews with some of the largest existing investors in the CDFI field, a sampling of investors that have not actively participated in community development finance in the past and our own years of experience in dealing with some of the country's largest and most sophisticated institutional investors. While some of these investors plan to comment individually, we believe it is important to provide an overview of those conversations and experiences.

To summarize investors' concerns, by far and away the most important issue is, to paraphrase a real estate phrase, "recapture risk, recapture risk, recapture risk". Their primary need is to understand clearly the circumstances under which recapture will be triggered. They also want avoid recapture being triggered by events that are outside the control of themselves and the CDE in which they have invested, especially in situations in which the public policy intent of the NMTC statute is realized.

IRS Question 1. The NMTC may be claimed only with respect to qualified equity investments in a CDE. Section 45D(b)(1)('B) requires CDEs to use substantially all of the cash from a qualified equity investment to make qualified low-income community investments.

(a) How should "substantially all" be defined for purposes of section 45D(b)(1)(B)? For example, what percentage should constitute "substantially all" of the cash from a qualified equity investment?

(b) What amounts should be treated as used to make qualified low-income community investments? For example, how should issuance costs (including underwriters compensation) and reserves be treated?

(c) How much time under section 45D(b)(1)(B) should a CDE have to invest the cash from a qualified equity investment in a qualified low-income community investment?

(d) How should repayments of equity or principal in respect of a qualified low-income community investment be treated for purposes of section 45D(b)(1)(B) ? For example, are there circumstances when a CDE should not be required to reinvest any such amounts in another qualified low-income community investment during the 7-year credit period?

(e) How should the 'substantially all" requirement under section 45D(b)(1)(B) be administered during the 7-year credit period?

Not surprisingly, investors approach this issue from a business perspective. They want to invest in CDEs that have the same features as other comparable investment opportunities, whether focused on low-income communities or not. Absence of these features increases risk and makes the CDE investment a less competitive option. In the context of higher risk business investments, these features include:

• Adequate funds for initial organization and ongoing operating expenses (including expenses associated with project identification, underwriting, closing, monitoring and servicing)

• Adequate funds for pre- and post-closing technical assistance/advisory work with businesses that often have a higher need for such services (thus mitigating investor risk)

• Adequate loan loss reserves (if the CDE is primarily a lender)

• An ability to commit funds that are not disbursed until certain performance thresholds are attained (e.g., construction loans that are drawn as work is completed)

• Adequate reserves for follow-on investments if the CDE is primarily an equity investor (otherwise a business that has been successfully nurtured may be deprived of capital at the point at which it is most likely to thrive and generate a return for the investor)

· An ability to exit the CDE investment at the end of the tax credit period (which means a limited reinvestment requirement during the latter years of the 7-year credit period, since such a reinvestment effectively extends their investment period beyond 7 years until the CDE can exit that new investment).

As implied by your question 1(b) above, investors need to know, in order to avoid recapture, which amounts will be treated by the IRS as being used "to make" qualified investments. Loan loss reserves, staged disbursements, reserves for follow-on investments, reasonable organizational and operating funding and funds for technical assistance/advisory work are integral risk management practices in making such investments. Thus, investors believe that the IRS should treat such amounts as being used "to make" qualified investments. The IRS is given further flexibility in determining these amounts by the definition of Qualified Active Low-Income Community Investments, which include financial counseling and other services (emphasis added) to business located in low-income communities.

Our individual comments as well as the comments of the New Markets Tax Credit Coalition detail possible quantitative standards and specific language for defining "substantially all", amounts used to make

investments and appropriate re-investment periods and practices, so we will not repeat those comments here.

IRS Question 2. Section 45D(b)(3) contains a safe harbor under which the substantially all'" requirement of section 45D(b)(1)(B) will be treated as met if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments.

(a) How should "aggregate gross assets" be defined under section 45D(b)(3)? For example, are there any assets of a CDE that should not be taken into account for these purposes?

(b) How should the aggregate gross assets of a CDE be determined under section 45D(b)(3) ?

(c) How should compliance with the 85 percent test of section 45D(b)(3) be determined? For example, should the CDE be required to satisfy the test throughout the entire 7-year credit period following the issuance of a qualified equity investment? Should any grace periods be provided? If so, what should those grace periods be?

For CDEs to be a competitive alternative for investors, CDEs must be able to engage in the same routine, sound business practices as other asset management firms. Thus, it is important to investors that reasonable grace periods be given for periods of non-compliance, particularly when that temporary period of non-compliance is necessary for the CDE to protect the potential and the integrity of its portfolio. For example, investors want a CDE to able to exit any of the CDE's equity investments at the most opportune time from an investment manager's perspective. They do not want that CDE's exit strategy to be driven by a uniform, statutorily mandated seven-year holding period. As noted earlier, investors want to exit the CDE investment as quickly and as prudently possible at the end of the tax credit period, and they believe that a reinvestment requirement in the latter years of the CDE effectively extends their holding period since it may take several additional years to exit that new investment. Investors are also concerned that a reinvestment requirement, particularly in later years when the recapture amount will be the greatest, will pressure CDEs to make investments that negatively impact investor returns in order to avoid recapture.

Similarly, in the case of CDE's that are primarily lenders, the CDE cannot ultimately control when borrowers prepay. Investors are concerned that prepayments, absent a grace period, may eliminate the availability of the 85% safe harbor. In the same vein, investors want a CDE to be able to pursue collection or liquidation actions at the appropriate time against any non-performing Qualified Low Income Community Investment (QLII). They believe a successful recovery action that converts the failing QLII to cash should not immediately eliminate the availability of the 85% safe harbor. For all these reasons, investors believe that an appropriate grace period should be given for purposes of the 85% safe harbor test of Section 45D(b)(3) and for purposes of the "substantially all" requirement of Section 45D(b)(1)03).

We refer you to our individual comments and the comments of the New Markets Tax Credit Coalitions for suggestions on specific language, including suggested grace periods and a proposed definition of aggregate gross assets.

IRS Question 3. As indicated previously, section 45D(b)(1)(B) requires CDEs to use substantially all of the cash with respect to a qualified equity investment to make qualified low-income community investments. Under section 45D(d)(1)(A), the term "qualified low-income community investment" includes any capital or equity investment in, or loan to, any qualified active low-income community business. Section 45D(d)(2)(A) provides that the term "qualified active low-income community business" means, with respect to any taxable year, any corporation (including a non-profit corporation) or partnership if for the year (i) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business (as defined in section 45D(d)(3)) within any low-income community, (ii) a substantial portion of the use of the tangible property of the entity is within any low-income community, (iii) a substantial portion of the services performed for the entity by its employees is performed in any low-income community, (iv) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles

that are held primarily for sale to customers in the ordinary course of the business, and (v) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to nonqualified financial property (as defined in section 1397C(e)).

(a) How should "substantial portion " be defined for purposes of section 45D(d)(2)(A)(ii) and (iii)?

(b) When should the determination be made regarding whether a trade or business constitutes a "qualified active low-income community business"? For example, should the determination be made at the time of the investment in the business based on reasonable expectations? Under what circumstances, if any, should an investment in a business lose its status as a "'qualified low-income community investment" under section 45D(d)(1)(A) by reason of a failure of the business to satisfy the requirements for a qualified active low-income community business under section 45D(d)(2) ? Should the degree of control of the CDE over the business be relevant to this determination?

(c) Should special rules be provided under section 45D(d)(2)(A) for determining whether a newly-formed entity meets the requirements for a qualified active low-income community business?

Investors have three primary concerns arising from the definition of "qualified active low-income community business". First, the definition simply needs clarification. Since failure to invest in a qualified business triggers recapture, investors will assume the "worst case" and avoid investments that are even arguably subject to recapture under an ambiguous definition. The New Markets Tax Credit Coalition's comments recommend specific clarifications for the gross income, property and services tests.

Second, investors hope that the definition of qualified business will not be construed so narrowly that NMTC investment opportunities in these low-income communities will be severely limited. The examples used by investors are similar to those provided by the New Markets Tax Credit Coalition, e.g., transportation and service companies based in low-income neighborhoods but delivering goods and services outside it and manufacturing companies exporting products beyond the immediate community.

Third, investors are concerned about recapture being triggered by events outside of the control of themselves or the CDE. From an investor's perspective, they and the CDE can control events only up to the time the CDE makes the QLII. Thus, investors believe that compliance should be determined at the time a CDE makes the QLII. If post-closing compliance is required, investors will probably discount the value of the credit, since it is subject to recapture in circumstances over which they have little effective control (e.g., relocation, changing market focus, etc.). Even if the QLII has covenants prohibiting such actions, it may take months or even years to legally enforce those provisions, during which time the CDE would be out of compliance.

If post-closing compliance for a QLII is required, investors feel strongly that eventual failure of the business should not disqualify the QLII. They believe that the CDE should not be in the position of "guaranteeing" business performance. They also feel strongly that a successful business that ultimately expands its market beyond its immediate community should not be penalized for the that success, so long as the portion of the business that received the NMTC investment continues to operate in the qualified
low-income community. Investors posit that this is the very type of "success story" that will bring new capital to these communities.

Investors also would like clarification of 45D(d)(2)(C) (Portions of Business may be Qualified Active Low-Income Community Business), which includes as a qualified business any business that would qualify as a qualified business if such business were separately incorporated. A couple of examples may be useful to illustrate this point. For example, if a business has two manufacturing plants, one inside a low-income community and one outside, can the CDE under this "portions of business" language make a loan to the business to expand the plant in the low-income neighborhood. Similarly, can a CDE make a loan to a retail business to build a distribution center in a low-income neighborhood, even if the business's stores

are outside that neighborhood, again using the argument that the distribution plant would qualify if it were separately incorporated? Investors would argue that the manufacturing plant and the distribution center should be permissible QLIIs. Otherwise, eligible businesses will be determined in part by how a company arranges its corporate structure.

We again refer to our individual comments and the comments of the New Markets Tax Credit Coalition for specific suggested language that addresses investors' issues with respect to these provisions.

IRS Question 6. Under section 45D(g)(3)(B), a recapture event (requiring an investor to recapture credits previously taken) may occur with respect to an equity investment in a CDE if the CDE ceases to use substantially all of the proceeds of the equity investment for qualified low-income community investments.

(a) What circumstances should constitute a change in use of the proceeds of a qualified equity investment that triggers a recapture event under section 45D(g)(3)(B)?

(b) What remedial action(s), if any, should a CDE be permitted to take to avoid recapture under section 45D(g)(3) (B) ?

As noted earlier, recapture risk is the primary issue for investors that are considering NMTC investments. In the answers to previous questions above, we have detailed clarifications that are needed to define the triggering events for recapture. We have also suggested language that will provide CDEs with a large enough market so they can compete effectively for investor dollars, and consequently channel those dollars to low-income communities. Similarly, we have also discussed investor needs with respect to a grace period to cure non-compliance issues.

Investors also believe that CDEs should be able to resolve non-compliance through substitution of other QLIIs. The CDE may make the business decision not to force a business to come back into compliance through litigation, particularly if repayment of the QLII would stunt the growth or otherwise damage the business. In such circumstances, the parent/sponsor of the CDE should have the ability to substitute another QLII for the QLII that is no longer in compliance in order to cure the noncompliance. For example, a nonprofit revolving loan fund (RLF) that has a CDE affiliate should be able to repurchase a non-qualifying loan from the CDE and to sell the CDE a qualifying loan from the RLF's portfolio (assuming the RLF is a CDE as well) in order to cure the non-compliance and to avoid the expense of extended litigation with the original borrower.

Investors would also like for the IRS to provide an example on the mechanics of recapture. For example, assume that a CDE has $5 million in investments that it in good faith believes to be QLIIs; the CDE has an individual $1 million investment that is determined not to be a QLII after the CDE investors have received three years of NMTCs; and, for whatever reason, the CDE cannot cure that non-compliance. Investors assume in that ease that the amount of the NMTC recaptured would be 20% ($1 million/$5 million) of the NMTC taken over the 3-year period plus non-deductible interest. The penalty would be draconian if it were 100% of the credit taken on the full $5 million. Investors would like to have that assumption confirmed.

Please contact the undersigned or any individual member of the New Markets Group if you have any questions on these comments.

Sincerely,

/s/

David J. McGrady, on behalf
of the New Markets Group

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