IRS Comment Letters
Enterprise Corporation of the Delta Comment on Proposed Regulations (REG-119436-01) Regarding New Markets Tax Credit

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CC: M&SP: RU (REG-119436-01)
Room 5226
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir/Madam:

The Enterprise Corporation of the Delta (ECD) is pleased to submit its comments on the Internal Revenue Service's (IRS) Advance Notice of Proposed Rulemaking (ANPR). We are also submitting comments to the Community Development Financial Institutions Fund (CDFI) on its Guidance, New Markets Tax Credit (NMTC) Program. ECD was also involved in writing the comments submitted by the New Markets Tax Credit Coalition. In the ANPR the IRS requested comments on a number of tax-related questions. The following comments are our views on the issues the IRS raised and on other issues we believe are important.

ECD is a not-for-profit CDFI. Our core business has been to provide commercial financing to businesses in the Delta region of Arkansas, Louisiana and Mississippi. Almost all of the census tracts we serve will be qualified areas under the NMTC Program. Since our inception in 1994 we have provided $32 million in financing to businesses in this region.

We see the NMTC Program potentially helping us raise a significant amount of additional capital that we can use to continue and expand our commercial lending and investing activities. However, in implementing the program the Treasury Department should attempt to ensure that the program achieves its objectives, the primary of which is increasing the availability of commercial capital in qualifying areas around the country. With the way the statute is written, this will not be easy and the Treasury Department should do all it can to overcome the obstacles. The following are what we consider to be the three primary and inter-related issues of the NMTC:

1. The NMTC requires that investors make equity investments into Community Development Entities (CDE's) in order to receive a credit. Traditionally, most for-profit corporations have made debt investments in CDFI's at below market rates, In discussions with potential investors, we have generally heard the refrain "If we have to make an equity investment, we will need equity like returns." These returns *are* substantially higher than CDFI's have traditionally paid, or are likely able to pay. We ask that the IRS consider this issue in designing the Program. For there to be a significant increase in capital made available to CDE's there must be vehicles in which potential investors can invest.

2. Related to my previous point, the NMTC is relatively small. I understand that the original architects of the NMTC intended for it to be a small subsidy that would make less attractive economic models more attractive, rather than encouraging completely uncompetitive economic models. However, combining this with the requirement for equity, makes the benefit of the NMTC a difficult proposition. By contrast, the low-income housing tax credit investor gets its capital back and a return on its capital solely from the credits (and related tax benefits) from qualified low-income housing projects. The investor in such projects is, for the most part, indifferent to it's underlying economics. The same is largely true for investors in projects that qualify for historic rehabilitation tax credits (Section 47) and the credit for producing synthetic fuels (Section 29).

3. Finally, the risk of recapture to the equity investors could make any transaction prohibitively expensive and completely nullify any benefit the NMTC Program may have originally been intended to achieve.

In the light of these issues, we request that the IRS, in writing the regulations, carefully consider its options, and work to implement a program that will *achieve* its intended objectives. The higher the costs and risks to the *potential* equity investors, the less likely they will *make* any investment, and if they do the more costly that investment will be to the CDE. In a worst case scenario the NMTC will not assist the CDE's in moving capital into qualified businesses, but will only be a benefit to the equity investors because of the discount the CDE's will have to give, if they can place the NMTC at all.

Also, in order to best utilize the existing tax credit structures with the NMTC, CDE's will need to be able to leverage the tax credit investment or be allowed to specially allocate the NMTC to investors solely interested in such credits. We request that the IRS allow special *allocations* of the NMTC, in order to do this. In theory, the IRS should not care whether the NMTC is claimed by one class of investors or two - as long as the revenue cost is the same and the program's objectives are *realized.*

We also request that the IRS consider insulating the NMTC from rules pertaining to abusive corporate tax shelters. These rules would frustrate the public purpose of the NMTC legislation whether they are applied to a single class of investor or to transactions that include "credit" and economic investors. Thus, we would urge that the regulations specifically provide that NMTC be treated as a cash equivalent for purposes of Sections 6111 and 6700 of the Internal Revenue Code.

Finally, as the NMTC is a seven year credit, most CDE's will likely structure limited-life funds, to maximize the benefit of the credit to the CDE and minimize their cost of capital. Molding the *regulations* to assist CDE's in doing this will, again, be critical to the effectiveness of the NMTC Program.

Comments on IRS Questions:

IRS Question Number 1.

New Markets Tax Credit 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.

1a. 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?**

The 'substantially all' test is central to the risk of recapture, and therefore central to the CDE's ability to attract capital at a cost that would be beneficial to its ability to invest in qualified businesses. In writing the regulations, we request that the IRS carefully weigh the objectives of the program with the tax policy and public policy priorities of complying with the letter of the law and previous tax rulings.

We believe the 'substantially all' test should be considered met if a CDE has at least 85 percent of its cash derived from Credits in qualified low income community investments. This would permit a CDE to use up to 15 percent of its total cash from the Credit to cover costs related to fund *management* and *have* cash available for operations and *additional* future lending.

Establishing the substantially all standard at 85 percent would make it consistent with the 'safe harbor' standard which by statute is set at 85 percent.

1b. 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?**

We recommend that a CDE be considered to have 'substantially all' of its cash in qualified equity investments if at least 85 percent of its cash is either invested in or loaned out in qualified low-income community investments or is committed and legally obligated to qualified low-income community investments, or is in committed reserves.

It is important to include the "committed and *legally* obligated" component, as common products among potential CDE's *are* commercial lines of credit and *construction* loans which *are* usually not completely *advanced* at any *period.* In essence, these funds are already committed to a qualified investment activity.

Non-performing assets that are in compliance with the low-income community investments requirements should be included for purposes of the 'substantially all' test and for the purpose of meeting the 'safe harbor' test. This should also be true of investments in qualified businesses that ceased operations because of business failure. It would not be reasonable or workable to overlay the risk of recapture on top of the credit risk, which, in these types of businesses, will generally be higher than traditional commercial financing could permit.

1c. 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?

1d. 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?

Once a CDE has secured a qualified equity investment from an investor, it will need sufficient time to loan or invest its cash in qualified low-income community investments before it is required to meet the 'substantially all' test. In addition, whether a CDE makes its qualified low-income community investments in the form of loans or equity investments, it will receive principal and/or capital re-payments throughout the seven-year credit period and while we understand the policy requirements that these funds be reinvested in qualified low-income community investments during the course of the seven-year credit period, we recommend that the 'substantially all' test provide at least a grace period that allows CDE's time to accumulate these repayments, finds new and viable qualified investments, and reinvest its cash.

It is also important to understand the different potential uses that will likely be made of the proceeds of the New Markets Tax Credit. The startup time required by a debt fund will be very different from that of a venture fund. The latter will more easily structure staged investments into the fund. It will also experience different repayments to the fund. Debt funds will likely be making many more investments over a period, making staged investments into the fund less practical and will more likely hold amortizing debt, which will make reinvesting a little more complicated, as those debt repayments will need to accumulate before they are of a sufficient size to allow for reinvestment, without even thinking of the time it will take to close new deals once actively pursued.

Venture funds, on the other hand, will have more difficulty structuring a reinvestment strategy as investment periods tend to be much longer (typically 4-7 years) which could create problems for the exit strategy of the funds investors after the credit period ends.

In addition, in the final years of the credit, particularly years six and seven as CDE's work to liquidate their portfolios, the regulations will need to provide flexibility in how the 'substantially all' standard is enforced. A CDE cannot be expected to reinvest principal and/or capital paid back in year six or seven of the term and yet without flexibility in how the 'substantially all' test is implemented, a CDE would be out of compliance if they failed to meet the test.

We recommend that, at the very least, a CDE have up to 6 months from the time it secures cash in the form of a qualified equity investments to the time it is required to comply with the 'substantially all' test. In the following period through year 5, a CDE would be required to maintain 85 percent of its cash in qualified investments in order to satisfy the substantially all test. In years 6 and 7 the substantially all standard would be reduced to 65 percent and then 45 percent, to allow for the liquidation of the portfolio.

This assumes that in order for cash to be considered towards meeting the 'substantially all' test, a CDE would need to document that it was either invested in or loaned out to qualified low-income community investments, or committed and legally obligated to qualified low-income community investments, or committed to a reserve.

We recommend that CDEs be granted a grace period of at feast 12 months to reinvest any principal and/or capital re-payments made back to the CDE from qualified low-income community investments. This grace period would allow time for principal/capital paybacks to accumulate and time for the CDE to identify new qualified low-income community investments. During the 12-month grace period, any principal or capital repayments would not be counted towards meeting the CDEs 'substantially all' standard.

As member of tax credit coalition we understand the need for flexibility among potential CDE's in meeting the 'substantially all' test, and request that the IRS maintain some flexibility.

1e. How should the 'substantially all' requirement under section 45D(b)(t)(B) be administered during the 7-year credit period?

We recommend that a CDE be required to certify compliance as part of its tax return for each fiscal year, based on standards set forth in an IRS form worksheet attachment to the tax return. As part of this certification, the CDE would have certifications from each of its qualifying investments, that the business meets the required compliance tests, and the CDE would certify that it is in compliance with the 'substantially all' test by certifying that it meets compliance tests.

Temporary noncompliance should not result in de-certification or recapture if cured within a reasonable time. This would be similar to low-income housing tax credit rules permitting a reasonable cure period for noncompliance.

IRS Question Number 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.

2a. 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?

We recommend that 'aggregate gross assets' be defined as all assets treated as such under generally accepted accounting principles, and should include cash received from investors, capital and equity investments and loans made by the CDE, Cash or investments held in reserve, and commitments to make qualified low-income community investments.

Section 1202(d)2(A) of the Code defines aggregate gross assets with respect to gains on certain small business stock as the amount of cash and the aggregate adjusted bases of other property held by the corporation.

The aggregate adjusted bases of other property would include varied calculations depending on the types of entities and the types of assets:

1. Loans - banks would value loans net of reserves; non-bank lenders would value loans at gross value as allowance for loan loss reserves is not a taxable expenses. The IRS may wish to consider this difference and eliminate it in evaluating compliance for the New Markets Tax Credit.

2. Venture investments - most funds would value these investments at cost unless there has been a material impairment in the value of the investment. A gain in the value of the investment would generally only be recognized when realized or if the investment is in marketable securities.

3. Fixed assets - the value assigned is generally the cost less the depreciation on the asset.

2b. How should the aggregate gross assets of a CDE be determined under section 45D(b)(3)?

CDE's should be required to document that they meet the aggregate gross assets test on an annual basis as part of their tax returns as suggested in our response to question number le. The determination should be made annually and certified by the CDE as part of its tax return, based on an attached IRS worksheet prepared by the CDE. If the CDE falls out of compliance at any time during the year, it should be allowed up to one year to cure the noncompliance, or a longer period if reasonably required.

Temporary noncompliance should not result in de-certification or recapture if cured within a reasonable time. This would be similar to low-income housing tax credit rules permitting a reasonable cure period for noncompliance.

2c. 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?

As with the 'substantially all' test, we recommend that CDEs have adequate time to deploy cash investments upfront once investments are brought in. As we recommend with the implementation of the 'substantially all' test in our response to question ld, we recommend that a CDE be granted a degree of flexibility in satisfying the 'safe harbor' test in the early months of the credit as it ramps up its investments and in the end years (years six and seven) as it ramps down investment activity.

As we recommended in our response to question number ld, we suggest that CDE's be granted a grace period of at least 12 months to reinvest any principal and/or capital repayments made back to the CDE from qualified low-income community investments. This grace period would allow time for principal/capital paybacks to accumulate and time for the CDE to identify new qualified low-income community investments. During the 12-month grace period, any principal or capital repayments would not be counted towards meeting the CDE's 'safe harbor' standard.

IRS Question Number 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 ii) 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 iv) 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)).

3a. How should "substantial portion" be defined for purposes of section 45D(d)(2)(A)(ii) and (iii)?

We recommend that 'Substantial portion' be considered to be less than 50 percent. If it were more than this, the statute would have used majority, or even 50 percent itself as it did in section 45D(d)(2)(a)(i). The statute is specifically vague here, whereas it is very precise in ii), (iv) and iv). It appears that the statute may have intended this measure to be more subjective. It would be simple to use a simple test, for example 25 percent. The IRS may *also* wish to *take* other factors into consideration.

We are concerned that the requirement that 50 percent of a business' total gross income be "derived from the active conduct of a qualified business within any low-income community" may present a problem for CDE portfolio companies 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.

We therefore recommend that "derived from the active conduct" be defined to mean that the activity originate in a business located in a low-income community. For manufacturing businesses, this would mean that 50 percent of production must occur within a low-income community. For services businesses, this would mean that 50 percent of services must be provided by employees of offices in low-income communities, even if the services themselves are provided in other geographies. Moreover, we recommend that the expansion of facilities outside low-income communities be considered a distinct "portion" of a business as defined in section 45D(d)(2)(c) of the NMTC statute, unless otherwise elected, so as not to disqualify the business under the gross income test.

In addition, we recommend that the following multi-criteria tests be used in determining whether a qualified low-income community business satisfies

the use of tangible property test, and the service performance test. These multi-criteria tests were developed in order to ensure that a variety of low-community businesses that we believe the Credit was intended to assist could be reached.

Tangible Property Test We recommend that the tangible property test be considered met if a business satisfies one of the following criteria:

a) the business is located in a qualified area;
b) the business operates a major facility in a qualified area; or
c) the business' primary business activity takes place in a qualified area.

Services Requirement: We recommend the service requirements be considered met if a business meets one of the following criteria:

a) the business is located in a qualified area;
b) the business operates a major facility in a qualified area; or
c) the business' primary business activity takes place in a qualified area.

The IRS may also wish to consider the types of qualifying census tracts in the New Markets Tax Credit Program. For example, some portions of CBDs in large cities will meet the income or poverty tests under the statute even though they are not truly distressed. For example, we understand that the World Trade Center in New York and even the Treasury Department in Washington are in census tracts eligible for NMTC investments. Treasury may wish to use its anti-abuse authority to clarify that credits may not be used to finance businesses in these types of census tracts.

3b. 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?

We recommend that compliance be determined at the time a CDE makes a qualified low-income community investment. Unless the CDE is in control of the qualified business, it is only at the time of initial investment that the CDE has any control over the business.

While I understand the desire of the IRS to prevent abuse of the credit, for example, by CDE's investing in qualified businesses with the intention that they leave qualified census tracts, it is not *reasonable* to burden the risk of *recapture* of the credit with events that fall out of the control of the CDE or the investors. As an *alternative* to requiring that qualified businesses remain qualified for the full period of the investment by the CDE in the business, the IRS may wish to consider the following options:

1. Compare the NMTC Program to NMVC regs issued by the SBA. If the business has a change in business activity within one year of the

transaction that makes it ineligible, it may not be included in the portfolio, unless specifically approved by SBA. After one year, you may also provide additional financing in order to avoid loss. (13 CFR Section 108.760(b)). In this case a business would have to quality for the first12 months after an investment. After that period, changes to the business would not lead to disqualification. If it were to change within 12 months, CDFI could approve it remaining qualifying if requested and approved. This would effectively mirror the SBA regulations.

2. Establish a safe harbor for CDE's. The safe harbor would protect CDE's and investors from disqualification of investments and potential *recapture,* by ensuring that the investments not be disqualified. The safe harbor would be established if the CDE did the following:

a) require the business, at the time the investments is made, to certify that it does not intend to move into an ineligible area within the compliance period,

b) require the business to sign a financing agreement that triggers immediate repayment if the business moves to an ineligible area within the compliance, and

c) take reasonable steps to recover its investments within a reasonable period, short of forcing the business into bankruptcy.

Bankruptcy or other economic failure of the low-inc0me community business should not disqualify it as such. For the NMTC Program to attract investments, economic risk should not also be a risk of CDE de-certification or investor recapture. Nor should economic success of the low-income community business, with expansion beyond the qualified low-income community, disqualify it as such, so long as the portion of the business that received the investments continues to operate in the qualified low income. Investors should not *have* to worry about recapture except in the most narrowly defined significant circumstances, or else the tax credit incentive program may not be effective.

We recommend that CDEs that make qualified low-income community investments in businesses in which they, or a subsidiary, have a controlling interest be held to higher compliance standards than CDEs that invest in firms in which they do not have a controlling interest.

As we recommended above, there should be a 'good faith' test to determine whether or not a CDE did due diligence in making its qualified low-income community investments. In addition, we suggest in our response to question number 6b, that there be a reasonable cure period during which the CDE be expected to move the investment back into compliance. However, if a CDE makes a qualified low-income community investments in a business in which they, or a subsidiary, have a controlling interest and the business moves out of compliance and cannot be cured within a reasonable period of time despite the good-faith efforts of the CDE - then the investment in the business would be disqualified.

We suggest that "controlling interest" refer to an entity that controls 50 percent or more of the voting power in a corporation or partnership. This 50 percent standard is consistent with the standard applied to businesses operating in Empowerment Zones and Enterprise Communities as defined

by Section 1397 of the Code, incorporating Section 52 of the Code and its implementing regulations.

3c. 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?

It is important that the NMTC be available to help finance new businesses in communities where there is little business activity. To ensure that start-ups can qualify for NMTC capital, we recommend that a CDE be permitted to rely on 'projected business activity' in satisfying the requirement that a substantial portion of a business's activity is derived from a qualified low-income community. The CDE should be allowed to rely on reasonable expectations based on a certification by the new business supported by its business plan.

Once a newly formed business has been in operation for twelve months, we recommend that it be required to meet the general compliance tests that all other low-income community businesses are required to meet in order to stay in compliance with the Credit. This would mirror the Passive Foreign Investment Company rules in the IRC.

IRS Question Number 4

Section 45D(d)(1)(C) provides that the term "qualified low-income community investment" includes financial counseling and other services to businesses located in, and residents of, low-income communities. What types of services should constitute 'financial counseling and other services" for these purposes?

We recommend that 'financial counseling and other services' be defined to include a broad range of activities, including services that promote community development and are integral to making qualified low-income community investments. Such services would include costs associated with identifying investment opportunities, preparing business owners to use financial products offered to them, underwriting loans and investments, helping business owners create viable business plans, and, after loans and investments are made, enhancing business planning, marketing, management, and financial skills of business owners and serving on their boards of directors.

The IRS should note, that because of the relatively small amount of the NMTC, CDE's would, most likely, be fairly limited in the amount of the non-revenue producing activities they participate in. It is likely that most of the 'financial counseling and other services' would fall within this category.

IRS Question Number 5

Section 45D(d)(I)(D) provides that the term "qualified low-income community investment" includes any equity investment in, or loan, to a CDE.

5a. What restrictions, if any, should apply to the use by a CDE of the proceeds of a qualified low-income community investment received from another CDE?

It appears clear that the statute did not contemplate that different types of CDE's would have different reporting requirements. It is also clear that exempting CDE's, that receive a qualified low-income community investment from another CDE, from the same requirement as the CDE's that receive equity investments in return for the NMTC would potentially create a loophole in the Program that every entity would choose to use to avoid the other compliance issues.

Consequently, it appears necessary that a CDE that receives a qualified low-income community investment from another CDE should have the same restrictions placed on it - namely meeting the 'substantially all' test or the safe harbor, and reporting this to the investor CDE.

5b. Under what circumstances, if any, should an *investment* by one ODE in another CDE lose its status as a "qualified low-income community investment under section 45D(d)(1)(D)? Should the degree of control of the investing CDE over the other CDE be relevant to this determination?

Following our answer to 5a. above, an investment in a CDE would lose its status as a 'qualified low-income community investment' if the CDE failed to use 'substantially all' of the proceeds of the investment during the reporting period required by the IRS. This reporting period would be the same as recommended in 3b. above.

IRS Question number 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.

6a. 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)?

We recommend that recapture be triggered as a final measure for a CDE that has been out of compliance and has failed to come back into compliance. The statute enumerates three events that trigger recapture. Obviously the most problematic of these is under section 45D(g)(3)(B).

We recommend that recapture be triggered if a CDE has failed to use 'substantially all' the proceeds for eligible purposes within the required time period. This could happen in several ways.

1. The CDE fails to make investments and still holds too much cash

2. The CDE has made investments and these have been repaid

3. The CDE has made investments that may no longer qualify

In the latter two cases, we recommend that the IRS build in significant grace periods for reinvestment purposes and enable CDE's to use the methods described in 3b., which include mirroring the SBA NMVC regulations and the additional safe harbor.

The IRS should note, that in most cases the CDE will not be controlling the qualified business, and therefore would not be able to dictate actions to the business. To contrast the NMTC Program with the Low-Income Housing Tax Credit (LIHTC), if a low-income individual or family leaves the facility or moves into a higher income category, the manager of the facility can replace them with another low-income individual or family. There are no funds tied to the individual or family that are owed.

In contrast, under the NMTC Program the CDE will be making investments in businesses and looking for repayment. Not only will the businesses owe the CDE, but the types of businesses that CDE's will be making investments in will likely not be sewed by other financial institutions, and will likely not have the liquidity needed to pay off the CDE. As a result it will be much more difficult for the CDE to replace the investment with another, as they may not have the funds to do so.

In particular reference to our point 3. above, the use of the rules we discussed in 3b. are extremely important in allowing the CDE's to be *able* to manage the risk of *recapture* rather than passively hoping that things turn out alright. The failure to mitigate this risk will likely result in a complete lack of interest in the NMTC Program.

6b. What *remedial* action(s), if any, should a CDE be permitted to take to avoid recapture under section 45D(g)(3)(B)?

We recommend that a CDE be granted a reasonable period of time to move into compliance once it has been deemed to be out of compliance. Regulations should provide a reasonable cure period similar to that provided by the Low Income Housing Tax Credit.

As recommended in our response to question 3b, we suggest that Treasury establish a standard to determine whether a CDE is making a 'good faith' effort to meet compliance versus a standard for 'abusive intent'. If a CDE can demonstrate that it made a 'good faith' effort in investing in a qualified investment but for reasons beyond its control the business is no longer in compliance, and the non-compliance cannot be cured, then recapture would not be triggered.

IRS Question Number 7

Section 45D(i)(1) provides that Treasury may prescribe regulations that limit the new markets tax credit for investments that are directly or indirectly subsidized by other Federal tax benefits (including the low-income housing tax credit under section 42 and the exclusion from gross income under section 103). Under what circumstances should investments be treated as directly or indirectly subsidized by other Federal tax benefits?

Tax-Exempt Bonds: A CDE should not be permitted to use the proceeds of a qualified equity investment to purchase of tax-exempt bonds. However, there should be no restriction on a qualified low-income community business's use of tax-exempt bonds *sold to third parties,* even if the low-income community business receives other financing from a CDE attributable to a qualified equity investment. The use by a low-income community business of tax-exempt bonds sold to third parties

would be separate from the CDEs financing of the business.

Low Income Housing Tax Credits: Since the rental of residential housing is not an eligible low-income community investment activity, Housing Credits and NMTCs would not generally be available on the same investments. Just to be certain, however, it might be useful to exclude from the definition of a LCB the *development* (i.e., not just the *rental)* of housing receiving (or expected to receive) Housing Credits. The financing of the nonresidential portion of a building should be a qualified low-income community investment regardless of whether Housing Credits are claimed on the residential portion of the building. For this purpose, the amount of the low-income community investment should not exceed the portion of the building's cost reasonably attributable to nonresidential use.

Historic Rehabilitation Tax Credits: Like any other investor, a CDE must already reduce its basis in a property by the amount of any historic rehabilitation tax credit it claims. No further limitation is needed on the use of historic rehabilitation tax credits with NMTCs. The historic rehabilitation tax credit is designed to offset the additional cost associated with meeting historic standards for rehabilitation. The NMTC is designed to address a broader financing gap for low-income community businesses.

Wage Tax Credits (including Work Opportunity Tax Credits, Welfare to Work Tax Credits, Empowerment Zone wage tax credits, and Renewal Communities wage tax credits): No limitation should apply a CDE's investment in a low-income community business that claims a wage tax credit. NMTCs and wage tax credits serve fundamentally different functions. That is, NMTCs provide capital to a business, while a wage tax credit is designed to encourage hiring of targeted employees by offsetting the additional cost of hiring, training, and turnover. The availability of NMTC financing will not obviate. Neither the CDE nor the low-income community business will typically know at the time of financing whether the low-income community business will be eligible to claim wage tax credits. There is no NMTC requirement that a business must hire targeted employees, and the number of such employees will vary from time to time.

Depreciation: There should be no limitation on a CDE claiming widely available depreciation benefits on investments made with the proceeds of qualified equity investment.

IRS Question Number 8

Section 45D(i)(2) and (4) provides that Treasury may prescribe regulations that prevent the abuse of the purposes of section 45D and that impose appropriate reporting requirements.

8a.What anti-abuse rules may be necessary for carrying out section 45D? Safeguards should be put in place to ensure that a CDE cannot divert principal and/or capital repayments to be paid as dividends to their investors. We recommend that dividends be limited to *actual* earnings on a taxable basis and that any payments to investors that cannot be traced as such should be considered repayment of principal and trigger a recapture event if not paid back to the CDE and reinvested appropriately.

Investors should be able to claim only one layer of NMTCs for a given

qualified equity investment .The following example presents a potential abuse. Two CDEs - "CDE-A" and "CDE-B"- *each* receive *allocations* for NMTCs on $1 million of qualified equity investments. Investor-I makes a qualified equity investment of $1million in CDE-A, a limited partnership or LLC. CDE-A uses the proceeds to invest in CDE-B, also a limited partnership or LLC. CDE-B uses *substantially* all of these proceeds to *finance* qualified businesses. Technically, Investor-I might claim two levels of NMTCs on its single investment of $1 million. The NMTCs allocated to CDE-B would pass through CDE-A to Investor-I. The NMTCs allocated to CDE-A would also go to Investor-I. We do *not* believe that such double-dipping should be permissible.

8b. What types of reporting requirements should be imposed for carrying out section 45D?

We recommend that reporting should be on an annual basis and focus on documentation needed to ensure compliance. We suggest that these be a part of the CDE's annual tax return, which should include details of compliance.

Additional Comments

1. CDEs Purchasing CDE Loans

Section 45D(d)(1)(B) provides that the term "qualified low income community investment" includes the purchase from another CDE of any loan made by such entity that is a qualified low- income community investment, Neither the statute nor the accompanying report makes reference as to how the proceeds from such a loan sale must be spent by the CDE from whom the qualified loans *are* purchased. The Administration's FY 2001 General Explanation of Revenue Proposals states that a CDE would be treated as indirectly making a qualified low-income community investments when it purchases loans made by a CDE, which in turn uses the proceeds from the transaction to provide additional capital or financial services to qualified active community businesses.

We believe that requiring a CDE purchasing loans from another CDE to only purchase loans that qualify as low-income community investments and, at the *same* time, require that the proceeds from such loan sales be used to provide capital for qualified low-income community investments would unduly restrict the activity of CDEs and was not the intent of the statute.

We recommend that a CDE that purchases loans from another CDE be required to demonstrate only that the loans they purchase qualify as low-income community investments.

We appreciate the opportunity to comment on the ANPR and thank you for your consideration of the comments.

Sincerely,

/s/ Richard Campbell
CFO & VP/Operations

Cc: CDFI Fund
Eric Solomon