

ROPES & GRAY

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February 28, 2006

Loretta R. Richard

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Via Electronic Mail

Eric Solomon

Acting Deputy Assistant Secretary for Tax Policy

U.S. Department of the Treasury

601 13th Street, N.W.

Washington, D.C. 20005

Re: Targeted Populations Guidance Under Section 45D(e)(2)

Dear Eric:

Thank you for taking the time to meet with me and my colleagues, Alex Reid and Michael Novogradac, and the New Markets Tax Credit working group on December 7, 2005 regarding our comments on the forthcoming Treasury guidance on "Targeted Populations". Specifically, we discussed the ways in which entities may be treated as qualified active low-income community businesses ("QALICBs") with respect to Targeted Populations. We also discussed the possibility that Treasury and the IRS would issue interim guidance in the form of a Notice, which could be issued more quickly than temporary and proposed regulations.

My colleagues and I are strongly in favor of this proposal to issue a Notice as soon as possible because our client, as well as the New Markets Tax Credit ("NMTC")

community, would like to begin making investments in businesses that benefit Targeted Populations at the earliest opportunity. Until guidance is issued, we can neither apply for an allocation of credits from the CDFI Fund to fund Targeted Populations projects in the next, and final, round of credit allocations, nor can we apply for existing credits from community development entities.

To that end, we thought it would be helpful to address further certain of the issues that were raised in the meeting and to prepare a draft Notice, for purposes of discussion, that incorporates our prior comments and provides additional information with respect to matters discussed.

Definition of Targeted Populations and Other Targeted Populations

As discussed at the meeting, there seemed to be general agreement that the definition of Targeted Populations should include low-income persons, meaning persons whose income is less than 80% of area median gross income and that the CDFI Fund should have administrative authority to identify groups that lack access to capital and to designate such groups as Other Targeted Populations.

As explained more fully below, we recommend that an entity qualify as being a QALICB with respect to a Targeted Population if it employs members of a Targeted Population. In this regard, you expressed some concern that by itself the employment of low-income persons may not be a sufficient measure of the benefit to Targeted Populations. We believe that the CDFI Fund has existing procedures in place to ensure that successful awardees of NMTCs serve more deeply distressed communities. Specifically, the CDFI Fund awards additional points to applicants that commit to serving businesses in more deeply distressed areas, such as empowerment zones. We suggest that the CDFI Fund be responsible for developing the appropriate measures for how an applicant can score more points in the application process if it commits to providing greater benefits to the distressed areas and Targeted Populations.

Defining Other Targeted Populations is a more difficult exercise, because the use of a list of specific racial or ethnic groups as a proxy for identifying individuals who historically lack access to capital raises possible issues under the Equal Protection Clause of the U.S. Constitution. *Grutter v. Bollinger*, 539 U.S. 306, 331 (2003). In particular, any racial or ethnic classifications imposed by the government must survive "strict scrutiny", which means that race-based actions are permitted only to the extent that they are necessary to further a "compelling state interest". *Id.* at 335. This does not mean that race cannot be taken into account as a factor, but the program must be "flexible enough that each applicant is evaluated as an individual". *Id.* at 337. The legislative history of the Riegle Act, which forms the basis for much of the CDFI Fund's activities, cites numerous studies that document that minority applicants are more likely to be denied when seeking loans. Accordingly, we propose that the Notice and any regulations define Other Targeted Populations in terms of groups that lack access to capital, and allow the CDFI Fund to make the specific findings based on its due diligence. In this regard, it may be best for the

CDFI Fund to impose some conditions, such as evidence that the individual seeking funding has been turned down by at least one conventional commercial lender.

Definition of QALICB That Benefits Targeted Populations

For your convenience and consideration, we have drafted a proposed Notice that provides that a QALICB with respect to Targeted Populations should be defined as a business that benefits Targeted Populations in one of the following ways:

- (i) Sales-- at least 50 percent of the business's income is from Targeted Populations comprise,
- (ii) Employment--Targeted Populations comprise at least 40 percent of the business's workforce, subject to a minimum of 50 employees, or
- (iii) Ownership--Targeted Populations own more than 50 percent of the business.

We understand that some groups have proposed a property test in addition to the three tests described above. Such an added property test would appear to require that some percentage of a business's tangible property be used with respect to serving a Targeted Population. It is our view that this requirement would be redundant, because to determine whether property is used with respect to serving a Targeted Population one would have to look to the use of the property by the business's customers, employees, or owners who are members of a Targeted Population. Moreover, including such a requirement would cause confusion, because the rules of statutory construction generally require that an additional regulatory provision be read to give it additional meaning (and not merely to be read as a restatement of another provision). We believe that if property had to be located in a geographic area to qualify, such an interpretation would defeat the congressional purpose of the recent changes that created a nongeographic based definition of a low-income community through reference to Targeted Populations.

Thank you again for taking the time to meet with us. We appreciate having had the opportunity to discuss this with you. Please let us know if we can provide you with any additional information.

Very truly yours,

Loretta R. Richard

cc: Stephen E. Shay

Michael J. Novogradac

Matthew Josephs

Paul Handleman

Notice 2006-XX

Section 45D.--New Markets Tax Credit

PURPOSE

The purpose of this notice is to announce that the Treasury Department and the Internal Revenue Service will amend section 1.45D-1(d) of the Income Tax Regulations to define Targeted Populations and to provide procedures for determining which entities are qualified active low-income community businesses (QALICBs) with respect to such Targeted Populations.

BACKGROUND

Section 221(a) of the American Jobs Creation Act of 2004 modified the Secretary's authority to designate targeted areas as low-income communities under Section 45D(e)(2). Rather than designating targeted areas, Section 45D(e)(2), as amended, requires (i) that the Secretary issue regulations under which one or more targeted populations may be designated as low-income communities and (ii) that such regulations' include procedures for determining which entities are qualified active low-income community businesses with respect to such populations.

Section 45D(e)(2), as amended, defines a "targeted population" by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. §4702(20), (the "Riegle Act") as individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments.

Section 103(17) of the Riegle Act, 12 U.S.C. §4702(17), defines the term "low-income" to mean having an income, adjusted for family size, of not more than (i) for a metropolitan area, 80 percent of the area median income, and (ii) for a nonmetropolitan area, the greater of 80 percent of area median income or 80 percent of statewide nonmetropolitan area median income.

Under section 1.45D-1(d)(4)(i)(A)-(E), a qualified active low-income community business is a corporation or a partnership if for the taxable year: (1) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified

business within any low-income community; (2) a substantial portion of the use of the tangible property of the entity is within any low-income community; (3) a substantial portion of the services performed for the entity by its employees is performed in any low-income community; (4) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain collectibles; and (5) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain nonqualified financial property.

DISCUSSION

Comments concerning the definition of "targeted populations" and the procedure for determining whether an entity is a qualified active low-income community business with respect to such populations have been received in response to advance notice of proposed rulemaking for the issuance of regulations relating to the New Markets Tax Credit Program, 70 Fed. Reg. 29,658 (May 24, 2005).

In response to these comments, section 1.45D-1(d)(4) will be amended to provide that, for purposes of section 45D(d):

1. The term "targeted populations" will be defined as individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons, where low-income persons are persons having an income, adjusted for family size, of not more than (i) for metropolitan areas, 80 percent of the area median income, and (ii) for nonmetropolitan areas, the greater of 80 percent of the area median income, or 80 percent of the statewide nonmetropolitan area median income, or (B) otherwise lack adequate access to loans or equity investments, as determined by the Community Development Financial Institutions Fund in published guidance under the Community Development Financial Institutions Program.¹

2. An entity is a qualified active low-income community business with respect to targeted populations if it satisfies the requirements of sections 1.45D-1 (d)(4)(D) and (E) and any one of the following three requirements:

(A) Sales. At least 50 percent of the gross income of such entity is derived, in the active conduct of a qualified business (as defined in section 1.45D-1(d)(5)), from the provision of goods and/or services to persons that are members of a targeted population.

(B) Employment. At least 40 percent of the employees of such entity are members of a targeted population at the time of their hiring, subject to the requirement that at least 50 employees of the entity are members of the targeted population. For purposes of this provision, the term "employees" includes employees under a management contract, substantially all of the services of which are to provide services to the entity for purposes of conducting the entity's business.

(C) Ownership. More than 50 percent of the equity interest of such entity is owned by members of a targeted population at the time the qualified low-income community

investment is made in the entity. In the event of a change in ownership, such entity will satisfy this ownership requirement provided that members of a targeted population continue to own a majority of the equity interest in such entity after the

change in ownership. If, after a change of ownership, members of a targeted population no longer own a majority of the equity interest in such entity, then the entity will no longer satisfy this requirement; however, in such event, a debt or equity investment in such entity will continue to be a qualified low-income community investment until the repayment of the loan or the equity investment is returned, provided that the investment agreement governing the loan or equity investment requires that in such a change in control event the loan must be repaid or the equity investment returned. An owner of an entity who is a member of a targeted population prior to a change of ownership shall continue to be treated as a member of a targeted population after a change of ownership.

An entity that leases more than 85 percent of its tangible property to an entity or entities which, in the aggregate, satisfy any one of the sales, employment, or ownership tests listed above itself will be deemed to satisfy such test.

If more than 85 percent of an entity's tangible and real property is located within an Empowerment Zone or Enterprise Community, as defined in Sections 1391 (including, without limitation, Section 1391 (g)(3)(A)(iii)) and 1397C, then the percentage requirement for the sales test shall be 25 percent rather than 50 percent, the percentage requirement for the employment test shall be 20 percent rather than 40 percent, and the percentage requirement for the ownership test shall be 25 percent rather than 50 percent.

The regulations will be revised to incorporate the guidance set forth in this notice. Taxpayers may rely on this notice prior to the issuance of the revised temporary regulations.

DRAFTING INFORMATION

The principal author of this notice is of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact on (not a toll-free call).

¹ See, e.g., Notice of Funds Availability (NOFA) inviting applications for the FY 2005 funding round of the Technical Assistance Component of the Community Development Financial Institutions Program, 69 Fed. Reg. 70,3037 at 70,309 (Dec. 3, 2004) (defining "Other Targeted Populations").