

New Markets Tax Credit Coalition (NMTCC)

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May 10, 2004

CC:PA:LPD:PR (REG-115471-03)
Room 5203
Internal Revenue Service
POB 7604
Ben Franklyn Station
Washington, DC 20040

Dear Madam/Sir:

I am writing on behalf of the New Markets Tax Credit Coalition (the Coalition) to submit comments on the revised temporary rule issued by the Internal Revenue Service (IRS) on the New Markets Tax Credit (NMTC), under Internal Revenue Code, Section 1.45D-1T.

On behalf of the Coalition, I would like to thank the Treasury Department's NMTC team, including the IRS, Tax Policy and the Community Development Financial Institutions (CDFI) Fund, for their willingness to engage with the Coalition as our members work to implement this new credit. While there are a number of outstanding issues that we hope will be addressed as the rule is finalized, we did want to take this opportunity to commend the Department for developing a temporary rule and administrative procedures that clearly maintain the integrity of the NMTC and at the same time address the practical operational needs of both CDEs and investors.

The revised temporary rule includes a number of key changes and clarifications that the Coalition has long supported and we recommend that these provisions be maintained in the final rule governing the NMTC. Specifically, we recommend that the final rule include the following provisions as included in the temporary rule:

1. Establishing the control threshold at more than 50 percent ownership or control of an entity **(45D-1T(d)(6)(ii)(B))**;
2. Providing a 12 month cure period for CDEs that spring control after making an initial NMTC investment in a Qualified Active Low Income Community Business **(45D-1T(d)(6)(ii)(C))**;
3. Clarifying that a Qualified Active Low Income Community Business with no employees can satisfy the services test if that entity can document that at least 85 percent of its use of the tangible property (whether owned or leased) is within a low-income community **(45D-1T(d)(4)(i)(C))**;

*Community Development
Venture Capital Alliance*

Stockton Williams
The Enterprise Foundation

4. Institutionalizing a look back period for Qualified Equity Investments made in CDEs after the annual Notice of Allocation Availability is issued **(45D-1T(c)(3)(ii)(A))**;
5. Providing special rules under which a CDE can purchase a loan from another entity and treat that loan as being made by a CDE even if the originator is not a CDE **(45D-1T(d)(1)(ii)(A))**;
6. Clarifying the ability to engage in multiple loan sales between CDEs **(45D-1T(d)(1)(ii)(C))**;
7. Expanding the eligible activities of lower tier CDEs by allowing CDEs to make investments through three tiers of CDEs **(45D-1T(d)(1)(iv)(A))**;
8. Providing that the 50 percent gross income test can be met by a start-up business if there is a reasonable expectation that the business will generate revenues within three years of the CDE making an investment or loan in the business **(45D-1T(d)(4)(iv))**; and
9. Clarifying that taxpayers can claim the full value of a Qualified Equity Investment made in a CDE that goes bankrupt **(45D-1T(g)(4)(iv))**.

Additional Recommendations for NMTC Regulations:

There are several critical NMTC issues that are not addressed in the revised temporary rule and the Coalition urges the IRS to address these issues in the final rule or through IRS Notice before the final rule is issued.

The Coalition has identified the following as policy priorities and we strongly urge the IRS to provide additional clarity on these issues.

1. NMTC Exemption from Internal Revenue Code (IRC) Section 183.

The Coalition recommends that the NMTC be treated like the Low Income Housing Tax Credit (LIHTC) as it relates to IRC Section 183 – Activities Not Engaged in for Profit.

Resolving the issue of how IRC 183 is applied to the NMTC has been a priority for the Coalition since January 2003 when the Treasury Department issued Revenue Ruling 2003-20 permitting an investment partnership, financed with both equity and non-recourse debt, to finance the purchase of a Qualified Equity Investment in a CDE. Prospective NMTC investors have continued to voice reservations about the leverage model until they can be assured that IRC 183, or other related tests, would not apply to NMTC transactions. While IRC 183 applies only to the activities of individuals and S Corporations it sets an important precedent on how such provisions like Section 183 should be applied to the NMTC.

In order for CDEs to take full advantage of the leverage model, the IRS must provide a clear exemption from Section 183 for investors participating in the NMTC.

2. Economic Substance Doctrine.

Momentum has been building in Congress to pass legislation designed to clarify and codify the economic substance doctrine in an attempt to curtail abusive transactions that are purely motivated by tax incentives. Coalition members, particularly NMTC investors and prospective investors, have voiced concern that such legislation would apply to and have a negative impact on the NMTC.

The Coalition has been given assurances by Congressional staff on both sides of the aisle that any legislation designed to codify the economic substance doctrine would have no impact on the NMTC or any other congressionally mandated tax credits. The Coalition understands that any legislation designed to clarify the

doctrine would clearly uphold and protect congressionally mandated tax benefits while curtailing unintended abuses of the tax code.

In fact, the Senate Finance Committee report (108-192) accompanying the Jumpstart Our Business Strength Act (S. 1637) includes the following footnote in reference to the economic substance provision of the bill:

“If tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority it is not intended that the tax benefit be disallowed if the only reason for the disallowance is that the transaction fails to meet the economic substance doctrine as defined in this provision.”

The Senate Finance Committee report also specifically identifies the Low Income Housing Tax Credit and the Historic Rehabilitation Credit as examples of tax benefits that would not be taken into account in measuring potential tax benefits. These credits were noted as examples of the types of tax benefits that would not be considered in applying the economic substance doctrine.

If legislation codifying the economic substance doctrine is signed into law, the Coalition will look to the IRS to insure that this interpretation stands and that the NMTC is not impacted.

3. Treatment of Periodic Cash Distributions to NMTC Investors.

The Coalition is seeking clarification that periodic cash distributions made by a CDE to its investors and derived from cash flow of the CDE (interest income or operating profits) in excess of the CDE's taxable income **would not be** considered as redemption of principal. The problem arises in cases where a CDE's cash flow exceeds its taxable income, for example due to the fact that the CDE's expenses are amortized or it deducts depreciation. If distributions in excess of a CDE's taxable income are treated as redemption of principal, then CDEs could not pass cash flow through to investors, which would substantially hamper the economic feasibility of many CDE transactions.

There is concern that current NMTC rules do not offer enough guidance on redemption. This is an issue for both leveraged and non-leveraged structures where Allocatees need to pass on some return (cash distribution) to investors before the end of the 7-year NMTC term.

The Coalition recommends that the IRS provide additional guidance on this issue and clarify that as long as the CDE does not repurchase ownership interests from an investor and continues to satisfy the 'substantially all' test, a CDE would have the ability to pass on cash distributions to its investor as it sees fit throughout the 7-year term of the credit.

4. Defined Cure Period.

The Coalition has long advocated that a defined cure period, of at least one year, be provided to all CDE Allocatees. The revised temporary rule provides a 12 month cure period to a CDE that acquires control of an entity after an initial loan or investment is made in the entity. However, the revised rule provides no such cure period for other unexpected situations beyond the control of the CDEs.

The temporary rule continues to offer CDEs 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)), though 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.

The following examples illustrate the type of scenarios under which CDEs operating in good faith would find themselves at risk of immediate recapture under the current rules:

- *Scenario 1:* As is common in real estate transactions, a CDE has 51 percent investment interest in a limited liability company, triggering control under Section 1.45D-1T(d)(6)(ii)(A) and thereby requiring that the Qualified

~~Active Low Income Community Business satisfy the applicable requirements throughout the entire 7-year period.~~ Under an LLC structure, the investor has no voting or management control and would not have control over management decisions affecting the business' status. In this circumstance, if the Qualified Active Low Income Community Business ceases to meet the requirements, the CDE needs time to work with the business or move to substitute another Qualified Active Low Income Community Business into the portfolio in order to remedy the noncompliance. Having a defined cure period would instruct a CDE how best to address the situation.

- *Scenario 2:* A CDE loses its CDE certification due to unforeseen changes in its board composition or a board member ceases to meet the representative criteria, which would trigger immediate recapture. A cure period would provide the CDE the ability to make the needed changes and continue to operate within the rules of the NMTC program.
- *Scenario 3:* A CDE finds itself short of meeting the 85 percent 'substantially all' threshold and only has 83 percent of its capital invested. This scenario could arise due to timing delays resulting in the normal course of a business transaction but where the CDE nonetheless has every intention of operating in compliance. In this scenario, the CDE should be provided with the ability to regain compliance and not be faced with immediate recapture.

While the Coalition believes that the scenarios described above call for including a defined cure period in the regulations, we would like to stress that these are not the only scenarios in which such a cure period would be needed. We are reluctant to present a comprehensive list of examples that call for such a cure period since developing an all-inclusive list is nearly impossible.

Instead, the Coalition recommends that a 1-year cure period go into effect as soon as a CDE was notified by Treasury that they were out of compliance. Such a cure period would provide investors as well as CDEs with certainty on what happens in the face of unexpected non-compliance.

We recommend that a CDE still have the option of applying for a waiver after the 1-year cure period expired if for some reason the CDE was unable to remedy the non-compliance and felt they needed more time to address the issue. However, granting of the waiver would be at the discretion of Treasury.

Investors continue to raise concerns regarding the fact that there is no clearly defined cure period for NMTC investments. This lack of guidance on a cure period factors significantly into how investors calculate the risk associated with the Credit.

5. Non-Qualified Financial Property.

It has come to the Coalition's attention that the limitation of Non-Qualified Financial Property contained in 45(D)(d)(4)(i)(E) may limit the eligibility of certain businesses that otherwise meet the requirements of a Qualified Active Low Income Community Business. For example, a start-up business may have few, if any assets. A CDE may structure a loan to a start-up so that business makes interest-only payments during the loan term and establishes a sinking fund for principal that is paid at the end of the loan term. If, at any point, the total deposited in the sinking fund exceeds 5 percent of the unadjusted basis of the business as defined in 45(D)(d)(4)(i)(E) then the business does not meet the requirements of 45(D)(d)(4), is not a Qualified Active Low Income Community Business and, therefore, the loan to the start-up does not comply.

The Coalition recommends that the definition of Non-Qualified Financial Property be modified as it applies to start-up businesses so that such businesses can accumulate capital for a sinking fund related to a loan financed with proceeds from the NMTC.

6. Guidance Needed to Assist in Identifying Qualified Census Tracts.

There continue to be a number of unresolved issues regarding the identification of qualified census tracts and we strongly urge the NMTC team within the Treasury Department to work together to resolve these issues.

There are unresolved questions related to how census tracts with few or no residents can be treated for purposes on the NMTC. We urge the IRS to issue a ruling that would accommodate the inclusion of under-populated or unpopulated census tracts.

In addition, it is unclear whether a CDE must rely solely on the census tract information provided by the CDFI Fund's website or whether a CDE can also rely on data from the Census Bureau or data from an official government website – whether federal or state - if it documents current median income, poverty or other qualifying or prioritizing data.

It is critical that there be clear consensus on how and from what sources CDEs are expected to determine whether a project is located in a qualified census tract and we encourage Treasury to issue additional guidance on these issues related to the geographic targeting requirements of the NMTC.

Recommendations for the CDFI Fund:

In addition to submitting comments on the revised temporary rule, the Coalition would like to submit the following comments regarding policies and procedures used by the CDFI Fund in their administration of the NMTC Program.

1. Interpretation of 'Unrelated Entity'.

The Coalition disagrees with the current interpretation of the 'unrelated entity' test as described in the CDFI Fund's Q&A (September 8, 2003 – Question 28). The Coalition's quarrel is not with the timing of the test, but with the basic interpretation of an unrelated entity and this has been a long standing issue for the NMTC Coalition.

Under the CDFI Fund's Q&A, in order to qualify for bonus points a CDE must make substantially all of its investments in businesses in which persons unrelated to the CDE hold a majority equity interest in the businesses **after** the CDE makes a Qualified Low Income Community Investment. This interpretation penalizes equity investing or venture capital investing by a CDE in cases in which the CDE takes a majority ownership interest in the business.

It is important to consider the legislative history behind the unrelated entity provision and review the current interpretation in that context. The original Clinton Administration NMTC proposal did not explicitly allow a CDE to use proceeds available under New Markets to finance a business in which the CDE had an interest.

This was a concern for the Coalition for a number of reasons. First, a number of Community Development Corporations hold interests in any number of businesses in low-income communities that would and should qualify for NMTC investments. In addition, there is an emerging Community Development Venture Capital (CDVC) industry that uses traditional venture capital investing techniques to promote economic growth in poor communities and the NMTC was intended to be a tool that the CDVC community could utilize.

The Coalition raised these concerns with Treasury as the NMTC proposal was evolving and it became apparent that accomplishing the Coalition's objective would be tricky, since opening the door to using capital derived from the NMTC to finance businesses owned by a CDE might also open the door for abuse. The principal concern has been

that a private for-profit business, with no community development experience or track record, would establish a CDE, provide a Qualified Equity Investment to the CDE and then the CDE would use the NMTC proceeds to develop or expand the private for-profit business' activity.

Under this scenario, the investor receiving the NMTCs also controls the CDE and the business receiving the investment and therefore it is impossible to ensure that community development motives are driving the investment as opposed to purely maximizing the profits of the private for-profit business on a transaction that may have moved ahead even without

~~the NMTC. This scenario differs significantly from the CDC business investments model or the CDVC investments scenario – and we believe is not the type of transaction that should be encouraged by the NMTC.~~

In order to accomplish the Coalition's objective while at the same time avoiding such abuses, the Treasury drafters developed a framework that:

- 1) Included the provision of capital as an eligible activity under the definition of a Qualified Low Income Community Investment (45D(d)(1)(A)). The inclusion of 'capital' clears the way for a CDE to invest in a deal that it, or its parent owns; and
- 2) Added a second priority for receiving Credits (45D(f)(2)(B)) for a CDE proposing investments in unrelated entities. This priority was in addition to the priority given to CDEs with a community development track record.

The idea was that a private for-profit business as described above, may or may not, gain points for a community development track record, but the unrelated entity priority would certainly not favor them.

The Coalition's interpretation of the unrelated entity priority was and is different from that of IRS, Tax Policy and CDFI Fund. In our view, the investment decision by the CDE will, in most cases, be governed by the investor. Most investors will require that they have the right to approve a CDE's loan or investment before making a Qualified Equity Investment in the CDE. Therefore, the unrelated entity test should be based on the investor's relationship with the business, rather than the CDE's relationship with the business.

We will continue to work with the CDFI Fund to clarify the Coalition's position and resolve this issue.

2. Amending the 50 Percent Equity Placement Requirement.

While a number of first round Allocatees were able to meet the 50 percent equity placement requirement which allowed them to compete for a second round NMTC allocation, the Coalition recommends that the 50 percent requirement be modified in order to recognize legally obligated investments in addition to recognizing equity placements.

The Coalition appreciates the need to set a benchmark to ensure that Allocatees are utilizing a current allocation of Credits before applying for an additional allocation. However, requiring that the benchmark be measured using only cash in hand is problematic particularly for Allocatees involved in real estate development, and especially for Allocatees providing permanent financing which cannot be closed until construction is completed.

The Coalition recommends that the 50 percent benchmark be maintained, but we suggest that only 25 percent of the funds be required to be cash in hand and that the remaining 25 percent be allowed to be in the form of legally binding investor commitments. Such a test would satisfy the Treasury Department's need to document that an Allocatee is moving forward with their capitalization strategy while at the same time recognizing that some development plans will require that equity investments be issued over time.

Conclusion:

I appreciate your consideration of these comments and look forward to working with the IRS and other members of the Treasury Department's NMTC team as the rules governing the NMTC are finalized.

The Coalition will be submitting a separate letter to the CDFI Fund with additional comments specific to the NMTC Allocation Application process and several other administrative issues related to the Fund. We will circulate a copy of that letter to members of the Treasury Departments' NMTC team at both the IRS and Tax Policy.

We have also submitted a letter requesting that the Coalition have an opportunity to present testimony on the above mention issues at the public hearing on the NMTC temporary rule scheduled for June 2, 2004.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert A. Rapoza". The signature is fluid and cursive, with the first name being the most prominent.

Robert A. Rapoza