

WASHINGTON WIRE**Regulators Prepare to Implement Volcker Rule****By Michael J. Novogradac, CPA**[DOWNLOAD PDF](#)

More than 18 months after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, implementation of one of the bill's major provisions is on the horizon and the results could have significant implications for the tax credit community. Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act contains a provision commonly referred to as the Volcker Rule, named for former Federal Reserve Chairman Paul Volcker who originally proposed restricting banks from making certain kinds of speculative investments.



On October 11, 2011 the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC) and Securities and Exchange Commission released proposed regulations for applying the Volcker Rule. At the time of this writing, the deadline for comments on the proposal was January 13, but some reports indicated the deadline could be extended to allow for additional comment. The Dodd-Frank bill requires that the rule's provisions be implemented by July 21, 2012.

ADVERTISEMENT

The Volcker Rule is particularly relevant to the tax credit community because it generally limits banks' ability to make equity investments, with certain exceptions. The rule prohibits banks and their holding companies from investing in hedge funds and private equity funds. Because the bill's definition of private equity funds applies to equity investments in a broad range of limited liability company (LLC) and limited partnership (LP) transactions, the tax credit community - including the New Markets Tax Credit Working Group, Low-Income Housing Tax Credit Working Group and Renewable Energy Tax Credit Working Group - are submitting comments about the Volcker Rule's potential effect on the tax credit equity market.

Exceptions

Section 619(d)(1) of the Dodd-Frank Act does allow several permissible activities as exceptions to the rule. Specifically, investments that meet the "public welfare" definition of Section 5136 of the Revised Statutes (12 U.S.C. 24) are identified as a permitted activity. Within this same exception, the historic rehabilitation tax credit (HTC) is specifically exempted. The HTC's exemption was the result of quick and decisive action by the Historic Tax Credit Coalition (HTCC) while the bill progressed through Congress.

However, no other tax credit programs received the same exclusion. This has created concern among the affordable housing, community development and renewable energy communities that the Volcker Rule could be interpreted in a manner that would prevent banking entities from making investments in transactions that involve tax credits that were not statutorily exempted, such as renewable energy tax credits (RETCs) and, to a somewhat lesser extent, the new markets tax credit (NMTC) and low-income housing tax credit (LIHTC).

Public Welfare Investments

Public welfare investments are further defined elsewhere in the Dodd-Frank bill as investments designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as by providing housing, services or jobs). A national banking association may make such investments directly or by purchasing interests in an entity primarily engaged in making such investments.

The NMTC and LIHTC communities applauded the inclusion of this language because it recognizes the congressionally legislated intent of the NMTC and LIHTC. However, while the LIHTC and NMTC qualify as public welfare investments and HTCs were explicitly excepted from the Volcker Rule, implications for the RETC are less certain. Some RETC investments may qualify as public welfare investments based on factors such as location or population served, while other RETC investments will not. Some have suggested that banks could invest in those RETC investments that do not qualify as public welfare investments as "operating" companies rather than as "investment" companies.

The NMTC Working Group and LIHTC Working Group, in letters submitted to the Financial Stability Oversight Council on November 5, 2010, requested that specific guidance be issued that the LIHTC, NMTC and similar tax credit programs, as well as state and local programs that were created for similar purposes as the federal tax credits, qualify as permissible activities by a banking entity, as they meet the requirements of promoting public welfare under the Dodd-Frank bill's definition. This treatment would be consistent with the explicit exception made for the HTC.

The groups suggested the guidance allowing investments in RETCs, NMTCs and LIHTCs as permissible activities should be similar to guidance provided in the Joint Committee on Taxation's (JCT) footnote 344 in its report on the Health Care and Education Affordability Reconciliation Act of 2010. In footnote 344, discussing codification of the economic substance doctrine, the JCT said:

"If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed ... Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage."

Because banks are such a sizeable portion of the tax credit equity market, guidance allowing banks to invest in the LIHTC, NMTC and RETC could prevent a dramatic decrease in the amount of subsidy available for the congressionally mandated goals the tax credits were enacted to achieve.

Investor, Sponsor or Guarantor?

It's important to note that the rule distinguishes between banks' roles as investors versus their roles as sponsors. Section 13 of the proposed rule permits banking entities to acquire an ownership interest in, or act as sponsor to an investment that is designed primarily to promote the public welfare, or an investment in historic tax credits. As such, it appears a bank may act as a sponsor to funds comprised of LIHTC, NMTC or HTC investments. Again, it is unclear to what extent banks could sponsor RETC funds under this provision.

In the preamble to the proposed rule, the agencies say, "In addition to the acquisition or retention of an ownership interest, permitting a banking entity to act as sponsor to these types of public interest investments will provide valuable expertise and services to these types of entities, as well as help enable banking entities to provide valuable funding and assistance to small business and low- and moderate-income communities. Therefore, the agencies believe this exemption would be consistent with the safe and sound operation of banking entities, and would also promote the financial stability of the United States."

The proposed rule does appear to impose a limit on the ability of banks to engage in "covered transactions" with otherwise permissible equity fund investments. For example, it is unclear as to whether or not a bank may guarantee the performance of a tax credit fund because a guarantee is considered a "covered transaction" under Section 16 of the proposed rule. However, it is widely believed in the tax credit community that if a bank is permitted to invest in a fund under the public welfare exemption, then that fund should not be subject to the limit on "covered transactions."

High-Risk Investments and Material Conflicts of Interest

Two additional points of consideration under the Volcker Rule are whether investments in certain transactions cause a material conflict of interest, or cause material exposure to high-risk assets or high-risk trading strategies. In both cases, a banking entity's involvement in NMTC, LIHTC or RETC transactions should not cause concern.

The size of most tax credit transactions compared to a banking entity's overall transactions is very small and generally not material to the banks. Moreover, investments made under the LIHTC, RETC and NMTC programs are strictly monitored for compliance by a variety of government agencies, including one or more of the following: the Internal Revenue Service, Treasury Department, state housing agencies and Community Development Financial Institutions (CDFI) Fund. In addition, the recapture rates for these programs are believed to be extremely low, which is a strong testament to the investments' soundness.

Conclusion

The affordable housing, community development and renewable energy communities do not believe that the intent of the Volcker Rule was to limit the involvement of banking entities in the LIHTC, RETC or NMTC programs, or other similar tax credits. If regulators issue positive guidance confirming this belief, it would help alleviate industry concerns that may be preventing banking entities from participating in these important, job-creating programs. ❖

RELATED RESOURCES

Hot Topic: Volcker Rule

Extension of Comment Period on Proposed Rule Regarding Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (January 3, 2012)

OCC Notice of Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (October 11, 2011)

ADVERTISEMENT



The Novogradac Journal of Tax Credits offers news, opinions and features about affordable housing, community development and renewable energy tax credit industries. The complete version is available by paid subscription only. [Click here](#) for more information on receiving a monthly print subscription.

Encourage your friends and associates to subscribe to Novogradac & Company LLP's Industry Alerts, including the Journal of Tax Credits e-mail edition, by sending an e-mail to cpas@novoco.com.

Copyright 2016 • By Novogradac & Company LLP • All Rights Reserved

For more information about Novogradac & Company LLP's upcoming events: www.novoco.com/events

For more information about Novogradac & Company LLP's products and publications: www.novoco.com/products

© 1996-2016 Novogradac & Company LLP | [Professional Services](#) | [Industries](#) | [Site Map](#) | [Legal Info](#) | [Privacy Policy](#) | [Terms of Use](#) | [Address Change](#) | [Feedback Form](#) | [Advertising](#) | [Sponsorships](#)