NEW MARKETS TAX CREDIT COALITION

September 8, 2011

CC:PA:LPD:PR (REG-114206-11)
Room 5205
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Madam/Sir:

I am writing on behalf of the New Markets Tax Credit Coalition (NMTCC) in response to the Advanced Notice of Proposed Rulemaking (ANPR) issued by Internal Revenue Service (IRS) requesting suggestions on how the New Markets Tax Credit (IRC Section 45D) program regulations could be amended to encourage non-real estate investments.

The Coalition supports the Treasury Department's effort to facilitate investing in operating businesses. We have commented on this effort in prior correspondence and appreciate this opportunity to offer our recommendations and comment on the ideas and questions posed in the Federal Register notice.

In March 2010, the Coalition wrote to then-Assistant Secretary for Tax Policy, Michael Mundaca, and recommended that the IRS provide a special rule, or safe harbor protection, for any community development entity (CDE) organized to make Qualified Low Income Community Investments (QLICIs) in operating businesses. The Coalition continues to believe this approach will encourage investments in CDEs that are committed to financing non-real estate businesses and we encourage the IRS to consider this approach. I have attached a copy of the Coalition's letter to Secretary Mundaca.

The safe harbor is designed to address what the Coalition understands to be the principal barrier preventing NMTC investing in operating businesses – namely, the risk of recapture. Investors are well aware of the recapture penalties triggered if a CDE falls short of its substantially all requirements at any point during the 7-year compliance period. As a result, investors seek NMTC investment opportunities with CDEs that can guarantee that a Qualified Equity Investment (QEI) will remain fully invested in a QLICI for the full 7-year term of the NMTC. This limits a CDE's ability to offer the flexible financing products that many operating businesses need and increasingly are difficult to secure through conventional lenders.

The Coalition proposed a 'safe harbor' because it directly addresses the concerns voiced by investors by providing a safety net to protect investors if and when a CDE receives a return on investment from a QLICI made in an operating business that for some reason the CDE cannot re-invest in another operating business. In order to take advantage of the safe harbor protection, the Coalition recommends that a CDE be required to:

> 1) Satisfy the substantially all test as defined in paragraph 1.45D-1(c)(5), with the initial deployment of the Qualified Equity Investment (QEI) into one or more (Qualified Low Income Community Investments (QLICIs) made in one or more Qualified Active Low Income Community Businesses (QALICBs) as long as the business was established for a purpose other than the development, management, or leasing of a real estate project or projects; and
>
> 2) Any amounts received by the CDE as a return of capital, equity or principal with respect to such a QLICI must either be reinvested in another qualified non-real estate business or retained by the CDE for the remaining term of the 7-year credit period.

If a CDE, including a single purpose CDE was able to satisfy both of the above described tests an investor would be protected by a safe harbor throughout the 7-year term. This protection would ease investor concerns about recapture and would generate investor interest in CDEs that are committed to financing operating businesses.

To implement this safe harbor, we recommend that the CDFI Fund amend its allocation agreement to ensure that any CDE using the safe harbor be required to make a reasonable effort to re-deploy any principal returned to the CDE within the regulatory period and present evidence of such effort. Existing IRS anti-abuse provisions would also be applied to any CDE transactions.

If a CDE failed to satisfy either of proposed safe harbor tests, the CDE would be subject to the remedies set forth in its allocation agreement, including disbarment from receiving further NMTC allocations, but the investor **<u>would not</u>** be subject to recapture. We believe this safe harbor protection would ease current investor fears and encourage investors to make QEIs in experienced CDEs with a business plan in place and a track record of lending and/or investing in operating businesses in low income communities.

There are a core group of seasoned CDEs, including CDFIs, CDCs, community development venture capital funds and others, with significant experience financing businesses, managing revolving funds and deploying and re-deploying capital in operating businesses. These CDEs consistently report a strong pipeline of demand from businesses seeking flexible capital but they are limited in their ability to finance these businesses using the NMTC for the reason we have mentioned: Investor fear that a CDE will fall short of substantially all investments requirements during the 7-year compliance period and trigger recapture.

A safe harbor would protect an investor against recapture risk when a QEI is made in a CDE established to finance non-real estate operating businesses. The investor would be protected by safe harbor whether the QEI was in a CDE established to finance a single non-real estate operating business or the QEI was invested in a CDE revolving fund established to financing a pipeline of operating businesses. If implemented in its simplest form, the revolving fund model would allow a CDE to incur formation and up-front closing costs at the sub-CDE or fund level which would allow the CDE to distribute the costs across multiple QLICIs and reduce the burden on any one business loan.

A safe harbor would allow a CDE and its investor to negotiate the parameters of the QEI investment using a single set of documents to underwrite loans and investments and manage the CDEs business portfolio over the 7-year compliance period. As long as the investor receives no return of principal from the portfolio over the 7 -year term, they would have a safe harbor against recapture risk.

The questions presented in the ANPR are primarily focused on how the IRS might encourage investing in non-real estate businesses by simplifying the substantiation rules governing investments made by a CDE in another CDE (a second tier CDE) in cases when the second-tier CDE was to invest in a non-real estate business. While this is one approach, the Coalition suggests the safe harbor would be a more direct way to facilitate CDE investing in operating businesses. Whether a CDE established a single purpose CDE to finance a single operating business or established a revolving fund to finance a pipeline of businesses, the safe harbor would require the CDE to retain any returns of capital, equity or principal or reinvest in another qualified operating business, all transactions would be at the CDE level.

The ANPR suggests capping the dollar amount of a QLICI in an operating business. The Coalition opposes placing any cap on the size of a CDE’s loan or investment and we were particularly concerned by the $250,000 cap suggested in the ANPR. Such a limitation, even if limited to initial QLICIs, would severely undermined the ability of CDEs to address the capital need of operating businesses in low income communities and CDEs working in rural areas, where infrastructure and construction costs are high, were particularly concerned about any effort to limit the dollar amount of QLICIs in operating businesses. The Coalition also noted that the lending cap suggested in the ANPR is well below the $5.5 cap imposed on lenders using the Small Business Administration’s (SBA)

7(a) guarantee program and that cap was recently raised to address the financing needs of small businesses.

The Coalition opposes placing any floor or ceiling on the size of a QLICI made in an operating business. Our goal is to encourage more NMTC investing in operating businesses and we have intentionally avoided referring to these firms as "small businesses" in part because there is no agreed upon definition of "small business" and also because we want to encourage NMTC investing in a full range of businesses whether it be a $500,000 loan to a timber mill in rural West Virginia to purchase equipment or a $5,000,000 line of credit to a specialty foods venture in Portland, Maine that had its bank credit line cancelled and is unable to finance inventory.

The Coalition believes the safe harbor, as proposed, would encourage and facilitate investing in operating businesses whether the QLICI is structured as equity or debt. Under a safe harbor rule, a CDE could make an equity investment in an operating business and if the investment (principal) was returned to the CDE, either in part of in whole, during the 7-year compliance period investor would not be subject to recapture as long as the CDE retained or reinvested the principal. The CDE could not return any principal to its investor until after the term.

In order to facilitate additional equity investing in both non-real estate as well as real estate businesses, the Coalition recommends that the IRS amend the current definition of control as it applies to the reasonable expectations test. Under current regulations (§1.45D-1(d)(6)), a CDE that "…reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business [for the term of the investment…]" then the business will continue to be treated as a QALICB even if it falls out of compliance at a later time. This provision permits a CDE, and its investors, to avoid a recapture event if and when a business entity ceases to qualify as a QALICB during the 7-year credit period for reasons that are outside the control of the CDE.

In cases where the CDE has control of the QALICB, the regulations require that the CDE ensure that the business remains a QALICB for the entire 7-year compliance period. If a CDE obtains control of a QALICB at any point during the 7-years compliance period, the CDE is required to ensure that the business remain a QALICB for the remainder of the term and the CDE can no longer rely on the reasonable expectation protection it assumed when the initial QALICI was made. Investors are reluctant to allow a CDE to acquire a majority equity interest in a QALICB unless they can be guaranteed that the

CDE will be able to exercise meaningful control of the business in order to ensure it will remain in compliance with all requirements of a QALICB and thus protect the investor from the risk of recapture Therefore, we recommend that the definition of "control" in (§1.45D-1(d)(6)(ii)(B) be amended to clarify voting and management rights and to read :

> *"Control means, with respect to an entity, control of voting or management rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) to override or block actions by the QALICB that are necessary to enable the entity to remain a QALICB.*
>
> > *(a) The existence of rights in the CDE to remove for cause a managing member of a limited liability company, a general partner of a limited partnership, or majority of directors of a corporation by substituting a new managing member, general partner, or majority of directors with control would not, by itself, be deemed to give the CDE 'control' for purposes of this provision."*

If this change is made to the definition of control, we believe investors will be more inclined to make equity investments in both real-estate and non-real estate businesses.

I appreciate the opportunity to submit comments on behalf of the NMTC Coalition and I look forward to working with the IRS on this effort to direct more NMTC investing to operating businesses.

Sincerely,

Robert A Rapoza

Attachments (2)
1. Michael Mundaca Letter
2. NMTC Coalition Board of Directors (Directory)