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ARIEL
Ventures, LLC

February 6, 2012

Mr. Robert Ibanez, Manager
New Markets Tax Credit Program
Community Development Financial Institutions Fund
U.S. Department of Treasury
601 13th Street NW, Suite 200 South
Washington, DC 20005

Dear Bob:

We are writing in response to the Community Development Financial Institutions Fund's (CDFI) request for comments on the mission, purpose and implementation of the New Markets Tax Credit (NMTC) Program.

Cohen & Company, Ltd and Ariel Ventures, LLC (Cohen-Ariel) is a joint venture full-service tax credit consulting firm. We have consulted with QALICBs, CDEs, and investors since the NMTC program originated in 2001. Our experience includes providing CPA tax and audit services, deal structuring, financial and compliance advisory services for over $1.5 billion in NMTC, historic tax credits (HTCs), renewable energy credits, and other public-private financing transactions.

Our comments below address the specific areas listed in the CDFI's November 11, 2011, request and include recommendations of our own.

Specific Questions:

1. Low-Income Communities and Areas of Higher Distress

a) Should the CDFI Fund consider using different standards or methodologies for determining whether census tracts meet the statutory definition of low-income communities?

§45D(e)(4) provides that census tracks with low population can be considered low-income if the tract is within an empowerment zone and is contiguous to one or more low-income communities. Requiring an empowerment zone designation limits the application of the NMTC program in blighted industrial urban areas, which may have zero population. In addition, the process of obtaining an empowerment zone designation currently requires Congressional action.

We recommend that §45D(e)(4) be revised to provide that either:

> A census tract with a population of less than 2,000 that is contiguous to two or more low-income census tracts shall be treated as a low-income community for purposes of this section *if such tract is designated as an empowerment zone, slum or blighted area by the local government authority in which the tract is located. The designation as a low-income community must be made in accordance with strict policy guidelines established by the CDFI and/or subject to CDFI approval.*
>
> **OR**
>
> A census tract with a population of less than 2,000 shall be treated as a low-income community for purposes of this section *if such tract is contiguous to a low-income community within guidelines established by CDFI.*

b) In the allocation award process, should the CDFI Fund increase the commitment percentage from 75 percent of investments made in Areas of Higher Distress in order to receive the highest scores for this sub-section of the Community Impact score? Should the CDFI Fund include additional distress indicators, alter or eliminate any existing indicators?

The NMTC program was created to incentivize private sector investment in low-income communities. It is important that the funds generated by this program are allocated to the communities that need it the most. As such, we recommend that the commitment percentage be increased from 75% to 90% of investments made in Areas of Higher Distress.

2. Treatment of Certain Businesses

a) Are there certain other types of businesses that should be discouraged or barred from receiving NMTC investments? If so, what types of businesses, and what administrative means could be utilized to discourage such investments?

Reg. §1.45D-1(d)(5)(iii) limits investments made in certain businesses (intangibles, private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises).

Creating additional limitations on qualifying businesses may have unintended consequences and limit the pool of eligible projects. We feel the provision currently in place to bar certain types of businesses is adequate and does not require expansion.

b) Should the CDFI Fund provide additional opportunities in the allocation award process for applicants to score more highly by committing to invest in certain business types over others (e.g., small business or rural investment, operating businesses vs. real estate projects, etc.)?

We recommend that applicants score more highly if they commit to invest in small businesses or businesses in the manufacturing industry. Both small businesses and businesses in the manufacturing industry generate long-term job growth, which will ultimately provide the greatest benefits to low-income communities.

c) Are there specific administrative or regulatory changes that would facilitate the financing of specific types of businesses while preserving public policy objectives and safeguards?

Currently, it is difficult for operating businesses to use the NMTC program for non-real estate investments. The risk of recapture, limitation on the investor pool due to AMT, and uncertainty related to Nonqualified Financial Property restrict the use of the NMTC program for non-real estate investments.

<u>Reducing Investor Risk:</u>

One of the issues with using NMTC to invest in operating businesses is the risk of recapture due to amortizing loans. Providing investors with protection against recapture increases the fees involved in the process and also reduces the available pool of leverage lenders, again increasing the overall cost of the project.

To provide the investor with more certainty, we recommend that a safe harbor provision be added to the proposed regulation. The safe harbor provision would provide that the “substantially-all” test would be met if:

1. The CDE satisfies the substantially-all requirements under Treas. Reg. §1.45D-1(c)(5) upon the initial qualified equity investment into a non-real estate business, and

2. Amounts received by the CDE as a return of capital, equity, or principal must be reinvested or held by the CDE during the remaining seven-year credit period.

Applying the safe harbor provision up front and throughout the entire seven-year credit period would provide the investor with greater protection and confidence that risk of recapture would not occur. It also would provide the CDE with the flexibility of using other investment vehicles to allow the leveraged model to be used for transactions with non-real estate businesses. To prevent any potential abuse of this flexibility, the CDEs could report annually to the CDFI Fund the efforts being made to reinvest into other business loans, in the event the funds were returned to the CDE and not invested within 12 months.

Increasing Investor Pool:

Increasing the investor pool may encourage more investments in non-real estate businesses. Generally, private equity investors will invest in businesses in which they are knowledgeable. The inability of the NMTC to offset against AMT will prevent this from happening.

An expansion of the investor pool also would allow investors with appetites for smaller tax credit transaction deals as well as venture capital funds to participate in the NMTC program. The main restriction that has prevented these types of investors in participating in the NMTC program is the AMT.

In order to expand the investor pool, modifications will need to be made to allow NMTC to be offset against AMT. We recommend that a modification be made to §38(c)(4)(B) to include NMTC. Below is the specific text to modify.

x. the credit determined under section 45D

Additionally, for venture capital funds where the owner/members/partners are comprised of both taxpaying investors and tax-exempt investors, we recommend an exception be provided to the Substantial Economic Effect Rule of §704(b). The exception would allow the fund to specially allocate the NMTC to taxable "partners," as long as reductions in basis are reflected in the partners' capital—and would encourage mixed-investor funds to participate in NMTC deals.

NQFP Definition / Safe Harbor

Expansion / clarification of the "reasonable amount of working capital" safe harbor would help to support the purpose of the NMTC program and increase investments in non-real estate businesses in the following cases:

- Real estate projects where the construction period exceeds 12 months
- Production of personal property, e.g., machinery used in manufacturing, wind turbines, solar panels, etc.
- Projects where investors require reasonable reserves / sinking funds at the QALICB
- Cash received after the QLICI date from non-QLICI sources, including additional loans, equity, venture capital, and grants that will be used for QALICB project costs or expansion within 18 months of the date cash is received
- Cash received by nonprofit entities from charitable contributions, grants for use toward charitable purposes or held as endowments
- Cash generated from successful project operations that are held to be invested in business expansion, upgrading equipment, or R&D

The current safe harbor does not provide comfort in the above cases, and, as a result, there is a disincentive to invest or re-invest non-QLICI cash from above mentioned sources, for the purpose of improving or expanding the business and creating additional jobs. In addition, the lack of certainty regarding NQFP is a disincentive for NMTC investors to fund many projects that clearly do not fall within the safe harbor.

Investors / practitioners would also benefit from clarifications of how "average" balances are computed, and how "reasonable working capital" for a particular QALICB is measured, given that the range of typical "working capital" ratios varies by industry.

Suggested language:

- Nonqualified Financial Property (NQFP) shall not include the following:

    - QLICI proceeds that will be invested in construction of real or personal property by the QALICB within 18 months after the date of the QLICI.

    - For non-QLICI proceeds:
        - Alternative 1: Non-QLICI proceeds (including loans, equity investments, sales proceeds, and charitable contributions) that will be invested in construction of real or personal property or used toward charitable purposes by the QALICB within 18 months after the date the cash was received by the QALICB.

        - Alternative 2: Non-QLICI proceeds from business operating cash flow or charitable contributions shall be deemed to be reasonable working capital.

An alternative suggestion is to narrow the NQFP requirement so that it only applies to certain types of entities, e.g., banking or financial institutions; or specifically exclude certain types of entities, e.g., tax-exempt organizations, businesses primarily involved in services or sales of tangible personal property, real estate prior to Certificate of Occupancy.

- Clarification of "average": For purposes of this subsection, "average" shall mean the average of the amounts at the beginning and end of the tax year, unless the investor establishes a more reasonable method of computation.

- Clarification of what is evidence of "reasonable working capital": For purposes of this subsection, "reasonable amounts of working capital" for a QALICB that intends to operate a business shall be determined by reference to one or more of the following, at the discretion of the taxpayer: (a) publicly available industry working capital ratios for the industry(ies) in which the QALICB intends to operate; (b) actual average working capital ratios maintained by the QALICB (or a related entity in a comparable business); or (c) the amount of operating expenses, purchases of fixed assets, and debt service payments projected for the 12 months following the measurement date.

- A QALICB should be allowed to establish a Sinking Fund from operational cash flow, which would not be considered NQFP. The sub-CDE lender and the leverage lender should be allowed to take first and second security interest in the fund. Sinking Fund Assets could only be used to pay down or payoff the sub-CDE loan to the QALICB. Funds in excess of the principal amount of the sub-CDE loan would be considered NQFP.

3. **Community Accountability**

a) Should the CDFI Fund increase the community accountability standards for an entity to qualify as a CDE?

Currently the CDFI Fund requires that at least 20% of the board members represent low-income community. We recommend that the percentage be increased to 40%. Increasing the threshold of representatives from low-income communities will allow the program to provide the highest and best use of the credit to the low-income community.

b) Should CDE community accountability standards differ for CDEs depending on whether they use governing or advisory boards to demonstrate accountability?

We do not believe the standards should be different for CDEs regardless of whether or not they use a governing or advisory board. All CDEs should be held to the same standards of accountability.

c) Should the CDE be required to have Low-Income Community Representatives approve of investments made by the CDE?

Low-income community representatives are actively involved in the due diligence process in their capacity as board members of the CDE. We do not recommend that any additional approval process be put in place for low-income community representatives.

d) Should CDE activities be required to be coordinated with community stakeholders? If so, how should this coordination be conducted and demonstrated?

CDEs should make every effort to coordinate with community stakeholders. We do not recommend any specific requirement be imposed on the CDE. Doing so may significantly delay projects and/or put CDEs and investors at risk due to timing issues.

4. **Transaction Costs**

d) Are there specific administrative or regulatory changes that would reduce transaction costs while preserving public policy objectives and safeguards?

<u>QALICB Qualification: Reasonable Expectation Safe Harbor:</u>

A. Currently, investors are allowed to rely on a "reasonable expectation" at the time of the QLICI that the QALICB will continue to meet the QALICB criteria throughout the seven-year compliance period. However, where the Sub-CDE controls the QALICB, the "reasonable expectation" safe harbor does not apply. The definition of "control" for this purpose includes ownership of more than 50% of the "value" of the entity, even if the owner of such "value" does not have the ability to actually control the entity via majority vote or management rights. This provision is a disincentive to structure QLICIs as equity where such equity would be more than 50% of the total value invested in the QALICB because of the risk and cost associated with continuing to ensure that the QALICB will meet the QALICB criteria throughout the seven-year compliance period.

We recommend removing indirect control from the definition of control under §1.45D-1(d)(6)(ii)(B). This would allow CDEs to make equity investments in a QALICB and still not meet the definition of control. In addition, we recommend safe harbors specifying that non-voting ownership, regardless of the percentage of overall ownership, would not result in control.

We also recommend that the percentage of ownership be increased to 80% under §1.45D-1(d)(6)(ii)(B). This increase in ownership percentage would exclude a significant number of CDEs from having to apply the rules under §1.45D-1(d)(6)(ii)(A).

The intention of the reasonable expectations rule, which is to put the responsibility on the CDE as it relates to the qualifications of the QALICB, falls more in line with the restrictions under §1563 (controlled group rules) rather than the related party rules under §267.

B. Taxpayers would also like clarification regarding whether a reasonable expectation at the time of the QLICI is sufficient even if the loan agreement is later modified. For example, suppose that in year four, due to unexpected economic conditions, the QALICB has trouble servicing the debt and the CDE agrees to reduce the fixed interest rate. For another example, suppose that to correct a mutual oversight, the term of the loan is extended for six months beyond the original maturity date. Are such changes considered substantive changes and would they require that the investor re-evaluate the QALICB qualifications at the time of the amendment? Clarification of this question would make it easier for parties to amend QLICI arrangements in keeping with the spirit of the NMTC program.

Suggested language:

An amendment to a QLICI loan agreement will not be treated as a new QLICI for purposes of this subsection [1.45D-1(d)(6)(1)].

<u>True Debt</u>

A. The purpose of the NMTC program is to encourage investment in low-income / high distress areas, where many projects involve above-average risk. In the typical marketplace, loans to such projects would carry terms and conditions reflecting above-average risk, including collateral requirements, interest rates, payment terms, reserves, etc. But the CDFI requires that debt QLICIs bear "more favorable terms and conditions" compared to the market. These can include non-traditional collateral requirements, higher LTV, lower DSCR, equity equivalent terms and conditions, very low interest rates, etc. Furthermore, reserves at the QALICB can make it difficult to qualify for the NQFP working capital safe harbor (as currently written). On the other hand, there is concern that certain "better than market" terms and conditions could cause QLICI loans to run afoul of "true debt" requirements and result in (a) a recast of QLICI debt to equity; (b) a recast of QALICB debt service payments from interest to distributions; and consequently, (c) a recast of CDE income distributions to redemptions.

The complexity and perceived risk that the "true debt" issue adds to NMTC projects increases costs and decreases the flexibility of CDEs to provide QALICBs with better rates and terms, as required to meet CDFI Fund's NMTC Program objectives, including the "but-for" test. An exemption for QLICI loans from the "true debt" criteria would encourage structures that provide more overall benefit to QALICBs, lower the transaction closing costs, and help CDEs meet the CDFI Fund's NMTC Program objectives.

B. If the "true debt" analysis continues to be required, taxpayers would like clarification regarding whether a new "true debt" analysis needs to be done whenever the QLICI loan agreement is modified in a substantive way, and whether a change in the interest rate or term is considered substantive. The ability for CDEs and investors to rely on the original "true debt" analysis would make it easier to make modifications to help QALICBs to succeed.

C. In addition, bright line standards and safe harbors would decrease the overall cost of the placement of QLICI debt, by reducing the complexity and risk associated with the issuance of a tax opinion with respect to how a QLICI investment structures its debt.

<u>OID</u>

Structuring QLICIs with "more favorable terms and conditions" as required by the CDFI Fund, may involve the use of multiple QLICI loans to most effectively tailor the structure to the needs of the QALICB, while still respecting the needs and risk concerns of the providers of capital. However, concerns about "original issue discount" limit the flexibility to structure different loans to the same borrower. For example, a $10M QEI may be funded by a leverage loan of $7M and an equity investment of $3M. The project will need to be structured to ensure that the leverage lender of the $7M gets paid off; one way to do this would be to structure one $7M QLICI with exactly the same interest rate, term, and payment schedule as the leverage loan. Meanwhile, since there is no loan to pay off at the investment fund level with respect to the remaining $3M, a second $3M QLICI could be structured with more favorable terms, such as a lower interest rate of 1% and a longer term of 20 years.

However, investors are concerned that such a structure, while very much in keeping with the purposes of the NMTC program, could trigger OID issues. Specifically, the concern is that some of the interest on the higher-interest loan could be treated as principal payments and impact the substantially-all test as well as qualification for the "operating income" safe harbor.

As with the above "true debt" issue, the complexity and perceived risk that the OID issue adds to NMTC projects increases costs and decreases the flexibility to provide QALICBs with the types of debt instruments most suited to their needs. Again, to help CDEs meet the CDFI Fund's NMTC Program objectives, an exemption for QLICI loans from the OID provisions would help address these issues and encourage structures that provide more overall benefit to QALICBs and lower the transaction closing costs.

Economic Substance

The NMTC program is designed to encourage taxpayers to enter into business transactions that they would not enter into in absence of the federal tax credits. Therefore, we believe that it would be contrary to congressional intent and IRS policy to require taxpayers to demonstrate "economic substance" with respect to NMTC transactions. However, in the absence of an IRS statement to that effect, investors perceive a risk and may be less willing to invest or may require a higher return. Therefore, we would like to see the IRS make a binding statement that the "economic substance" doctrine does not apply to NMTC.

6. Use of Other Federally Subsidized Financing in Conjunction with NMTCs

a) Should there be any additional restrictions in the allocation award process regarding the use of NMTCs with other sources of federally subsidized financing? If so, are there certain types of federal financing that should be disallowed? Should it matter whether the financing is made as part of the QEI investment (e.g., through the leveraged debt structure) or at the project level?

We do not believe that there should be any additional restriction in the allocation award process regarding the use of NMTCs with other sources of federally subsidized financing. Each source of federally sourced financing generally achieves a different congressional goal. For example, NMTC twinned with HTCs achieves the program goal of NMTC, which is to encourage investments in low income communities, and also achieves the program goal of HTCs, which is to encourage private investment in the rehabilitation and preservation of historic structures. Combining the credits achieves two different congressional goals.

In addition, many of the other tax credit programs would not be viable without the use of other federally subsidized financing.

c) Are there specific administrative or regulatory changes that could facilitate the coordination of other federally subsidized financing in conjunction with NMTCs while preserving public policy objectives and safeguards?

Currently SBA financing cannot be used in coordination with NMTC. The NMTC Program does not allow the leveraged lender to take direct collateral interest in the property of the project. This is in direct conflict with the requirement under the SBA program for the lender to take a direct collateral interest in the property.

We recommend that an exception be provided for SBA financing in the NMTC structure that would allow the lender to take a direct collateral interest in the underlying property. Using SBA financing with NMTC could expand the application of the program to small businesses.

We appreciate the opportunity to submit these comments. We commend the CDFI's efforts in soliciting comments to further enhance the NMTC Program. We look forward to working with CDFI, the IRS, and the Department of Treasury on future discussions regarding NMTC.

Very truly yours,

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