Community Development Venture Capital Alliance CDVCA

September 6, 2011

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Room 5205
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

To Whom It May Concern:

The Community Development Venture Capital Alliance ("CDVCA") submits this letter of comment in response to the advance notice of proposed rulemaking REG-114206-11, dated June 7, 2011.

CDVCA is the trade association of community development venture capital ("CDVC") funds. We represent 73 domestic CDVC funds with aggregate capital under management of more than $2 billion. Our member funds provide venture capital financing, mostly in the form of equity and near-equity financial instruments, to rapidly growing operating businesses that create good, permanent jobs for low income people primarily in low income areas. CDVCA is both a CDE and a CDFI, as are many of our members and their affiliates.

We strongly commend the Department of the Treasury, the Internal Revenue Service, and the CDFI Fund for your interest in finding ways to facilitate use of the New Market Tax Credit ("NMTC") to encourage financing for operating businesses. In particular, it is important that patient, flexible equity and near-equity financing be made available to rapidly-growing, entrepreneurial businesses, which create most of the net new jobs in our economy, in low- and high-income areas alike. This type of entrepreneurial, high impact business, which the Obama administration has expressed a particular interest in encouraging, is the natural market focus of CDVC funds. While the NMTC was originally intended to encourage patient, flexible equity capital investment for such businesses, the mechanics of how the credit was implemented have unintentionally made it virtually impossible to use it for this purpose. The regulatory changes recommended below would allow the NMTC to be used more

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effectively for its originally intended purpose, encouraging greater job creation and community revitalization.

The Importance of Rapidly-Growing, Entrepreneurial Small Businesses, of the Type that CDVC Funds Finance, to the Creation of New, Permanent Jobs

The consensus of peer-reviewed studies of job creation is that small businesses are responsible for the lion's share of net new jobs in our economy. However, the major job creators are not just average small businesses. Recent studies from the National Bureau of Economic Research, the Kauffman Foundation, and the U.S. Small Business Administration all show that almost all net new job creation in our economy comes from a small group of rapidly growing small businesses, commonly called "Gazelles" or "High-Impact Firms."[1] For example, the SBA study found that these High-Impact Firms "represent between 2 and 3 percent of all firms, and they account for almost all of the private sector job growth in the economy."[2] Furthermore, the study found that High-Impact Firms are not limited to the archetypal Silicon Valley start-up, but rather have an average age of 25 years, are distributed geographically throughout the country, and exist in all industries. The study concludes that "economic development officials would benefit from recognizing the value of cultivating high-growth firms versus trying to increase entrepreneurship overall or trying to attract relocating companies when utilizing their resources."[3] Likewise, the Department of the Treasury must make an extra effort to make the NMTC program serve this type of job-creating business effectively if it wants the program to have the maximum possible impact on job creation in the nation

Unlike most jobs created by the real estate and project finance investments that currently dominate the NMTC program, the jobs created by High Impact Firms are *permanent* jobs that provide employment to low income populations year after year. Furthermore, the type of indigenous job creation encouraged by community development venture capital financing is dependent on home-grown entrepreneurs who have deep roots in their communities. They do not leave these communities to seek tax breaks or other transient incentives elsewhere. The jobs they create are permanent economic drivers of their local economies.

While entrepreneurial High Impact Firms are vital to job creation and our economy, they typically cannot finance their growth with debt, because they consume cash as they grow rapidly.

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[1] Dane Stangler and Robert E. Litan, "Where Will All the Jobs Come From?" Kauffman Foundation, November 2009, *available at* http://www.kauffman.org/uploadedFiles/where_will_the_jobs_come_from.pdf; John Haltiwanger, Ron Jarmin, and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," National Bureau of Economic Research, Working Paper No. 16300, August 2010; Small Business Administration, "High-Impact Firms: Gazelles Revisited," U.S. Government Printing Office, 2008, *available at* http://archive.sba.gov/advo/research/rs328tot.pdf.

[2] *See* Small Business Administration, Footnote 2, at p. 2.

[3] *Id*. at p.44.

Furthermore, these companies rarely have sufficient collateral or profitability to attract debt capital from a traditional bank, let alone from the risk-averse leverage lenders common in most NMTC deal structures.

Venture capital fills the financing gap faced by High Impact Firms by providing patient, flexible equity capital. Community development venture capital (CDVC) funds like CDVCA and its members provide this type of financing for high-growth operating businesses in underinvested, low-income markets. CDVC fund investments create entrepreneurial capacity and good, permanent employment opportunities accessible to low-income people.

Despite the importance of equity capital in creating and maintaining jobs in low income communities, equity capital is in short supply for businesses in these communities. Unlike debt, venture capital equity financing is concentrated in just a few areas of the nation. In fact, two thirds of all mainstream venture capital investments are made in just five areas of the nation (San Francisco Bay Area, Boston, New York, Houston, and Los Angeles), and only a miniscule percentage of venture capital is invested in low income communities. As for rural areas, a CDVCA study featured in the *Wall Street Journal* found that less than 1% of traditional venture capital investment went to rural areas, while 19% of our CDVC member investments went to these areas.[4] CDVC funds target businesses that provide good employment opportunities to low-income persons, as compared with the high-tech businesses that most venture capital funds target, which often provide employment primarily to highly skilled employees with exceptional educational backgrounds. The incentive provided by the NMTC is needed to drive additional capital into these businesses in low income communities.

The economic downturn has made it more difficult for all venture capital funds to raise money and exacerbated the inequities inherent in the distribution of mainstream venture capital. Although all venture capital investment is risky, CDVCA has found that the perceived risk of investing in low income community businesses has made it extremely difficult to raise capital explicitly intended for these communities. This perceived risk makes government and nonprofit assistance all the more necessary if High Impact Firms are to succeed in low income communities.

[4] CDVCA. “Assessing the Availability of Venture Capital in the US: A Preliminary Analysis.” (2003); “Most Venture Capital Flows to a Handful of States.” *Wall Street Journal* 5 Nov. 2002: B3.

Proposals

REG-114206-11 A. ***Streamlining Substantiation Requirements for Second Tier CDEs Making Small Business Loans to Non-Real Estate Businesses***

As lending is not the primary business of our membership, we will not provide extensive comments regarding the questions in Section A beyond saying that a $250,000 loan size limit would not meet the needs of most of our members that provide debt and equity financing to the market of High Impact Firms that we serve. We would note that there is a large gulf between $250,000 and $5 million, which is commonly considered to be the minimum size of investment that is economical using the NMTC because of the high transaction costs of tax credit deals. Our members that do provide debt financing could effectively do so in amounts up to $2 million and still be serving a market that is not currently served by the NMTC.

However, as described below, we do believe that the proposal and questions set forth in Section A could be quite useful if applied analogously to equity and near equity investment. We have therefore borrowed significantly from the proposal and questions in Section A in our response to Section B below.

REG-114206-11 B. ***Encouraging Equity Investments in Non-Real Estate Businesses***

REG-114206-11 B.1. ***What non-statutory requirements in Section 1.45D-1 can be revised to encourage CDEs to make equity investments in non-real estate businesses?***

Although some of our members make loans, CDVC funds make primarily equity and near-equity investments in operating businesses. Below we discuss a variety of changes that could be made in the tax credit regulations (as well as a few changes that would require legislation) to encourage CDEs to make equity and near equity investments in non-real estate businesses. Some of our proposals provide for some sort of special consideration for these types of investments, so as a first order of business we provide a suggested definition of Equity Investments.

Definition of Equity Investments

We recommend that Equity Investments be defined using the same definition that the Small Business Administration developed for the New Markets Venture Capital ("NMVC") program. Congress created the NMVC program in 2000 at the same time that it created the NMTC program.[5] The two programs were intended to serve similar purposes and to work together, although, for technical

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[5] The two programs were both enacted in December 2000 as part of the Consolidated Appropriations Act of 2001. The bills that created the two programs were both first introduced in the House on December 14, 2000, the NMTC program in H.R. 5662 and the NMVC program in H.R 5663.

reasons, this never occurred. Six NMVC Companies were initially created and still operate under the program, and this definition has served well in practice to delineate their real-world investment practices. In the NMVC legislation, Congress required that, unlike Small Business Investment Companies ("SBICs") which typically provide debt and mezzanine loans (although they are permitted to make equity investments as well), NMVC companies should be limited to making "equity capital investments." The issue that the SBA faced in defining equity investing was analogous to the one the Department of the Treasury would face if it chooses to distinguish equity investments from loans. The definition of "Equity Capital Investments" developed by the SBA for this purpose and implemented under the regulations of the NMVC program is as follows:

> ***Equity Capital Investments*** means investments in the form of common or preferred stock, limited partnership interests, options, warrants, or similar equity instruments, including subordinated debt with equity features if such debt provides only for interest payments contingent upon and limited to the extent of earnings. Equity Capital Investments must not require amortization. Equity Capital Investments may be guaranteed by one or more third parties; however, neither Equity Capital Investments nor such guarantee may be collateralized or otherwise secured. Investments classified as Debt Securities are not precluded from qualifying as Equity Capital Investments. Equity Capital Investments may provide for royalty payments only if the royalty payments are based on the earnings of the concern. 13 CFR Ch. I Section 108.50

Proposed Regulatory Changes

The following are recommendations of regulatory (and a few legislative) changes to encourage equity and near equity investments in operating businesses. To help the reader better understand the need for each proposed change, we have preceded each of our proposals with an explanation of why current NMTC regulations discourage such investment—the "Problem."

Problem: The "substantially all" and 7-year investment requirements discourage equity investments because equity investments have an indeterminate term, which might be more or less than 7 years.

Congress correctly recognized that businesses in low-income communities require patient, long-term equity capital. However, the translation of "patient and long-term" to "exactly 7 years" has unintentionally made it difficult to use the credit for venture capital equity financing. A loan can be structured to have a term of exactly 7 years. However, the investor in an equity or near equity investment of the type commonly used by venture capitalists is repaid only when an event occurs (a "liquidity event") that makes cash available to repay an investor (the investment "exit"). This liquidity event might result from an initial public offering of stock, a sale of the company, a recapitalization, a management buy-back, or creation of an Employee Stock Ownership Plan.

From a public policy perspective, while equity investments might not have a term of exactly 7 years, they are the epitome of patient capital: they are required to be repaid only when an event occurs that provides the company with cash to make the repayment. Until that time, the company has the use of cash that is subordinated to all debt in its capital structure, and can use the funds to grow and leverage other sources of financing.

The problem with respect to the tax credit is that a liquidity event might occur after 7 years, but it might also occur after 10 years or after 4 years, and the venture capital investor is not in control of the timing of its "exit." Because of the draconian recapture rules of the NMTC, tax credit investors are loath to invest when there is any significant possibility of an early repayment of tax credit capital. In addition, venture capital funds often do not have a sufficient pipeline of investments to guarantee reinvestment within the one-year reinvestment period, even if investors were willing to take this reinvestment risk. The 7-year investment requirement, as it is implemented under current regulations, makes it virtually impossible to find investors for true venture capital investing.

Solution 1: ***Streamline Substantiation Requirements for Second Tier CDEs Making Equity Investments in Non-Real Estate Businesses***

Changes analogous to those proposed in REG-114206-11 (A) for smaller loans under $250,000—streamlining substantiation requirements for second Tier CDEs making small loans to non-real estate businesses—would also be quite useful in encouraging use of the NMTC in equity and near equity transactions. Below, we have reformulated the proposed changes in the substantiation requirements for small business loans suggested in section (A), as they might apply to equity investments:

> . . . the substantiation requirements governing investments under Section 1.45D-1(d)(1)(iv)(A)(1) should be simplified in cases where: (i) The second CDE uses the new markets tax credit proceeds to make ***Equity Investments*** [defined as suggested above] in non-real estate businesses; (ii) neither the second CDE nor the non-real estate business receiving the new markets tax credit proceeds is affiliated with the primary CDE or the qualified equity investor; and (iii) the second CDE demonstrates that, at the time of initial investment in the non-real estate business, the non-real estate business receiving the new markets tax credit proceeds met some basic qualifying requirements (for example, the business is in a low-income community.)

In other words, if the proposal in Section (A) were adopted, we would suggest that the type of financing accorded this special treatment be extended to both loans under $250,000 (if the Treasury decides to impose such a size limitation) and also ***Equity Investments*** (with no size limit), as defined above.

Below are the four questions posed in section (A) but answered in relation to equity investments rather than small loans to businesses:

1. *Would simplifying the substantiation requirements in the manner proposed facilitate greater new markets tax credit [equity] investment in non-real estate operating businesses?*

Yes. As explained above, the 7-year investment requirement is one of the major impediments to using the NMTC to make equity investments in operating businesses, because the time to exit cannot be controlled, leading to an unacceptable (to investors) possibility of recapture in the event of an early exit. Our understanding of the proposal in REG-114206-11 (A)—streamlining substantiation requirements for second Tier CDEs under certain circumstances—is that the recapture provisions in place during the 7-year investment period would apply to the QALICI made by CDE 1 into CDE 2, but not to the investment made by CDE 2 into a business. Therefore, in case of an early exit, CDE 2 could either retain or reinvest returned capital at its option, but would not be subject to the strict reinvestment requirements of the 7-year investment period.

2. *The Treasury Department and the IRS believe that, if there is to be a simplification of the substantiation requirements for these transactions, there may need to be a cap on the total transaction size. Is $250,000 the appropriate cap to put on the initial loan size? Should special considerations be made for follow-on investments and lines of credit? For example, should there be a cap on the total aggregate investment in one business? Is so, what should that cap be?*

A cap of $250,000 per investment would be unworkable for equity investments. Such a small cap would effectively mean that the NMTC would not be used for such investments, even if all of the other regulatory changes suggested in these comments were adopted. Even with the regulatory changes we recommend, making venture capital-type equity investments using the tax credit will still be quite challenging for both CDEs and tax credit investors alike. Venture capital transactions are quite complicated and time consuming to structure and close. This is why the average deal size for traditional venture capital funds in the U.S. (with no tax credit involved) was $8 million in the first quarter of 2011. While CDVC deal sizes are typically significantly smaller, ranging from several hundred thousand dollars to a few million, a $250,000 limit would make venture capital investing unworkable. The cost per dollar invested would be unacceptable not only for CDEs and tax credit investors, but also to the companies receiving the investments, which need larger amounts of equity capital to fund their operations and growth.

Loans are currently being made to operating businesses using the NMTC, but they are not being made in smaller sizes. It therefore might be appropriate to place a cap of some amount on loans to encourage these smaller-sized loans. Equity investments simply are not being made at all with the NMTC, regardless of size. Placing a size limitation on such investments would mean they never will be.

Placing a cap on the total investment amount in any one company over multiple rounds of investment would be even more harmful than placing a limitation on the size of each individual investment. Venture capital is typically done in multiple rounds of investment; a venture fund may

invest in as many as five to ten rounds of investment in any one company, particularly if it is successful. The venture capitalist provides rounds of investment to a company as it grows and its cash needs increase. Placing a cap on total investments in any one company would choke off the venture capital fund's ability to fund company growth, and in many cases would mean the death of the company. It would also make the investment business of the venture capital fund unviable. A fund needs to be able to make successive rounds of investment both to allow successful portfolio companies to become more successful (creating both financial returns and more jobs) and also to defend its financial position in a company against dilution by other investors. Investors would not invest in a venture capital fund whose ability to make follow-on investments in successful companies was artificially limited.

3. *What are the appropriate minimum requirements that a non-real estate business should satisfy in order for the second CDE to be able to take advantage of the simplified substantiation requirements . . . ?*

All of the NMTC requirements regarding the low-income character of the business should remain in effect. The only new requirement to take advantage of the simplified substantiation requirement should be that the form of investment be an equity investment as defined above.

4. *Should the Treasury Department and the IRS consider additional limitations (other than those specified) on affiliated CDEs or businesses? For example, should the regulations require that the second CDE be a non-profit entity or the affiliate of a non-profit entity?*

Our understanding is that much of the venture capital investment activity that the NMTC should, as a matter of public policy, encourage would not qualify as charitable under IRS regulations. Therefore, limiting the second CDE to non-profits would prohibit investment that should be encouraged. Also, in most states a non-profit CDE could directly accept only a loan, not an equity investment. Taking the risk of an equity investment in a business using debt as the source of capital would be imprudent. Finally, the expertise to make successful, effective venture capital equity investments is in short supply, and it is housed primarily in for-profit institutions. Limiting the second CDE even to organizations affiliated with non-profits would make most of that expertise ineligible for use of the credit.

Solution 2: ***Proceeds of equity investments that are exited earlier than 7 years may be reinvested in a CDFI.***

This is a variant on the regulation proposed in REG-101826-11. The percentage step-down contained in the proposed regulation, which seems to be designed to accommodate amortizing debt, would not work for equity investments, because equity investment exits are generally all or nothing events; that is, a premature exit would generally result in 100% repayment. 100% of the proceeds would have to be allowed to be reinvested in the CDFI. We will provide separate, more detailed comments directly responding to the request for comment contained in REG-101826-11, but we wanted to mention this option here.

Solution 3: ***Give the tax credit investor credits only for the period during which the investment remains compliant, but do not subject the investor to recapture of credits already taken.***

This would probably be the simplest solution of the 7-year investment period problem; however, our understanding is that this would require a legislative rather than a regulatory change.

Problem: Lenders in the "leverage model" typically used in NMTC transactions tend to be highly risk averse, so NMTC transactions using this investment structure typically do not provide much-needed risk capital to operating businesses

From a public policy and economic development standpoint, one of the most valuable things about venture capital equity investors is their ability and willingness to bear risk. Equity stands at the bottom of the capital structure of a corporation: equity investors are the last to be paid in the case of bankruptcy. In fact, investment of equity capital into a business often allows it to qualify for additional debt financing from banks. The venture capital financial model is to accept significant risk of loss and be compensated for that risk with upside financial potential. For this reason, venture capital equity investors are willing to provide capital to businesses in situations and subject to terms under which most lenders would never be willing to lend. In particular the job-creating High Impact Firms discussed earlier—that should be a significant target of the NMTC program—usually do not qualify for debt, but are the primary market for venture capital equity investors. This is particularly true when they expand rapidly, develop new products or make significant new changes in their businesses that create business risk but also the potential for substantial new growth and job creation.

Almost all NMTC transactions currently use the "leverage model," in which a lender provides debt that is combined with NMTC equity in an upper tier entity, which in turn invests in a CDE. The "leverage lender" in this model receives no tax credits and receives only an interest rate, which does not compensate it for taking any significant risk. Therefore, even if the CDE and tax credit investor are willing to accept financial risk, the leverage lender will veto investments that create any significant risk of non-repayment, as well it should, because it is not being compensated for taking that risk. This is a major reason that NMTC investments are made almost exclusively in relatively safe real estate development, project finance, and loans to operating businesses connected to real estate.

Solution 1: ***The IRS should provide assurance that it will respect contractual agreements allocating New Markets Tax Credits among equity investors in a fund that provides a QEI to a CDE.***

If current NMTC leverage lenders are unwilling to bear the substantial risk of investing venture capital equity in high-risk operating businesses, such as entrepreneurial High Impact Firms, the obvious solution to that problem is to replace the leverage lender with an entity that is willing to bear more risk. But the reason leverage lenders are currently unwilling to bear risk is that they are not compensated to do so, and it is difficult to develop a structure in which the leverage lender is compensated for risk because of IRS partnership tax allocation rules.

Under current partnership allocation rules, an investment fund that provides a QEI to a CDE (using funds pooled from a tax credit investor's equity investment and a leveraged lender's debt financing) must be almost entirely owned by the tax credit investor to avoid the risk that tax credits will be reallocated to the non-tax credit partner. However, if the non-tax credit partner is compensated for risk, as an equity investor would be, there is substantial likelihood that such a partner would be characterized by the IRS as an equity investor in the fund, meaning that tax credits might have to be allocated to it rather than solely to the tax credit investor.

This problem would be solved if the IRS would issue guidance assuring investors that it will respect contractual agreements allocating new markets tax credits among equity investors in a fund that provides a QEI to a CDE. This would allow investors who are interested in venture capital risk and return, but not in receiving the tax credit, to play the role of the leverage lender in an NMTC transaction. This would create a new source of tax credit capital that is willing to bear risk, supplying much-needed patient risk capital to job-creating High Impact Firms in low income communities.

Problem: The leverage model of tax credit investing results not only in leverage lenders who are extremely risk-averse but also in tax credit investors and CDEs that have little economic interest in the success of the businesses in which they invest

Another important aspect of the venture capital equity investment model is that venture capital investors care deeply about the success of the businesses in which they invest. They have economic incentive to do so because, as part owners of the businesses, they benefit in direct relation to the businesses' success. For this reason, the venture capitalist puts tremendous resources into helping the businesses in which they invest to succeed, sitting on their boards of director, helping them to line up other financing, working with them to win customers, performing strategic planning, and doing anything else the venture capitalist can possibly do to help the business succeed. The venture capitalist is compensated for all this work by high levels of financial return if a business is successful. This is a powerful economic development model, particularly in low income areas where management expertise may be in short supply.

By contrast, in the prevailing leveraged NMTC model, the tax credit investor receives all of its gain from the tax credit, and therefore has little if any economic interest in the success of the business. The CDE is typically compensated through upfront and annual fees, so it likewise has little economic interest in the success of the business. The one party with a direct economic interest in the business is the leverage lender, which wants its loan repaid. As noted above, the leverage lender's interest is quite conservative and risk averse. Its primary economic role is to screen investments up front to make sure that they are not risky. No one involved in an NMTC deal using the typical leveraged model has an interest in pushing a business to higher levels of success (which can actually add business risk), nor are they compensated to expend resources to do so.

The following "solutions" may be implemented individually, or, ideally, in combination:

Solution 1: ***Favor CDE NMTC applicants that tie their returns to the success of the businesses in which they invest.***

This might be accomplished through equity instruments, such as common or preferred stock, or near-equity instruments, such as debt with warrants or debt with royalties. These instruments provide financial incentive for CDEs to assist the companies in which they invest and also financial resources to pay for such assistance.

Solution 2: ***Eliminate policies that disfavor CDEs and investors retaining significant portions of the NMTC subsidy in cases where equity investments are made in operating businesses***

CDFI Fund policy and the NMTC application currently seem to favor structures in which the NMTC subsidy goes primarily to the QALICB rather than to the CDE. Question 15 asks about deal terms, clearly implying that deal terms favorable to the QALICB are preferable. Question 42 asks about fees, with the implication that lower fees are better. And there is a new Question 16 that asks about the equity remaining after the tax credit period and specifically about any put/call arrangement. Applicants may assume that the Fund would prefer that the QALICB benefit from any put/call relationship rather than the CDE or investor.

This preference for subsidy going to the QALICB may be appropriate in a typical real estate development transaction, in which rent roles in low-income areas can be expected to be lower than in higher income areas, and the NMTC subsidy may make the difference between a viable project and one that will fail. Furthermore, real estate developers typically take all of their compensation up front. In these circumstances, allowing a CDE developer to keep the NMTC subsidy would be an unwarranted windfall for the developer and, perhaps, a serious detriment to the success of the project.

Equity investments in operating businesses are quite different, however. The best current public policy analysis indicates that, at least in the case of equity investments (and maybe business loans as well) in operating businesses, public subsidy should be used to give a business *access* to capital rather than to lower the cost of that capital. Most operating businesses in low income communities simply do not have access at all to venture capital-type financing, because the transaction costs of providing such financing are too high and/or the return to the investor of such investments is too low given the perceived risk. Denying CDEs and investors access to the NMTC subsidy to help pay for costs and perhaps boost returns runs contrary to the public policy interest of providing access to capital to businesses that need it. It worsens the incentives discussed above that drive NMTC capital into the least risky, most plain vanilla financings. Furthermore, resources are needed to provide the expensive ongoing entrepreneurial and managerial assistance that venture capitalists provide to their portfolio companies. Squeezing their revenue from the tax credit leaves them without resources to provide such services.

On the other hand, the public policy interest in providing a monetary windfall to an operating business QALICB is, in many cases, weak. Operating businesses are typically owned by the entrepreneur and maybe a few other key individuals (who usually are not low income persons), plus,

perhaps, some other outside investors. If the business is successful, they will make a substantial amount of money and should not require further subsidy. On the other hand, the CDE can use the subsidy to defray transaction costs, to provide services to portfolio companies, and, if necessary, to share some subsidy with an investor to induce that investor to make riskier investments. The argument for leaving the subsidy with the CDE rather than the QALICB is particularly compelling if the CDE is a not-for-profit, 501(c)(3), mission driven organization. In that case, by law any subsidy captured by the CDE will be used either to provide services to the company that receives the investment or for the other charitable purposes of the organization.

Solution 3: ***Give a double credit to investors who provide capital for equity investments in operating businesses without using the leverage model.***

The NMTC is a relatively "thin" credit in comparison with, for example, the low income housing tax credit. Without leverage, an investor's return is enhanced by a relatively small margin (5% or 6% per year) in relation to the size of the investment. The thin nature of the credit resulted in investors developing the leverage model, in which the tax credit is enhances substantially with debt, so that 100% of the compensation of the tax credit investor comes from the tax credit.

We believe that, given the current state of the investor market, it would be difficult or impossible to eliminate or even discourage use of the leverage model without a substantial change in the underlying economics of the credit. Doubling the credit for investors providing capital for equity investments in operating businesses would, we think, change the underlying economics sufficiently that some investors would consider making investments without leverage. A doubling of the credit still would not result in tax credit investors being compensated fully through the credit. They would have to receive some compensation from the underlying economics of the transaction. As noted above, that would be a good thing: it would give investors "skin in the game" and cause them to focus more on the success of the QALICB. It would also allow the conservative influence of the leverage lender to be eliminated from the picture. Both investor and CDE would have incentive to seek investments with high return potential in businesses that will grow rapidly and create large numbers of good jobs for low-income people.

We were unable to think of a way of doubling the credit (in the absence of leverage) without a legislative change. We believe, however, that this would be an important change to consider in the future, as it would open up the NMTC program to the type of high-impact investment with the largest job creation potential.

Problem: The NMTC program does not work well with the equity capital investment programs operated by the SBA.

As discussed above, the New Markets Venture Capital (NMVC) and the NMTC programs were proposed by the President and enacted by Congress at the same time and were intended to work together. The NMTC was to incent private investment into NMVC funds and the NMVC program was to provide government guaranteed debentures and operational assistance grants as leverage for the

private investment, thus creating larger, more impactful funds. Unfortunately, this did not occur in practice, because the two programs never worked well together because of technical incompatibilities. Funding for the NMVC program ended before these incompatibilities could be ironed out.

The President and the Small Business Administration recently announced the Impact Investment program (http://www.sba.gov/content/impact-investment-initiative). This program, based on the SBIC program on which the NMVC program was also based, is intended to bring equity and near equity capital to businesses in low income communities. The Department of Treasury and the SBA have an opportunity now to collaborate to make sure these two programs work well together, as the NMTC and NMVC programs never did.

As was intended with the NMVC program, the NMTC can provide incentive for private investors to invest in Impact Investment funds. The Impact Investment SBIC program can in turn provide leverage in the form of government guaranteed debentures for the private investment. In this case, the term "leverage" is used in two senses. The first is the sense in which it is used in the SBIC program, as providing debenture financing equal to two to three times the private capital invested in an SBIC. The second is the more technical sense in which it is used in NMTC transactions. SBA debenture financing could be drawn down to play the role of the leverage loan in the typical NMTC structure.

We believe that the coordination of these two programs could make both of them stronger, as each helps solve a problem faced by the other. The Impact Investment program is hampered by the fact that in the current budget environment there is little possibility that Congress would provide a subsidy for the program. The SBIC program, on which the Impact Investment program is built, is a zero subsidy program. The NMTC could provide a needed subsidy to Impact Investment funds. On the other hand, the Department of the Treasury has recognized that the NMTC program is not reaching operating businesses as it should. The SBIC program has a track record and experience in reaching that market effectively, and can provide a vehicle for helping the NMTC program to reach that market as well.

Many of the regulatory changes proposed in these comments would be necessary to allow the NMTC program to work with the Impact Investment program, particularly those aimed at ameliorating the 7-year investment problem. However, if these changes are adopted, we believe that the two programs can be coordinated without major additional changes to the NMTC beyond coordinating such things as application schedules, reporting and other logistical matters. CDVCA would welcome the opportunity to work with the Department of the Treasury and the SBA on such an effort.

While we believe that a coordinated NMTC and Impact Investment SBIC program could become an important and powerful source of capital for low income communities, we recommend that the Treasury not view this possibility as the sole answer to the problem of encouraging use of the tax credit for equity financing for operating businesses. The other recommendations in this letter should be pursued as well, as they would allow a number of investment vehicles that are not Impact Investment

funds to provide such capital using the credit, and, in any case, most of the recommended changes would be necessary for the tax credit to work with the Impact Investment program.

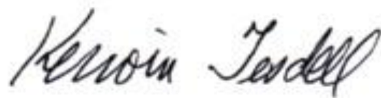
REG-114206-11 B.2. ***If consideration is given to potential changes to the "reasonable expectations" test of §1.45D-1(d)(6)(i), what modifications would be most effective in encouraging equity investments in non-real estate businesses, while still preserving the purposes of the existing limitation on the "reasonable expectations" test?***

The "control" carve-out from the "reasonable expectations" safe harbor is particularly problematic for CDEs that wish to make equity investments in operating businesses. Even if a venture capital investor does not initially acquire more than 50% control of a QALICB, typical venture capital investment terms make it quite possible that it will at some point acquire such control, within the meaning of the NMTC regulations. Unlike lenders, equity investors rely on the ability to take legal control of a company to protect their investments. Although they may never take actual day-to-day control of a business, their investment documents often provide for voting rights of the shares of stock of a corporation if, for example, a company does not meet certain financial benchmarks, allowing the venture capitalist to oust a poorly-performing CEO.

Since most NMTC investors are compensated entirely by the credit, and the NMTC recapture rules are so draconian, NMTC investors are extremely risk-averse regarding the possibility that they might lose their credits. Most NMTC investors will not invest in a deal where they think they might lose the benefit of the reasonable expectations safe harbor. Therefore CDVCA strongly recommends that the CDE's equity stake in the QALICB should not affect application of the safe harbor. At the very least, there should be a "look back" to see whether control existed prior to the time the initial investment was made in a QALICB. It is important that this "lookback" extend not just to the time prior to the making of the current investment but to the time of the making of the initial investment in the QALICB, since venture capital investments are made in multiple rounds.

Thank you for the opportunity to submit comments on this important subject.

Sincerely yours,



Kerwin Tesdell