

April 5, 2011

The Honorable Geoff Davis
United States House of Representatives
1119 Longworth House Office Building
Washington, D.C. 20515-1704

Dear Congressman Davis:

We respectfully submit the following comment letter for the record for the hearing you are holding on April 5th, 2011 on duplication in welfare and related programs as reported by the U.S. Government Accountability Office (“GAO”). Members of the New Markets Tax Credit (“NMTC”) Working Group have joined together to provide comments on the findings and recommendations made in the March 2011 and January 2010 GAO reports, “Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue” and more specifically the section within the report “Converting the New Markets Tax Credit to a Grant Program May Increase Program Efficiency and Reduce the Overall Cost of the Program” and “New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could be Simplified” (the “Reports”). The following comment letter was originally sent to the GAO.

The members of the NMTC Working Group are participants in the NMTC industry who work together to resolve technical NMTC Program issues and create recommendations to make the NMTC Program efficient in delivering the most amount of benefit to the end users. The Reports recommend that Congress should consider converting the NMTC to a cash grant program with the intention of making additional funds available to businesses. As explained in greater detail in the comment letter, the NMTC Working Group disagrees with the Reports’ considerations for converting the NMTC to a cash grant program and strongly recommends that changes to the current tax credit program that can accomplish many of the same goals that the GAO believes a cash grant program will achieve be considered instead.

Thank you for your consideration and please do not hesitate to contact us if you have any questions.

Yours very truly,
Novogradac & Company LLP

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by
Michael J. Novogradac

by
Brad Elphick

April 4, 2011

Mr. Gene L. Dodaro
Comptroller General of the United States
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

and

Mr. Michael Brostek
Director, Strategic Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Re: GAO reports – “Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue” (GAO-11-318SP) and “New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could be Simplified” (GAO-10-334)

Dear Mr. Dodaro and Mr. Brostek:

As participants in the New Markets Tax Credit (“NMTC”) Working Group, we, the undersigned, have joined together to provide comments on the findings and recommendations made in the March 2011 and January 2010 GAO reports, “Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue” and more specifically the section within the report “Converting the New Markets Tax Credit to a Grant Program May Increase Program Efficiency and Reduce the Overall Cost of the Program” and “New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could be Simplified” (the “Reports”). The members of the NMTC Working Group are participants in the NMTC industry who work together to resolve technical NMTC Program issues and create recommendations to make the NMTC Program efficient in delivering the most amount of benefit to the end users. The Reports recommend that Congress should consider converting the NMTC to a cash grant program with the intention of making additional funds available to businesses. As explained in greater detail below, the NMTC Working Group disagrees with the Reports’ considerations for converting the NMTC to a cash grant program and strongly recommends that changes to the current tax credit program that can accomplish many of the same goals that the GAO believes a cash grant program will achieve be considered instead.

We believe the Reports contain several oversights in regards to the possibility of simplifying the program by converting the NMTC to a cash grant program. The GAO suggests that it may be more efficient if CDEs receive all or part of their NMTC allocation authority in the form of cash grants rather than tax credits in an effort to eliminate up-front reductions in the federal subsidy. The Reports note that when tax credits sell for 75 to 80 cents per dollar of tax credit, the Federal government is losing 20 to 25 cents of each dollar of tax credit and it supports the idea of converting the NMTC to a grant program by suggesting that, “In a grant program, these up-front reductions in the federal subsidy could be largely avoided.” This statement contains a major oversight and misunderstanding of the structure of the tax credit. The 39% NMTC is not entirely claimed at the time the investor makes an equity investment in the CDE.

The NMTCs are claimed over a period of six years and a day¹ and the investor cannot receive any of its capital back until after seven years². This is one reason the present value of the credits is discounted to 75 to 80 cents per dollar of tax credit, in consideration of the time value of money. A typical investor would not be willing to pay a \$1 today for a \$1 of benefit it will receive six years from today. If you were to perform a simple net present value calculation of the credits received over the seven year compliance period using a modest 7% discount rate, the reduction in value of the tax credits is nearly 24%. That means that \$1 million of NMTCs claimed over six years and a day is only worth \$761,831 in today's dollars, or just more than 76 cents per dollar of tax credit. In addition to the discount in value of NMTCs due to the time value of money, a required reduction of the investor's qualified equity investments equal to the amount of NMTCs³ claimed also increases the discount of the NMTCs. Generally, if an investor pays less than a \$1 per NMTC, it will have to recognize a taxable gain when it exits the partnership. For example, if an investor pays \$0.80 per credit and purchases \$1,000,000 in NMTCs, it will make total capital contributions of \$800,000. After seven years and all required basis reductions have been taken, the investor's capital account would be negative \$200,000 (\$1,000,000 - \$800,000). Assuming no other increases or decreases in the investor's capital account other than the NMTC basis reduction, the investor would have to recognize taxable gain upon liquidation of its ownership interest equal to \$200,000, the amount of the negative capital account. The recognition of taxable gain is considered a tax cost to the investor and further reduces the value of the NMTC.

The current tax credit structure actually benefits the Federal government by spreading the revenue lost due to the tax credit over a seven year period, rather than recognizing it at the time the investment is made. If the NMTC Program were converted from a tax credit to a grant, the loss of revenue over seven years would be accelerated to the same year in which the grant is made to the CDE. This causes significant increases in the short-term cost of the program to the Federal government. If the goal is to reduce the discount described above, the GAO could simply suggest allowing the investor to claim the entire amount of the tax credit in the year of the investment, making the credits more similar to the theorized CDE cash grant program. The rehabilitation tax credit, often referred to as the historic tax credit, is an example of a community development tax credit that is earned upon the placement in service of the qualified rehabilitation expenditures. The entire credit is earned by the taxpayer in a single year instead of over a period of time like the NMTC. Generally, pricing for historic tax credits is much closer to a dollar since the investor is able to claim the credits sooner in relation to when it makes its equity investment.

There are several other considerations overlooked with a simple conversion to a cash grant program, which include the elimination of an established relationship between public and private sector investment resources that the NMTC Program was originally designed to promote. The NMTC Program is designed so that a substantial portion of the capital investment must be repaid at the end of the seven year compliance period. This relationship with the private sector encourages an extreme amount of transaction scrutiny which would be lost with a cash grant program. Additional considerations include tax credit recapture risk. By having full recapture risk, plus interest penalties, the NMTC Program has a level of compliance and transaction structuring unrivaled by other tax credit programs. This level of structuring and asset

¹ IRC §45D(a)(3)

² IRC §45D(g)(3)(C)

³ IRC §45D(h)

management ensures that the goals of the NMTC Program are achieved. The compliance factor may be lost with a cash grant program and would likely lead to the funding of transactions that generate a higher default and loss rate, and therefore fewer community benefits.

The demand for the NMTC is also a significant consideration affecting the discount and selling price of the credits. The Reports note that tax credit pricing has been falling in connection with declining demand for credits and further states that “one CDE indicated that it has sold NMTCs to investors for as low as 50 cents per dollar” of tax credit. We believe this example is an extreme outlier but we agree action could be taken to increase the desirability of the tax credit. As a possible means of increasing the pool of investors, ultimately raising the selling price of the credits due to increased demand for a finite resource, the NMTC Working Group supports allowing the NMTC to offset the alternative minimum tax. Another possible option includes increasing the carryback period of the NMTC to five years.

The suggestion to convert all, or even a portion of the NMTC Program, seems to be premature at best in light of the cost to implement a new cash grant program and the success the current program has already obtained in delivering much-needed capital to economically distressed low-income communities. In the report “New Markets Tax Credit Program: Promoting Investment in Distressed Communities,” published October 20, 2008, the CDFI Fund indicates that on average, each \$1 of federal tax revenue forgone as a result of the NMTC is estimated to induce more than \$14 of investments in low-income communities. In contrast to the substantial amount of investments that are induced by the NMTC, the same cannot be guaranteed with a cash grant program. In the GAO’s January 2007 report “New Markets Tax Credit Appears to Increase Investment by Investors in Low-Income Communities, but Opportunities Exist to Better Monitor Compliance”, the GAO stated:

“An estimated 88 percent of investors said that they would not have made the same investment without the NMTC. Of these investors who would not have made the same investment without the NMTC, 75 percent (66.6, 82.7) also indicated that in the absence of the NMTC they would not have made a similar investment in the same community.”

In the Reports, the GAO states:

“If the grant program is well designed and at least as effective as the credit in attracting private investment, it could save a significant portion of the estimated \$3.8 billion five-year revenue cost of the current program.”

We believe that if the NMTC were converted to a cash grant program, it would have less success in attracting private investment than the current tax credit program and therefore would not save a significant portion of the cost referred to above. We don’t have to look far for recent examples in the LIHTC and renewable energy tax credit (“RETC”) industries. In Sections 1602 and 1603 of the 2009 American Recovery and Reinvestment Act, two grant programs were established for the LIHTC and RETC industries, respectively, to help provide financing in lieu of tax credits as demand from private investors for tax credits declined. It has been our experience that most of the transactions that used Section 1602 or 1603 grants without any tax credits were able to attract very little private investment in addition to the cash grants, which makes the grants one of the

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Mr. Michael Brostek
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only available financing sources for these types of projects. We believe this would be the case if the NMTC Program is converted to a cash grant.

It is also important to note the continuous support the NMTC Program has received from Congress since its inception. In the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, the NMTC program was extended for two years, the Section 1603 cash grant was only extended for one year and the Section 1602 cash grant program was not extended. Since the most recent extension of the NMTC Program in 2010, the Obama administration has also proposed to expand the current NMTC Program from \$3.5 billion to \$5 billion in its most recent budget proposal. In the wake of Hurricane Katrina, the NMTC Program was expanded \$1 billion to encourage investment in low-income communities within the Gulf Opportunity Zone. During the recent downturn in the economy, Congress expanded the NMTC Program again from \$3.5 billion to \$5 billion in the 2009 American Recovery and Reinvestment Act to help spur more economic development.

We believe that the current program as a tax credit works better than a cash grant program but recognize that there are ways to make the NMTC work even better. Addressing technical matters, including inefficiencies of the NMTC Program, has been the sole purpose of the NMTC Working Group and why its members are dedicated to that goal. Since 2006, the NMTC Working Group has responded to requests from Treasury, the IRS, and the CDFI Fund with recommendations to improve the NMTC Program's ability to deliver significant community impact to this nation's low-income communities. Many of these comment letters provide suggestions to improve very specific aspects of the program that would improve the overall efficiency of the NMTC. All of these recommendations can be found in the Comment Letters page on www.nmtcworkinggroup.com.

We are excited about the positive impact that the NMTC Program is having on the nation's low-income communities and low-income persons and the potential for future success. However, we feel that the program can become even more efficient and deliver more subsidy to the end users within low-income communities without converting it to a cash grant program. Thank you in advance for your time and consideration.

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Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

Yours very truly,
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