

September 16, 2010

Sent Via Mail and E-Mail

Ms. Rosa Martinez  
Acting Program Manager  
New Markets Tax Credit Program  
CDFI Fund, Dept of Treasury  
601 13th Street, NW, 200 South  
Washington, DC 20005

Dear Rosa:

On behalf of the members of the NMTC Working Group, we would like to request that the CDFI Fund provide specific guidance regarding changes made to the Allocation Application Q&A document provisions which identify when a CDE may elect to treat an entity as a real estate or non-real estate qualified active low-income community business (“QALICB”) and the effect on allocation agreements from prior allocation rounds. We believe that the benefit of these changes should be available to allocatees who may receive allocations in the 2010 allocation round as well as prior round allocatees and that if guidance is provided for the reasons explained below, community development entities (“CDEs”) with existing allocation agreements will be able to more readily rely on the changes the CDFI Fund has made. We appreciate the CDFI Fund’s efforts to continually determine if there are ways to improve the guidance that is provided to NMTC Program participants.

In the responses to Question 32 in the 2009 Application Q&A document dated January 12, 2009 and Question 13 in the March 2009 Compliance and Monitoring Frequently Asked Questions document, after the description of real estate and non-real estate entities generally, the guidance continues:

Notwithstanding the above, loans or investments made to special purpose entities that are principally owned by a non-real estate QALICB, and that were set up specifically to lease property back to the QALICB such that the QALICB is the principal user of the property, may be classified as either a “real estate QALICB” or a “non-real estate QALICB” at the discretion of the Applicant/CDE.

In the response to Question 32 in the 2010 Application Q&A document dated April 15, 2010, the parallel paragraph reads differently with emphasis on the changes from previous guidance noted above:

Notwithstanding the above, loans or investments made to a special purpose entity that is **controlled by or under common control with an operating company**, and that was set up specifically to lease the property back to **the operating company** such that **the operating company** is the principal user of the property, may be classified as either a “real estate QALICB” or a “non-real estate QALICB”, at the discretion of the CDE.

The 2009 version of the guidance (1) requires the tenant to be a QALICB, and (2) requires the tenant to principally own the special purpose entity QALICB that is the borrower. With respect to the first requirement, in many common NMTC structures where an operating company wants to use NMTC financing, it chooses to form a special purpose entity to be the QALICB, to own property, and to lease that property back to the operating company. In many instances, the operating company sponsor itself is not a QALICB (though it is a “qualified business” under the IRS rules). For example, the operating company may want to develop an office in a low-income community but fail to qualify as a QALICB itself as a result of its existing operations elsewhere. In addition, with respect to the second requirement, the concept of ownership seems to eliminate the possibility that the special purpose entity QALICB borrower could be a non-profit since there are no owners of a non-profit. In addition, the requirement that the tenant QALICB *own* the special purpose entity QALICB could cause the tenant to exceed the permitted percentage of non-qualified financial property if the tenant QALICB does not have significant additional assets because stock and partnership interests constitute non-qualified financial property. For this reason, the revised guidance in the 2010 Application Q&A document, which requires that the tenant must control or be under common control with the special purpose entity QALICB borrower and requires that the tenant must be an operating entity (but not necessarily a QALICB) is much more favorable and amenable to practical implementation.

The concept of the tenant “controlling” the special purpose entity borrower as opposed to “owning” it is already incorporated in Section 3.3(h) of the Allocation Agreement dealing with permitted uses of QALICBs to real estate entities. However, in Section 3.3(h), both the tenant and borrower are identified as QALICBs. Therefore, there are effectively three different variations of the same provision. The Allocation Agreement provision reads as follows:

The restriction of this Section 3.3(h) does not apply to any loan to or investment in a QALICB (the “first QALICB”) ***that is controlled by*** (within the meaning of 26 C.F.R. 1.45D-1(d)(6)(ii)(B)) or under common control with ***another QALICB (the “second QALICB”)***, provided that: (1) the principal business activity of the ***second QALICB*** is not the rental to others of real property; and (2) the ***second QALICB*** will be the ***primary user of all*** of the real property owned by the ***first QALICB***.

An additional difference between the Application Q&A document and the Allocation Agreement has also created uncertainty in the NMTC industry. While the Q&A document specifies the tenant must be “the principal user of the property” owned by the QALICB borrower, the Allocation Agreement states that the tenant must be “the primary user of all of the real property owned by the first QALICB”. The use of the word “all” in the Allocation Agreement has led to the belief among some industry participants that the tenant that controls or is under common control with the borrower must be the sole tenant of the borrower’s property, while the Q&A language requiring that the tenant be the principal user of the property appears to allow for the possibility that the QALICB borrower may also lease some space to third party tenants. We believe that the purpose of facilitating the principal use of a property by an operating company may be balanced against the flexibility that some businesses may desire to lease a small portion of their space to third parties by adopting a “majority” or greater than 50% standard. If the operating company that controls or is under common control with the QALICB leases more than

50% of the rentable square footage of the QALICB's property, then the QALICB should be free to lease the balance of its property to third parties.

We recommend that the CDFI Fund send a letter to all allocatees adopting a single standard for (i) determining when a CDE may elect to treat a QALICB as a real estate QALICB or a non-real estate QALICB, and (ii) determining when QALICBs made to QALICBs whose principal business activity is the rental to others of real property are exempt from the restrictions in Section 3.3(h) of the Allocation Agreement.

We suggest that the CDFI Fund notify allocatees that the response to Question 32 in the 2010 Application Q&A document will govern future elections by the allocatees (even if allocation from an earlier round is being used) to treat QALICBs as real estate QALICBs or non-real estate QALICBs. We also suggest that the CDFI Fund clarify that the operating company, as the "principal user of the property", does not need to be the sole user of the QALICB's property. We propose the following statement:

An operating company is the principal user of the QALICB's property if it is the occupant of a majority (i.e., greater than 50%) of the rentable square footage of the QALICB's property. The QALICB may lease the balance of its property to one or more third parties.

In addition, we suggest the CDFI Fund notify allocatees that Section 3.3(h) of their Allocation Agreement is amended to incorporate language consistent with the concepts set forth in the response to Question 32 in the 2010 Application Q&A document, as follows:

Effective as of the date of this letter, Section 3.3(h) of the Allocation Agreement is replaced in its entirety by the following:

- (h) The Allocatee may not use the proceeds of its Qualified Equity Investments to make loans to or investments in QALICBs whose principal business activity is the rental to others of real property unless the proceeds of the loan or investment are primarily used for: (1) costs in connection with new construction located on such property; (2) costs in connection with the substantial rehabilitation of such property; (3) costs in connection with the acquisition and substantial rehabilitation of such property; (4) acquisition costs in connection with new construction; or (5) take-out financing for a loan, equity investment, or other financing, the proceeds of which were used for items (1), (2), (3), and/or (4) of this paragraph. Except as provided in item (5) of this paragraph, the proceeds of such loans and investments may not be used to re-finance or otherwise pay off an existing loan on the property.

The restriction of this Section 3.3(h) does not apply to any loan to or investment in a special purpose entity QALICB that is controlled by (the "first entity) that is controlled by (within the meaning of 26 C.F.R. 1.45D-1(d)(6)(ii)(B)) or under common control with another QALICB (the "second QALICB")an operating company, provided that: (1) the principal business activity of the second QALICBoperating company is not the rental to others of real property; and (2) the second QALICBoperating company will be the primary user of all principal user of the real property

owned by the ~~first QALICB.~~QALICB. An operating company is the principal user of the QALICB's property if it is the occupant of a majority (i.e., greater than 50%) of the rentable square footage of the QALICB's property. The QALICB may lease the balance of its property to one or more third parties.

This letter would be similar to the recently issued letter from the CDFI Fund related to the amendment to existing allocation agreements for changes made to the guidance for investment in unrelated entities.


We believe it is very important that the Allocation Agreement standard - in all allocation rounds - for evaluating when a transaction is exempt from the requirements of Section 3.3.(h) should be consistent with the current (i.e., 2010) Application Q&A document standard for evaluating when a CDE may elect to treat an entity as a real estate QALICB or non-real estate QALICB. If the Allocation Agreement requirements deviate from the current Q&A document, a CDE may find that while, based on the Q&A document guidance, a transaction would have been consistent with the CDE's commitment under its Allocation Application to invest in non-real estate QALICBs, the same transaction would be prohibited by more restrictive Allocation Agreement requirements. Failure to impose this consistency will create confusion for CDEs and may inhibit the closing of a number of worthwhile transactions.

If the changes above are adopted, it is likely that CDEs will be able to rely on the favorable changes the CDFI Fund has made. Without such changes, it is likely that transaction participants will continue to face confusion caused by inconsistency and difficulty in structuring around the previous guidance that will likely cause transactions to cost more time and money to complete.

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 if this change is made. We appreciate the opportunity to submit our suggestions on this guidance. Thank you in advance for your time and consideration.

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,  
Novogradac & Company LLP

  
by  
Michael J. Novogradac

Novogradac & Company LLP

  
by  
Brad Elphick