

NMTC MONTHLY REPORT

A MONTHLY PUBLICATION ON THE NEW MARKETS TAX CREDIT INDUSTRY

September 2006 Volume V, Issue IX, Published By Novogradac & Company LLP

CDFI Fund Releases Draft Allocation Agreement

By Brad Elphick, CPA, Novogradac & Company LLP

Last month the Community Development Financial Institutions (CDFI) Fund released a draft template of the 2006 allocation agreement. When finalized, the allocation agreement will be executed between the 2006 round allocatees and the CDFI Fund. This year's draft allocation agreement does not have as many substantial changes as it has in prior years but there are some that are notable.

The first significant change is to Schedule I, Sections 3.2(f) and (h). In prior agreements, Sections 3.2(f) and (h) listed percentages that corresponded to those selected by the allocatee in the allocation application. This year's allocation agreement removed any reference to those percentages and only has a checkbox designating whether these sections of the allocation agreement are applicable. It is assumed that the application rounds have become so competitive that every allocatee designated 100 percent of its products as flexible and non-conventional and that it would target at least 75 percent of those products to distressed communities. This is also reflected in the wording of Sections 3.2(f) and (h) later in the allocation agreement.

The draft allocation agreement also addresses, for the first time, restrictions on allocatees that received a GO Zone allocation as part of the \$600 million that was specially allocated to allocatees that plan on targeting the GO Zone area of Louisiana, Mississippi and Alabama. Restrictions for GO Zone allocatees have been added to Section 3.3(b), as well as a definition of what the GO Zone is in the definitions article of the draft allocation agreement.

Sections 2.20 and 2.21 of the definitions article have defined two new terms: reinvestment and repayment. Per the draft allocation agreement, reinvestment means investment of qualified low-income community investment (QLICI) repayments into QLICIs. Repayment means any QLICI equity capital or loan principal returned

or repaid to the allocatee by a QLICI recipient. These two terms are later incorporated in Section 3.2 - Authorized Uses of NMTC Allocation. One question that arises is whether these definitions are in any way different from those in Internal Revenue Code (IRC) Section 45D and related regulations since neither definition make any references to the Internal Revenue Code or regulations.

Also added in the definitions article of the draft allocation agreement is the definition of targeted populations. Although targeted populations were not listed in the 2006 allocation application, it is expected that all allocatees will be able to make QLICIs to targeted populations.

In Section 3.2, the CDFI Fund has made it clear that not only must the initial investments meet the authorized uses prescribed in this section but meet any reinvestments must meet these requirements as well. As mentioned earlier, Section 3.2(f) no longer indicates a percentage of an allocatee's QLICIs that must have flexible and non-conventional rates and terms. The wording has been changed in this Section to "...the Allocatee shall demonstrate that any QLICI..." must be flexible and non-conventional. Again, the assumption is that all allocatees indicated in their applications that they would make 100 percent of their products flexible and non-conventional. One of the issues with this change is how these criteria will affect the popular A/B loan structure used in many NMTC transactions. In this structure, the A loan mirrors the market-rate loan made by the leveraged lender and the B loan may be structured as an equity-equivalent loan. Many participants in the industry agree that the loan should be viewed as a single product with blended rates and terms that meet these criteria. The draft allocation agreement does note that if loans or investments are made in other community development entities (CDEs), then the requirements must "pass-through" to the recipient CDE.

(continued on page 2)

CDFI Fund Releases

(continued from page 1)

Section 3.2(h), as mentioned earlier, has been changed from the CDFI Fund incorporating the percentage listed in the allocatee's application to automatically requiring every allocatee to commit at least 75 percent of its QLICs to areas that are considered "higher distressed." Added to the list of higher distressed communities are major disaster areas, as declared by the Federal Emergency Management Agency.

In an area of Section 3.3(h)'s paragraph that caused some consternation by allocatees in the prior round, the CDFI Fund has added, but did not highlight as a substantive change, that take-out financing includes loans and equity investments or other financing. The prior allocation agreement stated only that take-out financing could be used for loans. The added change will prove most beneficial to allocatees that have a project in which they want to "take-out" the original investors by returning their equity investments as part of the overall financing structure.

The CDFI Fund has also added a paragraph to the end of Section 3.2(j) that has provided much needed clarification for the NMTC industry. This second paragraph states that when a CDE invests in a CDE that is not controlled or related to the allocatee CDE, the recipient CDE does not have to use the same percentage of proceeds required by the allocatee to use when it receives a qualified equity investment (QEI). For example, if the allocatee indicated in its allocation application that it would use 100 percent of the QEI proceeds it receives and is going to make QLICs to another CDE, the recipient CDE is not required to then use 100 percent of the QLICs it receives as long as it is not related to or controlled by the allocatee. This is good news for the industry and those that invest in other CDEs because many recipient CDEs have their own lending and underwriting requirements that prevent them from being able to meet the same percentage investment requirement of the allocatee.

In Section 6.2 – Fraud, Waste and Abuse, the CDFI Fund has added a second paragraph that may prove unsettling to many allocatees and investors. The paragraph is an "umbrella" statement that would allow the CDFI Fund "in its sole discretion" to find the allocatee in default of its allocation agreement if "...a principal purpose of a transaction or a series of transactions is to achieve, or if the outcome of such transaction(s) does achieve, a result that is inconsistent with the purposes of the Act, the NMTC Program Income Tax Regulations, the Notice of Allocation Availability (70 FR 41075 and as amended 71 FR 12423), or this Allocation Agreement..." Without further clarification from the CDFI Fund, the question of what does "inconsistent with" mean will remain.

Finally, in Section 6.5 of the draft allocation agreement, the CDFI Fund has reduced the amount of time to file institutional level and transactional level reports from 180 days to 90 days. It is believed that the

(continued on page 3)

NMTC REPORT EDITORIAL BOARD

Publisher

Michael J. Novogradac, CPA

Editor

Jane Bowar Zastrow

Managing Editor

Alex Ruiz

Technical Editor

Owen P. Gray, CPA

Contributing Writer

Brad Elphick

Production

James Matuszak

NMTC REPORT INFORMATION

Novogradac & Company LLP
246 First Street, 5th Floor
San Francisco, CA 94105
E-mail: cpas@novoco.com

Address all correspondence and editorial submissions to:
Jane Bowar Zastrow
Telephone: 415.356.8034

Address inquiries regarding advertising opportunities to:
Junhee Byun
Telephone: 415.356.8037

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property valuation or any other material covered in this publication can only be obtained from your tax advisor.

No portion of this material may be reprinted without written permission of Novogradac & Company LLP.

© Novogradac & Company LLP,
2006
All rights reserved.
ISSN 1541-2474

**NMTC REPORT
ADVISORY BOARD**

Chairman
Thomas G. Tracy
Hunter Chase & Company

Bruce Bonjour
Perkins Coie LLC

Rick Edson
New Market Ventures LLC

Donald S. Holm III
National Trust Community
Investment Corporation

Lewis M. Horowitz
Lane Powell Spears Lubersky
LLP

Norris Lozano
Portland Family of Funds

Scott Lindquist
Sonnenschein Nath & Rosenthal

Benson Roberts
Local Initiatives Support
Corporation

John Simon
Sidley Austin Brown & Wood

Herbert Stevens
Nixon Peabody LLP

Mary Tingerthal
Community Reinvestment Fund

Charles Werhane
The Enterprise Foundation

**HAS YOUR
ADDRESS CHANGED?**

We at Novogradac would like to stay in touch so if your contact information has changed, we'd like to know. Call us at 415.356.8037, or log on to www.taxcredithousing.com and click on the Change of Address link in the lower right hand corner of the page. Thank you for helping us keep our records up to date.

CDFI Fund Releases

(continued from page 2)

CDFI Fund is trying to get more timely information for its own reports. However, many allocatees may find it burdensome to provide financial information on a shorter timetable and may worry that the information will be less reliable if they don't have sufficient time to prepare it.

While the draft allocation agreement does not have as many substantive changes as the prior round's allocation agreement, allocatees should make sure they are aware of the changes that have been made and that they and their counsel are comfortable with and understand the new language. Since the allocation agreement is in draft form, it can be commented on. The CDFI Fund expects to send out organization-specific agreements in September. ❖

This article first appeared in the September 2006 issue of Novogradac & Company's NMTC Monthly Report and is reproduced here with the permission of Novogradac & Company LLP.

© Novogradac & Company LLP 2006 - All Rights Reserved.

Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking a transaction should seek advice based on their particular circumstances.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.newmarketscredits.com.