NOVOGRADAC
& COMPANY LLP
CERTIFIED PUBLIC ACCOUNTANTS

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Sent Via Mail and E-Mail

Matt Josephs
NMTC Program Manager
Community Development Financial Institutions Fund
U.S. Department of Treasury
601 13th Street, N.W., Suite 200 South
Washington, DC 20005

Dear Matt:

As participants in the New Markets Tax Credit ("NMTC") industry, Novogradac and Company LLP along with the undersigned, have joined together to provide the Community Development Financial Institutions Fund (the "CDFI Fund") our comments on the New Markets Tax Credit Program Allocation Agreement ("Allocation Agreement"). We have provided these comments in consensus. For your convenience, we have provided specific comments in order of specific sections within the Allocation Agreement.

Section 3.2(d) Authorized Uses of NMTC Allocation

Section 3.2(d) has changed so as to no longer allow up to 15% of a community development entity's ("CDE's") qualified low-income community investments ("QLICIs") in related entities, where the CDE checked the unrelated entity box in its NMTC application. We recommend that this provision be revised to allow such activity, as was allowed in the prior allocation agreements. The following sentence should be added to the end of Section 3.2(d):

> "At no time shall the aggregate dollar amount of QLICIs made to related entities exceed 15 percent of the Allocatee's total NMTC Allocation."

Section 3.2(g) Authorized Uses of NMTC Allocation

Section 3.2(g), if applicable, provides that the Allocatee is required to use the proceeds of qualified equity investments ("QEIs") minimally or solely for specific projects. We believe the reason for the use of the term "minimally" should be clarified. If the intent is to allow the CDFI Fund to require applicants who identified a discrete number of projects to use the allocation with respect to certain projects identified, and then allow such applicant to use the balance of the allocation with respect to projects of its choice

246 FIRST STREET 5TH FLOOR SAN FRANCISCO CALIFORNIA 94105 TELEPHONE (415) 356-8000 FACSIMILE (415) 356-8001 http://www.novoco.com

(identified in the application), that would be reasonable and consistent with the application. This might be done by eliminating the phrase, "minimally or solely" and adding to the end of paragraph (g) the phrase, "to the extent set forth on Schedule 1." The CDFI Fund would then indicate in reasonable detail on Schedule 1 the extent to which the Allocatee is required to pursue particular projects, consistent with its Allocation Application. We believe it should also be clarified that Section 3.2(g) will not apply to applicants that indicated in Question 24 of the Allocation Application that the applicant would use the allocation to support a general pipeline of QLICIs.

Section 3.2(j) Authorized Uses of NMTC Allocation

In Section 3.2(j), it is unclear whether an Allocatee or Subsidiary Allocatee must meet its designated percent of QEIs in QLICIs, as listed in Schedule 1, on a per QEI basis or based on its aggregate QEIs. Further, it is unclear whether an Allocatee or Subsidiary Allocatee must continue to meet its designated percent of QEIs on reinvestment. For example, if an Allocatee's designated percent is 100 percent, to require the Allocatee to reinvest 100 percent of any return of capital is unnecessarily burdensome and may not be possible depending on the amount to be reinvested and the types of available investments. Clarification on these issues is requested. We recommend the following clarification of and modification to Section 3.2(j):

> "If applicable, at such time that the Allocatee has made 100 percent of its QLICIs or September 30, 2008, whichever date is earlier, the Allocatee shall have used at least the designated percent of its Qualified Equity Investments (based on the aggregate dollar amount of all Qualified Equity Investments received by the Allocatee and/or Subsidiary Allocatee(s)), as listed in Schedule 1 to this Allocation Agreement, to make initial QLICIs. If the Allocatee is required to reinvest any proceeds received from the initial QLICIs, the Allocatee shall use at least 85 percent of such proceeds to make QLICIs."

Section 3.3(h) Restrictions on the Use of NMTC Allocation

We believe, in general, this provision suffers from many of the same kinds of problems that caused the IRS to withdraw its regulation regarding "substantial improvements" because it is vague, ambiguous, and creates serious impediments to the use of New Markets Tax Credits for real estate projects. Some of the questions it presents are:

- How much "new construction" or "substantial rehabilitation" must occur and how is it measured?
- Is there any time frame within which such "new construction" or "substantial rehabilitation" must occur?
- Can some QEI proceeds be used for such things as land costs, financing and brokerage fees, transaction costs and other "soft" costs, or must all QEI dollars be used only for new construction or acquisition/rehabilitation costs? For example, since "acquisition" appears only in relation to "substantial rehabilitation" and not

in relation to "new construction", there is at least an implication that land acquisition costs would not be a permitted use of funds in a new construction project.

- Which of the above costs are permitted to be refinanced through a "take-out" financing?
- What is a "take-out financing"?
- What is a "substantial rehabilitation?

If QEI dollars cannot be used to finance (or refinance) anything but construction or rehabilitation costs, the NMTC program becomes a difficult tool for real estate project financing. We also believe that, among other things, it presents the following issues:

(1) It will become almost impossible to do secondary or "mezzanine" financing, since typically those dollars are required to be used first (before senior loan sources fund) and are therefore used primarily (or even exclusively) for land acquisition, financing and brokerage fees, transaction costs, and other "soft" costs (as those are usually the first costs incurred). Since this type of financing depends on exactly the kind of higher-risk capital that the NMTC program is well suited to raising, it would be detrimental to the program to impede such financing.

(2) It will become difficult to do even first mortgage financing, since such financings generally provide funding for a broad array of project-related costs (such as those indicated above), not just "new construction" and "acquisition and rehabilitation". If QEI proceeds cannot be used for such other costs, this will require that they be covered by other financing sources and/or equity sources, making transactions more complicated and difficult. This will be a particularly difficult problem for projects in areas where land costs and entitlement costs are high in relation to construction costs.

(3) Even where there are multiple sources of funds and the above problems can be addressed, it will be necessary to trace and document the application of particular sources of funds to particular uses - a cumbersome and costly process, and one that will have little real integrity, since dollars are inherently fungible. We note that requiring Allocatees to trace proceeds of QLICIs to specific uses by qualified active low-income community businesses ("QALICBs") is something that neither the CDFI Fund nor the IRS has previously required and has generally not considered desirable.

Issues such as those noted above will create serious problems for investors, who may be unwilling to accept the risk of non-compliance with such provisions that most real estate transactions would present.

We believe the focus of this provision should not be on how the CDE's dollars are used, but whether the property itself will be improved with new construction or rehabilitation in connection with the CDE's loan or investment, or whether any loan that is being refinanced was made to enable the property to be constructed or rehabilitated. We also

appreciate the CDFI Fund's concern that QEI proceeds not be used for simple refinancings. We suggest you consider revising the first paragraph of Section 3.3(h) to read as follows:

> "To the extent that the Allocatee is authorized hereunder to use, and does use, the proceeds of its Qualified Equity Investments to make loans to or equity investments in QALICBs whose principal business activity is the rental to others of real property, the Allocatee shall be permitted to do so only if:
>
> (1) (i) the Allocatee shall have determined in good faith that such loan or equity investment will be used (in whole or in part) to pay for, or will be part of a financing and investment structure, the proceeds of which will be used (in whole or in part) to pay for, material new construction, renovation, or rehabilitation on the subject property, and (ii) the QALICB shall be obligated, under the terms of the applicable loan or investment documents with the Allocatee, to undertake and complete such material construction, renovation, or rehabilitation within a reasonable time following the closing of the applicable loan or investment transaction; or
>
> (2) such loan or equity investment will be used to re-finance or otherwise pay off an existing loan that was used (in whole or in part) to pay for, or that was part of a financing and investment structure the proceeds of which were used (in whole or in part) to pay for, material new construction, renovation, or rehabilitation on the subject property (as determined in good faith by the Allocatee), and material construction, renovation, and/or rehabilitation did, in fact, occur after such loan was made.
>
> For purposes of the preceding sentence, the requirement for "material new construction, renovation, or rehabilitation" shall be deemed satisfied if (A) the expenditures for new construction, renovation, or rehabilitation are projected to exceed 25% of the total projected investment in the subject property over (i) the stated term of the loan or investment or (ii) the end of the 7-year credit period (as defined in 26 C.F.R. 1.45D-1(c)(5)(i)) after the Allocatee receives the last Qualified Equity Investment used to fund such loan or investment, whichever is the shorter period, or (B) in the case of a refinancing or repayment of an existing loan, the actual expenditures for new construction, renovation, or rehabilitation exceeded 25% of the total investment in the subject property following the date of such existing loan. The proceeds of such loans and investments by the Allocatee may be used to re-finance or otherwise pay off an existing loan on the subject property only where the requirements of item (1) or item (2) above are satisfied."

In the alternative, if the CDFI Fund believes it is important and worthwhile to require Allocatees to trace the use of proceeds by QALICBs, we suggest that the proposed language in the first paragraph of Section 3.3(h) be revised as follows:

> "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) development costs in connection with new construction located on such property; (2) development costs in connection with the substantial rehabilitation of such property; (3) development 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, the proceeds of which were used in a manner consistent with items (1), (2), (3), and/or (4) immediately above. Except as provided in item (5) of the preceding sentence, the proceeds of such loans and investments may not be used to re-finance or otherwise pay off an existing loan on the property."

In connection with this alternative language, we also recommend that Section 3.3(h) contain a definition of the term "substantial rehabilitation". We suggest that the following should be added:

> "In the event that proceeds of a loan or investment are used for rehabilitation expenditures with respect to property, and such expenditures meet the minimum requirements of Internal Revenue Code Section 42(e)(3)(A) as of the close of the 1st taxable year in which such expenditures have been placed in service, such proceeds shall be treated as used for substantial rehabilitation of property. "

We note that the second paragraph of Section 3.3(h) requires that the first QALICB (the one which owns and leases the real estate) must control the "second QALICB" (the one which is the primary user of the financed property). We think that this second paragraph of Section 3.3(h) should be revised so as to allow a loan or investment in the "first QALICB" so long as it is ***commonly controlled***, directly or indirectly, by the person(s) which control(s) the "second QALICB". This would allow for commonly occurring variations in ownership structure. For example, this would permit loans or investments in circumstances in which a family or other closely held business has multiple business entities which are divided between real estate and operating QALICBs as "brother/sister" entities rather than merely in parent/subsidiary form which appears to be contemplated by the proposed language. This change can be implemented by revising the language to read 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 ***commonly*** controlled (within the meaning of 26 C.F.R. 1.45D-1(d)(6)(ii)(B)) either

> directly or indirectly by ***a person or group of persons who control*** another QALICB (the "second QALICB") provided that……"

Section 3.3(i) Authorized Uses of NMTC Allocation

We believe that this section will precipitate many questions to the CDFI Fund as to what falls within the generally consistent parameters as deals change from the original proposals in the allocation application. It is unclear if generally consistent refers to the type of transactions, including percentage of allocation used in various types of transactions (real estate loans versus equity investments in start-up businesses), community impact, or something else. We recommend the CDFI Fund delete this section entirely. To the extent that strategies are set forth in the application that the CDFI Fund wants the Allocatee to comply with, such strategies should be listed in Schedule 1. This language will generate significant concerns for investors as to compliance with the Allocation Agreement due to the lack of guidance as to the term "generally consistent" and the implication that the investors will have to review all of the Allocatee's investments to determine whether its specific investment is consistent.

Section 6.9(f) Advise the Fund of Certain Material Events

We believe that the CDFI Fund should define more clearly what it intends by "replacement". Does replacement mean a change in ownership (in whole or in part) of the Controlling Entity? Would replacement included mergers and acquisitions? Without this term defined further, CDEs will be unable to determine when it should advise the CDFI Fund of a material event. Furthermore, restrictions on corporate-level transactions by Controlling Entities will be unworkable for most larger institutions, who often will not, as a matter of policy, agree to such restrictions. This provision may therefore discourage or even preclude a large number of highly qualified applicants from participating in the NMTC program. We suggest the following alternative language to address this concern:

> "the Allocatee's Controlling Entity shall no longer have any ownership or management interest in the Allocatee; provided, that the foregoing shall not be deemed to prohibit mergers, asset transfers, stock transfers, or similar transactions with respect to the Controlling Entity that pertain to the business and operations of the Controlling Entity generally (and are not primarily undertaken for the purpose of transferring control of the Allocatee and the Allocation);"

Section 6.9(g) Advise the Fund of Certain Material Events

We believe that this specific section should be removed from the Allocation Agreement as it causes an Allocatee to be in default for an event that an Allocatee rarely has foreseeable control over. At some time during the compliance period, it is reasonable to assume key management officials may leave a company for various reasons. We believe that the Allocation Agreement should not give power to the CDFI Fund to determine that

the Allocatee is in default due to these changes or, in effect, to assert control over the employment decisions and circumstances of Allocatees.

Section 6.11 Common Enterprises

We believe that this section is unclear as it relates to a Qualified Equity Investment investor who also has its own allocation. We believe that this prohibition should **not** apply in the case where the entities are commonly controlled by a Qualified Equity Investment investor who also has its own allocation.

Section 6.12 Controlling Entities

We recommend that the CDFI Fund delete Section 6.12 in the Draft Allocation Agreement. As drafted, Allocatees will be required to have their Controlling Entities control "the day-to-day management and operations (including the investment decisions) of the Allocatee." This requirement is a change from the guidance Allocatees were given when they submitted their Allocation Applications. In fact, both an application tip and one of the Q&As state that the "Fund recommends that an Applicant identify the Controlling Entity that has the power to Control the management and investment decisions of the Applicant" (emphasis added). As this guidance did not provide a requirement that Applicants choose a Controlling Entity who controls both management and investment decisions, we are aware of multiple Applicants whose Controlling Entities either will not or cannot have such roles. This is particularly problematic for Applicants who are involved in joint ventures with their Controlling Entity and the parties have gone through intensive negotiations to determine which party would have certain duties and responsibilities. As Round 3 Applicants were not on notice that the CDFI Fund would require this particular kind of involvement from the Controlling Entity, Section 6.12 should not be included in the final Allocation Agreement.

Furthermore, we note that this requirement is inconsistent with the CDFI Fund's guidance on "control" as it relates to Subsidiary Allocatees. An Allocatee that chooses not to use subsidiaries (such as where the Allocatee intends to invest in a single project or to raise capital in a single investment pool) would face obstacles in giving its investors input and approval over management decisions that would be substantially different than those that would apply to an Allocatee that intended to form subsidiaries. Indeed, the restriction in Section 6.12 is easily avoided if the Allocatee simply creates a Subsidiary Allocatee and cedes control over the day-to-day management and operations of the Subsidiary Allocatee (in a manner consistent with the CDFI Fund's guidance). We believe the requirements regarding "control" by a Controlling Entity over an Allocatee should mirror those regarding an Allocatee's "control" over its Subsidiary Allocatees.

Section 8.1(e) Events of Default

We suggest that the wording for a default due to material events be reworded as follows:

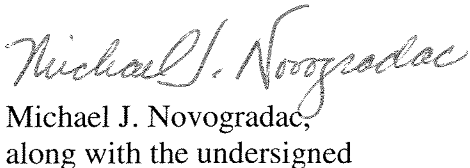
> "the occurrence of a material event (as defined in Section 6.9 of this Allocation Agreement and with the exception of Section 6.9(c)) to the extent that such event has a material adverse effect on the Allocatee's ability to carry out the authorized uses of the NMTC Allocation to be provided hereunder."

We believe that the fundamental concern of the CDFI Fund is the Allocatee's ability to utilize its Allocation, and that general adverse changes in financial condition or business operations should not, in themselves, give rise to a default.

Conclusion:

We are excited about the New Markets Tax Credit Program being able to reach and benefit more businesses and individuals who lack adequate access to loans or equity investments. 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 and Company LLP



Michael J. Novogradac,
along with the undersigned

Ruth Sparrow
Garvey Schubert Barer

Herbert F. Stevens
Gregory N. Doran
Michael J. Goldman
Merrill F. Hoopengardner
Nixon Peabody LLP

Michael I. Sanders
Powell Goldstein Frazer & Murphy, LLP

Neil S. Faden
Manatt, Phelps & Phillips, LLP

Bruce A. Bonjour
Richard E. Peterson
Perkins Coie LLP

Scott A. Lindquist
Sonnenschein Nath & Rosenthal LLP