

RD AN No. 4625 (4279-A,
4279-B, 4279-C, and 4280-B)

February 23, 2012

TO: State Directors, Rural Development

ATTN: Business Programs Directors

SUBJECT: Business and Industry Guaranteed Loan,
Rural Energy for America and
Biorefinery Assistance Programs, and
New Market Tax Credit Program

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to provide guidance and clarification concerning the Agency's policy on using the New Market Tax Credit (NMTC) program with the Business and Industry (B&I) Guaranteed Loan Program, the Rural Energy for America Program (REAP), or the Biorefinery Assistance Program (BAP). For purposes of this AN, REAP and BAP will be collectively referred to as "Energy." This AN revises and updates the Unnumbered Letter issued on June 13, 2011.

COMPARISON WITH PREVIOUS AN:

No previous AN has been issued on this subject.

IMPLEMENTATION:

The NMTC was authorized by Congress as part of the Community Renewal Tax Relief Act of 2000, to attract investment capital to low-income communities by permitting investors to receive a tax credit against their Federal income tax returns in exchange for making equity investments in specialized financial institutions, called Community Development Entities (CDEs).

EXPIRATION DATE:
February 28, 2013

FILING INSTRUCTIONS
Preceding RD Instructions 4279-A,
4279-B, 4279-C, and 4280-B

The NMTC Program is implemented by the Department of Treasury's Community Development Financial Institution (CDFI) Fund. The CDFI Fund designates eligible CDEs and allocates the tax credit through a competitive application process. The Internal Revenue Service (IRS) provides and monitors compliance with the NMTC Income Tax Regulations—the rules under which the taxpayer may receive the tax credit. Only CDFI Fund-certified CDEs are able to compete for and receive NMTC allocations. After receiving an allocation, the CDE has 5 years to raise Qualified Equity Investments (QEIs) from investors. The CDE has 12 months to place the QEIs into Qualified Low Income Community Investments (QLICIs) that include: (1) loans to, or investments in, qualified active low-income community businesses (QALICBs); (2) loans to, or investments in, other CDEs; (3) the purchase of qualifying loans originated by other CDEs; and (4) financial counseling and other services (FCOS) to low-income community businesses. The tax credits total 39 percent of the cash invested and is claimed over a 7-year credit allowance period.

The NMTC program serves a common purpose with the B&I and Energy guaranteed loan programs of improving access to capital for communities that have traditionally had inadequate access. The NMTC program, with its capital contributions from private sector investors and leveraged funds, can be used to leverage the B&I or Energy guaranteed loan programs for loans to qualifying businesses.

The NMTC program may be used with B&I and REAP guaranteed loans using, but not limited to, one of two basic models: (1) the CDE purchasing or participating in a guaranteed loan (model #1); and (2) the CDE or its subsidiary becoming a non-traditional lender (model #2). The NMTC program may be used with BAP guaranteed loans by the CDE purchasing or participating in a guaranteed loan (model #1).

Discussion on Project Proposals Utilizing NMTC Program Structures

Model #1: Holder/Participation Model

The CDE can become the holder/participating lender of the guarantee through: (1) a sale of the Loan Note Guarantee; (2) purchasing a participation in the loan; or (3) the purchase of the Loan Note Guarantee and participation in the non-guaranteed portion of the loan. All B&I and Energy program rules relating to participation or sale to a holder must be followed. This approach may provide more favorable interest rates to the borrower.

Model #2: Non-Traditional Lender Model

As background, a lender's subsidiary may apply for the B&I and REAP programs either by independently qualifying as a lender under the applicable subsection of RD Instruction 4279-A, section 4279.29, or the subsidiary's parent must qualify accordingly and request the subsidiary, under its control, also be approved under the appropriate subsection. In the case of the latter, the subsidiary does not need to meet the requirements of RD Instruction 4279-A, section 4279.29, separately from its parent. The control structure needs to be clearly defined in advance through a

management agreement, and a copy of the agreement must be provided to the Agency with the request for approval as a lender.

Approved non-traditional lenders may subsequently request approval of their subsidiaries in accordance with RD Instruction 4279-A, section 4279.29(b). In such cases, additional information submitted shall include the parent's current balance sheet (not more than 1 year old; an in-house financial statement is acceptable), commercial loan portfolio information in accordance with RD Instruction 4279-A, section 4279.29(b)(2)(iii), any changes to its license or charter since its initial submission, changes to its staff since its initial submission and updates on their commercial lending experience, license or charter of the subsidiary or its evidence of authority to engage in the proposed loan making and servicing activities, in accordance with section 4279.29(b)(2)(ii), and a copy of the control agreement.

A CDE is permitted to make loans and can apply to become a non-traditional lender under the B&I and REAP guaranteed loan programs in accordance with RD Instruction 4279-A, section 4279.29. CDEs that have been previously approved as B&I and REAP non-traditional lenders may submit a request for approval of sub-CDEs under their control. Normally, a CDE creates a special purpose sub-CDE for each NMTC loan or set of loans. The NMTC investor owns the majority (99.99 percent) of the sub-CDE through its Qualified Equity Investment (QEI). The CDE has a minority (0.01 percent) ownership interest in the sub-CDE and is the managing member, managing partner, or controlling stockholder, and controls the sub-CDE through a management agreement. In this case, the sub-CDE can apply to become a non-traditional lender in accordance with the subsidiary's provisions just discussed.

The primary concern with a CDE or sub-CDE in this instance is that the tax credits are taken over a 7-year period, at the end of which the NMTC investor will exit. Therefore, the request for approval of the CDE or sub-CDE as a B&I non-traditional lender must also include their NMTC exit strategy. In the case of a sub-CDE, the exit strategy should indicate if the sub-CDE will continue with the CDE as its sole member, partner, or stockholder, after the exit of the NMTC investor or if the sub-CDE will collapse into the CDE with a substitution of lenders.

Other Models

The NMTC program could possibly be used with B&I and Energy guaranteed loans using other structures not addressed herein. If the structure of the proposal involves the B&I guaranteed loan "taking out" the interim construction loan outside of the NMTC structure or the borrower investing in the CDE's NMTC, then provisions of RD Instruction 4279-B, sections 4279.113 and 4279.114 apply.

Discussion on General B&I Guaranteed Loan and Energy Guaranteed Loan and NMTC Program Issues

Loan Terms

Throughout the 7-year investment period, the CDE must ensure that substantially all (at least 85 percent during the first 6 years, reduced to 75 percent in year 7) of the QEI is deployed in one or more NMTC eligible loans or investments. CDEs that are NMTC lenders typically structure their loans with 7-year interest only terms, with a balloon payment at the end of the 7-year investment period. This loan structure is not eligible under RD Instruction 4279-B, section 4279.126(b) and (c), or Energy programs which cross-reference to section 4279.126(c). However, the B&I program and BAP permit interest only payments for a period not to exceed 3 years, in compliance with RD Instruction 4279-B, section 4279.126(b). The REAP RD Instruction 4280-B, section 4280.126(b), requires “the first installment of principal and interest will, if possible, be scheduled for payment after the project is operational and has begun to generate income.” RD Instruction 4279-B, section 4279.126(c), applies to B&I and Energy guaranteed loans and requires a periodic payment schedule which will retire the debt over the term of the loan without a balloon payment. CDE payment schedules must comply with these requirements to be eligible for the B&I or Energy programs.

Subordinated Debt/Quasi-Equity

As noted above, NMTC QEI funds may be used by the CDE to make loans to qualifying businesses, or to make equity investments in qualifying businesses. NMTC loans to a qualifying business (QALICB) must be considered as debt on the borrower’s balance sheet in accordance with Generally Accepted Accounting Principles. The NMTC Income Tax regulations do not allow the CDE, at the time of approving their loan(s), to commit to forgive a loan or convert loans to equity at a later date. NMTC project proposals may include a “double-borrower” model in which the CDE’s NMTC funds are lent to the QALICB (e.g. a real estate holding company) and the QALICB provides the funds as equity into the project (e.g. an operating company). If the two entities are variable interest entities, their financial statements might need to be consolidated or combined for our analysis. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards 167, amendment to FASB Interpretation No. 46, provides guidance in accordance with accounting standards.

Equity

If the CDE uses the NMTC funds to make equity investments in the qualifying business (partial ownership), the CDE or sub-CDE is ineligible to directly partake in model #1.

RD Instruction 4279-A, section 4279.75, prohibits a B&I or Energy lender from selling or participating in any amount of the guaranteed or unguaranteed portion of the loan to the borrower or members of the borrower's immediate families, officers, directors, stockholders, other owners, or a parent, subsidiary, or affiliate.

Likewise you should be attentive to potential for or appearance of conflict of interest under model #2, because RD Instruction 4279-B, section 4279.181(n), indicates that the Loan Note Guarantee will not be issued until the lender certifies that none of the lender's officers, directors, stockholders, or other owners (except stockholders in an institution that has normal stock share requirements for participation) has a substantial financial interest in the borrower. Requirements of section 4279.181(n) apply to B&I and REAP loan transactions that also include NMTC funds. This section does not prohibit the lender (that is, the CDE or sub-CDE) from having a financial interest in the borrower. Appropriate measures must consider the potential for or appearance of a conflict of interest, such as establishing appropriate loan covenants regarding limitations on dividends and distributions of earnings and other covenants in accordance with section 4279.161(b)(11), limiting waivers of loan covenants, and limiting future modifications of loan documents.

A lender may provide equity and take an ownership interest in the QALICB as part of their B&I or REAP/NMTC financing transaction, only if the lender does not have an ownership interest in the QALICB prior to their B&I or REAP loan application. The lender cannot take a controlling interest of the QALICB. Also be reminded that section 4279.149 requires personal or corporate guarantees from those owning at least 20 percent interest in the borrower. It is a conflict of interest for the lender to request an exception of itself from guaranteeing the loan. A lender cannot guarantee their loan; therefore, the lender cannot provide equity or take an ownership interest in a QALICB at a level that would result in owning 20 percent or greater interest in the QALICB.

The lender should address in their Application for Loan Guarantee to the Agency their exit strategy when the NMTC expires after the 7th year. The exit strategy should include a general plan to address the lender's equity and if the lender will divest their equity interest how will this will be accomplished and the impact on the QALICB.

The Office of the General Counsel Regional Attorney is available to review any issues or questions related to legal compliance and sufficiency of NMTC transactions. It is the responsibility of the State Office to review the documents for program compliance.

The NMTC program is evolving and additional loan structures may be proposed and may be considered for use with the B&I and REAP programs. Loan approval authority delegated to the State Director includes transactions involving the NMTC. Copies of proposals and funding schematics shall be submitted to the appropriate Business Programs Division, referenced below, in the pre-approval/pre-application stage for monitoring purposes. Deviations from these models, funds flow, and equity should be presented to and discussed with the B&I Division, and Energy loan applications with the Energy Division.

If you have any general questions regarding this AN and the NMTC program, please contact Mark Brodziski, Director, Specialty Programs Division, at (202) 720-1394. For questions regarding specific project proposals, please contact Todd Hubbell, Loan Specialist, B&I Division, at (202) 690-4103, or Lisa Siesennop, Loan Specialist, Energy Division, at (202) 720-1400.

(Signed by JUDITH A. CANALES)

JUDITH A. CANALES
Administrator
Business and Cooperative Programs