Highlights of the December 2022 CDFI Fund NMTC Compliance Guidance

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The Community Development Financial Institutions (CDFI) Fund Dec. 5, 2022, issued revised New Markets Tax Credit (NMTC) Compliance Monitoring and Evaluation Frequently Asked Questions (December 2022) (FAQs) replacing the guidance issued effective November 2021. This article summarizes the key revisions to the FAQs and issues raised by the guidance.

Background

The FAQs provide critical guidance for allocatees to maintain allocation agreement compliance as policies and requirements evolve. The CDFI Fund periodically issues updates to the FAQs to address substantive modifications to the allocation agreement and to respond to industry comments. The CDFI Fund retains the right to modify the guidance at any time upon public notice. The guidance is not exhaustive, and the CDFI Fund has discretion to consider additional factors when determining compliance with the allocation agreement.

Key Updates

Question 19: Substantial Rehabilitation

Allocation agreement: Section 3.3(h) of the allocation agreement requires that if a qualified active low-income community business's (QALICB's) principal business activity is rental real estate, the proceeds of the community development entity's (CDE's) loan or investment must be primarily used by the QALICB for (i) new construction or substantial rehabilitation of such property, (ii) acquisition and new construction, (iii) acquisition and substantial rehabilitation of such property or (iv) take-out financing for a loan or investment that funded costs described in (i), (ii) or (iii). The requirement does not apply if an operating company that controls the QALICB is the primary user of such property if its principal business is not rental real estate.

FAQ #19: Substantial Rehabilitation Threshold to be Satisfied by Each Building: Substantial rehabilitation for this purpose is defined in the FAQs, not in the allocation agreement. In response to a request for guidance from the Novogradac NMTC Working Group, the CDFI Fund revised the FAQs to clarify that in a multiple-building project, each building must satisfy the substantial rehabilitation threshold. For each building located on the property, the cost basis of any improvements made during a 24-month period that includes any portion of the taxable year in which the qualified low-income community investment (QLICI) is made must equal or exceed 25% of the adjusted basis of the building with respect to which the improvements are made as of the beginning of the testing period. If the substantial rehabilitation threshold is not satisfied with respect to a specific building, the operating company exception must apply with respect to the entire property.

Planning Options:

If there are buildings owned or leased by the QALICB that are not being financed with QLICI proceeds, consider the following options: (i) document the use of QLICI proceeds exclusively on the other buildings,

(ii) transfer the applicable ancillary buildings by the QALICB to a QALICB affiliate, or (iii) redefine the QALICB to be a "portion of business" that excludes such buildings in accordance with Internal Revenue Code (IRC) Section 45D(d)(2)(C), as amended (and Treasury Regulation (Treas. Reg.) Section 1.45D-1(d)(4)(iii).

Question 45: Generally Consistent with the NMTC Application

Allocation agreement: Section 3.3(i) of the CY 2021 allocation agreement provides that at least 85% of the QLICIs made under the NMTC allocation must be generally consistent with the strategies including, but not limited to, the proposed product offerings, QALICB type, fees, markets served (i.e., service area) and notable relationships) set forth in the applicable allocation application. Examples are provided in FAQ #45.

Allocation application: The allocatee will be required to address compliance with this requirement in future allocation applications. The 2022 NMTC Program Application Frequently Asked Questions (#42) provides that the CDFI Fund reserves the right to reject or reduce an award if a prior allocatee has failed to use its prior NMTC allocation in a manner that is generally consistent with the business strategy set forth in the applicable allocation application.

FAQ #45: Size of the QLICI is not dispositive. The revised FAQ #45 provides that the CDFI Fund acknowledges that the size of the QLICI depends on the QALICB's needs. The size of the QLICI will not be considered in determining compliance with Section 3.3(i) of the allocation agreement if the proposed products, fees, QALICB types, service areas, and notable relationships are generally consistent with the applicable allocation application.

New Question 46: Policies and Procedures on Investments

Allocation agreement: New Section 4.13 of the CY 2021 allocation agreement requires the allocatee to certify that it will adopt and adhere to written policies and procedures, including any investment committee policies approved by the allocatee's board of directors or other governing body setting forth how it shall use the QEI proceeds to make investments or reinvestments in accordance with the uses set forth in Section 3.2 of the allocation agreement.

FAQ #46: FAQ #46 provides that the intent of Section 4.13 of the CY 2021 allocation agreement is to ensure that allocatees adhere to governing board-approved written policies and procedures to select projects, to determine compliance with IRC Section 45D, and to determine the financial and operational viability of a QALICB throughout the NMTC compliance period and a successful exit.

The allocatee's written policies and procedures for selecting projects must at a minimum include the allocatee's due diligence activities, including but not limited to (i) financial considerations to secure collateral; (ii) the QALICB's ability to repay the QLICI or pay dividends; including an assessment of guarantees or other collateral; (iii) the likelihood of project completion related to the assets financed with NMTCs; (iv) assessment of management team experience and/or expertise relevant to the successful operation of the QALICB and (v) market demand for the QALICB's services and/or products. The written policies and procedures are expected to address other due diligence as needed based on the allocatee's business strategy and types of businesses financed with its NMTC allocation.

Planning: The policies and procedures should be documented and approved by the allocatee before submitting the applicable allocation application and should be discussed in such application.

New Question 47: Clarification of Disclosure to QALICBs

Allocation agreement: Section 6.12 of the allocation agreement requires that allocatees disclose to the QALICB, in a separate stand-alone document, any and all direct and indirect NMTC-related transaction costs related to the QLICI(s) (e.g., legal, accounting, compliance), fees and compensation that the allocatee is assessing the QALICB or otherwise requiring the QALICB to incur prior to, during, and at the conclusion of the tax credit period.

FAQ #47: No Substantive Change to the Requirement. FAQ #47 incorporates Section 6.12 of the allocation agreement and adds that Section 6.12 of the allocation agreement is intended to add transparency between the allocatee and the QALICB. Additional guidance, including examples of disclosures, is available on the CDFI Fund's website and a link is provided in FAQ #47.

New Question 74: Procedures to Request an Amendment to the Controlling Entity; Revised Question 73

Allocation agreement: Section 6.13 of the allocation agreement provides that the designated controlling entity must be maintained during the term of the allocation agreement unless removal is approved by the CDFI Fund.

FAQ #74: FAQ #74 sets forth the procedures and documentation required to submit a request to amend the designated controlling entity using AMIS, including an updated organizational chart and allocation application management capacity Table C2.

FAQ #73 provides the substantive requirements to request removal of the controlling entity. Revised FAQ #73 provides that the allocatee must not have received a final notification of default on any of its allocation agreements in the immediately preceding five years of the removal request.

Question 75: Controlling Entities: Definition of Control for CY 2021 Round

Allocation agreement: The definition of controlling entities in the CY 2021 allocation agreement provides a revised test from prior NMTC allocations to determine whether a controlling entity "controls" the allocatee. The revised test provides a clear basis to determine satisfaction of the "control" requirement, with distinct tests for for-profit CDEs and nonprofit CDEs. The revised "control" tests apply to allocatees with no prior NMTC allocations in any of the CY 2013-CY 2020 Rounds. The prior "control" test continues to apply to allocatees awarded NMTC allocation in such prior rounds.

FAQ #75: FAQ #75 is revised consistent with the CY 2021 allocation agreement to provide that the new test for determining "control" applies commencing with the CY 2021 NMTC allocation and does not apply to allocatees that have been awarded an NMTC allocation in any of the CY 2013 through CY 2020 Rounds.

Question 83: COVID-19 Pandemic Relief

Allocation agreement: Section 3.3(j)(i) of the CY 2021 allocation agreement incorporates the universal amendments issued to NMTC allocations from the CY 2015-CY 2020 rounds to allow QLICI proceeds to be used to repay or refinance documented reasonable expenditures of the debt or equity provider (or its affiliate), that are directly attributable to the qualified business of the QALICB, if such expenditures were incurred no more than 36 months prior to the QLICI closing date for QLICIs closed on or before Dec. 31, 2022, and 24 months prior to the QLICI closing date for QLICIs closed after Dec. 31, 2022.

FAQ #83: FAQ #83 is revised consistent with the CY 2021 allocation agreement to incorporate the universal amendments issued by the CDFI Fund.

Planning: In response to a request from the Novogradac NMTC Working Group to extend the 36-month provision beyond Dec. 31, 2022, and at another public forum, the CDFI Fund responded that it does not intend to extend the look-back period from 24 to 36 months for closings after Dec. 31, 2022.

Additional Changes

Question 26: Unrelated Entities

Allocation agreement: Section 3.2(d) of the allocation agreement describes the requirement applicable to allocatees that have committed to make QLICIs in businesses in which persons "unrelated" to the allocatee hold the majority equity interest in the QALICB.

FAQ #26: The revised FAQ #26 adds a requirement that the allocatee document the determination that the QLICI is being made in "unrelated persons" to the allocatee and CDE that makes the QLICI.

Planning: If this is a potential issue, an opinion of CDE tax counsel or an internal memorandum should be sufficient.

Question 34: Food Desert Determination

Allocation agreement: Section 3.2(h) of the allocation agreement includes as a higher distress criteria, a census tract (i) that is determined to be a food desert in the USDA's Food Access Research Atlas, or (ii) is identified as having low access to a supermarket or grocery store, through a methodology adopted for use by another governmental agency, to the extent the QLICI activities will increase access to healthy food.

FAQ #34: The revised FAQ #34 provides that allocatees can continue to use the 2015 Food Desert layer data in the USDA's Food Access Research Atlas until Nov. 1, 2023. QLICIs closed on or after Nov. 1, 2023, must use the 2019 Food Desert layer data.

Conclusion

The CDFI Fund's updated guidance and responsiveness to industry comments is appreciated and facilitates participation in the NMTC program. Due to the innovative uses of the NMTC and the evolution of the program, there are and will continue to be additional questions and issues to be addressed.

Ruth Sparrow has more than 30 years' experience representing clients in tax-incentivized investments and in the NMTC program since its inception.

Disclaimer: The information presented in this article is intended solely for informational purposes and should not be construed as legal advice by the author or Future Unlimited Law PC. It is not intended to and does not create any attorney-client relationship. For additional information, contact Ruth Sparrow, of Future Unlimited Law PC at rsparrow@futureunlimitedlaw.com; 360-458-1720; futureunlimitedlaw.com.

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