Audit Report

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DOMESTIC ASSISTANCE

Audit of Wisconsin Housing and Economic Development Authority New Markets Tax Credit Allocations

February 2, 2022

Office of Inspector General
Department of the Treasury

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Abbreviations

Allocation Agreement(s)	*NMTC Program Allocation Agreement(s)*
CCME	Certification, Compliance Monitoring and Evaluation
CDE	Community Development Entity
CDFI Fund	Community Development Financial Institutions Fund
CY	calendar year
GAO	Government Accountability Office
Green Book	*Standards for Internal Control in the Federal Government*
GWOF	Greater Wisconsin Opportunities Fund
IRC	Internal Revenue Code
IRS	Internal Revenue Service
MOU	Memorandum of Understanding
NMTC	New Markets Tax Credit
OIG	Office of Inspector General
QALICB	Qualified Active Low Income Community Business
QEI	Qualified Equity Investment
QLICI	Qualified Low Income Community Investment
TLR	Transaction Level Report
Treasury	Department of the Treasury
Treas. Reg.	Department of the Treasury Regulation
WCDLF	Wisconsin Community Development Legacy Fund
WHEDA	Wisconsin Housing and Economic Development Authority

Audit Report

February 2, 2022

Jodie Harris, Director
Community Development Financial Institutions Fund
Department of the Treasury

As part of our oversight of the Community Development Financial Institutions (CDFI) Fund's New Markets Tax Credit (NMTC) Program, we initiated an audit of NMTC allocations awarded to Community Development Entities (CDE)[1] based in Wisconsin. The objective of our audit was to assess Wisconsin-based CDEs' use of NMTC allocations and proceeds to make Qualified Low Income Community Investment(s) (QLICI)[2] and designate Qualified Equity Investment(s) (QEI)[3] in accordance with their *NMTC Program Allocation Agreement(s)* (hereinafter referred to as *Allocation Agreement(s)*) and applicable regulations, policies and procedures.

The scope of our audit covered two CDEs established by the Wisconsin Housing and Economic Development Authority (WHEDA), the Greater Wisconsin Opportunities Fund, Inc. (GWOF) and its predecessor the Wisconsin Community Development Legacy Fund, Inc. (WCDLF), which were awarded $280 million in NMTC

[1] Section 45D of the Internal Revenue Code of 1986, as amended, defines a CDE as any domestic corporation or partnership (a) whose primary mission is serving, or providing investment capital for, low-income communities or low-income persons, (b) that maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity, and (c) that is certified by the CDFI Fund.
[2] Department of the Treasury Regulation (Treas. Reg.) § 1.45D-1(d) defines a QLICI as (A) any capital or equity investment in, or loan to, any qualified active low-income community business, (B) the purchase of a QLICI loan from another qualified community development entity (C) specified financial counseling and other services to businesses located in, and residents of, low-income communities, and (d) any equity investment in, or loan to, any qualified community development entity.
[3] Treas. Reg. § 1.45D-1(c) defines a QEI as any equity investment in a qualified CDE if (A) such investment is acquired by the taxpayer at the original issue solely in exchange for cash; (B) substantially all of such cash is used by the qualified CDE to make QLICIs; and (C) such investment is designated by the qualified CDE no more than 5 years after the date that such entity receives an allocation.

allocations during the allocation rounds in calendar years (CY) 2008, 2009, 2010, 2012 and 2013.[4] WCDLF received a total of $195 million during the CYs 2008, 2009, and 2010 allocation rounds, and GWOF received a total of $85 million during the CYs 2012 and 2013 allocation rounds. In all, this comprised 26 QLICIs made in 21 Qualified Active Low Income Community Businesses (QALICB)[5] equaling the $280 million of NMTC authority provided to GWOF and WCDLF (referred to collectively as WHEDA CDEs). Since investors can take a tax credit totaling 39 percent of the applicable NMTC allocation, the $280 million of NMTC authority provided to WHEDA CDEs resulted in $109.2 million in Federal new markets tax credits. We reviewed all 26 QLICIs and the related 21 QALICBs within the scope of this audit. We also interviewed key personnel at the CDFI Fund, the Internal Revenue Service (IRS), and WHEDA, where we conducted two site visits in July 2017 and September 2019. Appendix 1 provides a more detailed description of our audit objective, scope, and methodology.

Results in Brief

We found that WHEDA CDEs used their NMTC allocations and proceeds to make QLICIs and designate QEIs in accordance with their *Allocation Agreement(s)* and applicable Federal regulations. That said, we had concerns over the lack of clearly defined requirements and guidance from the CDFI Fund to the CDEs for selecting QLICIs and QALICBs, including clarification from the IRS regarding the Department of the Treasury Regulation (Treas. Reg.) § 1.45D-1. These matters are outlined more specifically in the Matters of Concern section where we describe deficiencies in WHEDA's administration of its NMTC allocations that led to the decision to invest part of the proceeds from its WCDLF CDE's CYs

[4] There were no NMTC allocations to GWOF or WCDLF in 2011.

[5] Treas. Reg. § 1.45D-1(d)(4) defines a QALICB as any corporation (including nonprofits) or partnership that is engaged in the active conduct of a qualified business and that also meets the following: (1) at least fifty percent of total gross income derived from active conduct of business (or the CDE's reasonable expectation of revenue generation within 3 years) within any low-income community; (2) at least forty percent of tangible property within any low-income community; (3) at least forty percent of the services performed by its employees within any low-income community, or if the business has no employees, then eighty-five percent of tangible property must be within the low-income business; (4) less than five percent of the average of the aggregate unadjusted basis of collectibles for sale; and (5) less than five percent of the aggregate unadjusted basis of property attributable to debt, stock, partnership interest, and other prohibited financial property.

2008 and 2009 NMTC allocations in Kestrel, an airplane manufacturer. We identified several "red flags" as to the viability of Kestrel that called into question why a loan was made to the company. Specifically, WHEDA disregarded several risks related to the investment. Among other things, WHEDA ignored the external underwriter's recommendation *not* to invest in the Kestrel project, including an email advising that doing so "completely disregards [WHEDA's] fiduciary role to the CDFI" [Fund] since Kestrel's: (a) collateral would be worthless if used as planned, (b) Federal Aviation Administration approval was not guaranteed, (c) ability to raise needed future equity was not guaranteed, (d) business development and plane-building capacity had already failed twice, and (e) the management team had no personal capital at risk. Furthermore, WHEDA disregarded Kestrel's previous failure in a NMTC deal with a Maine CDE, which included technical defaults and intellectual property concerns which delayed and nearly disrupted closing of the Wisconsin deal. Kestrel also provided largely inconsistent (various versions with large differences) and unreconciled financial data, none of which was independently audited. The investment in Kestrel did not achieve its stated business plan in that it did not certify and produce a new aircraft nor did it establish approximately 600 jobs related to the manufacturing of those planes and composite material parts. WHEDA made a risky investment regardless of the impact to the taxpayers. Considering the "red flags," we referred these matters to our Office of Investigation, which reviewed them but could not open an investigation because the statute of limitations had expired. As a result, we expanded our audit procedures to review the deal with Kestrel in more depth.[6] The results of our expanded work are discussed in the Matter of Concern section of this report.

Due to the concerns noted above, we identified opportunities for the CDFI Fund, with assistance from the IRS, to provide more guidance to CDEs in the *Allocation Agreement(s)* and to strengthen monitoring of CDEs' NMTC Program compliance through ongoing coordination with the IRS. As such, we are reporting two findings.

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[6] Government Accountability Office's (GAO), *Government Auditing Standards* require that "when information comes to the auditors' attention indicating that fraud, significant within the context of the audit objectives, may have occurred, auditors should extend the audit steps and procedures, as necessary, to (1) determine whether fraud has likely occurred and (2) if so, determine its effect on the audit findings." GAO-18-568G (July 2018); p. 175.

Specifically, we found that there was a lack of guidance for selecting businesses to receive QLICIs and a definition of reasonable expectation that a business will satisfy the QALICB compliance requirements. Furthermore, the CDFI Fund's Memorandum of Understanding (MOU) with the IRS has not been updated since August 2004.

Accordingly, we made the following five recommendations to CDFI Fund management: (1) include as part of the *Allocation Agreement(s)* a requirement that CDEs establish and adhere to written policies and procedures governing the selection of entities for NMTC program investments or loans; (2) request that the IRS establish guidance for CDEs to assess reasonable expectation that an entity receiving an investment or loan will satisfy the requirements to be a QALICB throughout the entire investment period; (3) ensure that deficiencies identified in WHEDA's administration of NMTC allocations are considered as part of the CDFI Fund's future awards; (4) update the MOU with the IRS to include compliance monitoring of the NMTC program with current processes and systems and language permitting CDFI Fund requests of specific Treas. Reg. §1.45D-1 compliance reviews; and (5) update the MOU with the IRS to implement improved communication strategies for any completed Treas. Reg. §1.45D-1 compliance reviews.

As part of our reporting process, we provided WHEDA management an opportunity to comment on a draft of this report. In a written response, WHEDA management expressed appreciation that the audit confirmed WHEDA CDEs complied with requirements set forth in its *Allocation Agreement(s)* with the CDFI Fund and applicable Federal regulations. Management also provided specific comments in response to concerns identified. The response noted that Kestrel was anticipated to create jobs and that multiple iterations of financial projections for startups are common as the business is evolving. Additionally, WHEDA management explained that it pursued Kestrel because (1) the project met the objectives of the NMTC program; (2) the project had strong financial support from state government, local municipalities, and private entities; (3) Kestrel's management team had a proven track record in the aviation industry; (4) subsequent to the external underwriter's determination to the contrary, the intellectual property pledged as

collateral was determined to have value; (5) the project had an outside investor; and (6) contrary to the external underwriter's report, owner equity was included in the transaction.

In evaluating WHEDA's management response, we found that, with the exception of receiving support from state government, local municipalities, and private entities, management's reasons for pursuing the Kestrel allocation are still questionable. While we concluded that WHEDA complied with Treas. Reg. §1.45D-1, this determination was partially due to unclear NMTC program definitions and guidance, as noted in finding 1. Although WHEDA management may have anticipated that its investment in Kestrel would create measurable job increases and transform the community, there were several "red flags" (described above) that were indicators of the project's impending failure and were known at the time WHEDA decided to invest. WHEDA's external underwriter recommended that the funds be invested elsewhere. Furthermore, the independent consultant that compiled Kestrel's financial projections clarified in its report that a compilation is limited to presenting projected information that is the representation of management and does not include an evaluation of the support for the assumptions underlying such information. As such, the independent consultant did not express an opinion or any other form of assurance on the projected schedules or assumptions.

Regarding WHEDA management's reasons for pursuing the "Kestrel allocation," the Kestrel project did not result in measurable community development and significant economic impacts even though WHEDA provided a mechanism to fund a project in a highly distressed area. As noted in this report, Kestrel did not produce new aircraft, obtain Federal Aviation Administration approval, or create approximately 600 jobs. While WHEDA management recognized the Kestrel management team's experience in the aviation industry, WHEDA management disregarded the fact that Kestrel had already failed to achieve Federal Aviation Administration certification and stand-up production of its aircraft design in other markets. In fact, the external underwriter noted failures in getting the aircraft certified in Europe and in Maine.

As for the intellectual property, Kestrel agreed to share it with its subsidiary operations in Maine, which was previously expected to produce the same aircraft but did not.[7] While the external aviation specialist[8] stated that the intellectual property had value, Kestrel did not have rights to the full value of it.

Finally, it is standard practice for any NMTC deal to have an outside investor whose capital flows through a CDE to a qualified business.[9] Although there was an outside investor, the owners of Kestrel did not have equity in the project prior to WHEDA's initial review of the deal, which resulted in the decision to require the owners to contribute $1.5 million of their personal funds as capital at risk.

Overall, WHEDA management's response did not provide new or clarifying information, and as such, we maintain that WHEDA overlooked several "red flags" regarding the Kestrel deal.
We summarized WHEDA management's response and our evaluation in the Matters of Concern section of this report. WHEDA's management response, in its entirety, is included as appendix 2 of this report.

After incorporating WHEDA's response, we provided a draft of this report to the CDFI Fund's management for comment. In a written response, CDFI Fund management concurred with our recommendations and provided corrective actions to address each recommendation. To address recommendation 1 regarding CDE policies and procedures, management stated that, in October 2022, the CDFI Fund will implement a requirement in the *Allocation Agreement(s)* for CDEs to establish and adhere to written policies and procedures governing the selection of entities for NMTC program investments or loans. Management also noted that the CDFI Fund has also added new questions to the CY 2021 NMTC Program Application requiring additional information from

[7] Kestrel's subsidiary in Maine, Kestrel Brunswick Corporation, originally pledged the intellectual property as collateral for its NMTC allocation from a Maine CDE. The Maine CDE allowed the subsidiary to sublicense the intellectual property to Kestrel's Wisconsin operation, Kestrel Manufacturing, LLC (Kestrel).
[8] The Arvai Group, Inc. is a management consulting firm focused on the aviation and commercial aerospace sector.
[9] IRS, *New Market Tax Credit* (Audit Techniques Guide) (LMSB-04-0510-016, May 2010).

applicants on the types of due diligence they will conduct to ensure the financial viability of the QALICBs they plan to invest in, among other things. To address recommendation 2 regarding guidance to assess "reasonable expectation," management stated the CDFI Fund will request that the IRS establish guidance for CDEs to assess the "reasonable expectation" requirements and will work with the IRS to provide input and review any guidance developed by the IRS related to Section 45D. To address recommendation 3 regarding WHEDA deficiencies identified, management stated that the NMTC program currently takes any identified deficiencies into account in its evaluation of past NMTC Allocatees for future allocation awards, including evaluating portfolio quality, financial health of the CDE, asset management, explanation of NMTC delinquencies, and charge-offs, and will continue to do so for all applicants as necessary. To address recommendation 4 regarding updates to the MOU with IRS to include compliance monitoring, management stated that the CDFI Fund began discussions with representatives from the IRS (Enterprise Activities – Energy and Investment Tax Credit Practice Network) about changes to the NMTC program MOU and last provided draft edits of the MOU to IRS in March 2021. To address recommendation 5 regarding updates to the MOU with IRS to include improved communication strategies, management stated that the CDFI Fund is currently engaged with the IRS to update the MOU and the CDFI Fund's requested revisions are aimed at providing structure and timelines around information exchanges. We consider the CDFI Fund's planned corrective actions, if implemented as stated, to be responsive to our recommendations. We have summarized CDFI Fund management's response in the recommendation sections of this report. Management's written response, in its entirety, is included as appendix 3 of this report.

Background

New Markets Tax Credit Program

The *Riegle Community Development and Regulatory Improvement Act of 1994*[10] established the CDFI Fund to promote economic

[10] P.L. No. 103-325, 108 Stat. 2160 (September 23, 1994)

revitalization and development of low income and underserved communities. The NMTC program was created by the *Community Renewal Tax Relief Act of 2000*,[11] and was incorporated in section 45D of the Internal Revenue Code of 1986 (IRC),[12] as amended, to incentivize community development and economic growth through the use of tax credits that result in the creation of jobs and material improvements in the lives of residents of low-income communities. The NMTC program began operations in 2003 and has provided a total of $61 billion in tax credit allocation authority through calendar year (CY) 2020. The program is jointly administered by the CDFI Fund and the IRS.

Through its allocation authority, the CDFI Fund may allocate up to $125 million[13] in tax credit authority to a qualified CDE. By making QEIs in a CDE, taxpayers can receive a federal income tax credit over a 7-year allowance period with 5 percent of the amount invested in the CDE for each of the first 3 years, and 6 percent for each of the remaining 4 years. In turn, CDEs must use substantially all[14] the cash received through QEIs to make QLICIs in QALICBs in accordance with Treas. Reg. § 1.45D-1.[15]

Wisconsin Housing and Economic Development Authority

WHEDA is a public authority established in 1972 to stimulate Wisconsin's economy by providing affordable housing and business financing products. WHEDA created and controlled two CDEs during our scope period (WCDLF created in CY 2003 and GWOF created in CY 2011) to receive and administer NMTC allocations.[16] WCDLF was created as a non-profit organization formed by its controlling entity WHEDA and Legacy Bancorp, a minority and

[11] P.L. No. 106-554, 114 Stat. 2763A (December 21, 2000)
[12] 26 U.S.C. §45D, "New Markets Tax Credit"
[13] Per the Notices of Allocation Authority, the maximum allocation authority was $125 million for 2008 through 2009; $150 million for 2010; $125 million for 2011; $100 million for 2012; $125 million for 2013 through 2016; and $100 million for 2017 through 2020.
[14] "Substantially all" means at least 85 percent, per Treas. Reg. § 1.45D-1(c)(5).
[15] The *Allocation Agreement(s)* required WHEDA CDEs to invest a higher percentage (98 percent) of the funds received from QEIs into QLICIs.
[16] WHEDA formed Lift Wisconsin to replace GWOF in CY 2018, which became responsible for administering any new NMTC allocations awarded. However, no allocations have been awarded to Lift Wisconsin as of CY 2020.

women-founded Wisconsin bank holding company and regional CDFI. WCDLF administered WHEDA's NMTC allocations from CY 2003 through CY 2010. GWOF was organized as a non-stock corporation that was a wholly-owned subsidiary of WHEDA. Through its two CDEs, WHEDA was awarded $575 million in NMTC allocations between CYs 2003 and 2016.[17]

Audit Results WHEDA CDEs Made QLICIs and Designated QEIs in Accordance With *Allocation Agreement(s)* and Federal Regulations

WHEDA CDEs used their NMTC allocations and proceeds to make QLICIs and designate QEIs in accordance with their *Allocation Agreement(s)* and applicable Federal regulations. That said, we had concerns over the lack of clearly defined requirements and guidance from the CDFI Fund to the CDEs regarding selecting QLICIs and QALICBs, including clarification from the IRS on Treas. Reg. §1.45D-1. As described in the Matters of Concern section below, we performed a detailed review of the QLICIs made in CYs 2008 and 2009 in one QALICB, Kestrel Manufacturing LLC. (Kestrel) that did not achieve its stated business plan in that it did not certify and produce a new aircraft nor did it establish approximately 600 jobs related to the manufacturing of those planes and composite material parts.

WHEDA CDEs Appropriately Designated QEIs

For an investment to be an eligible QEI, it must satisfy the following Treas. Reg. §1.45D-1[18] requirements: (1) the investment in the CDE must take place after the date of the allocation as set by the *Allocation Agreement(s)* between the CDE and the CDFI Fund, (2) the CDE must invest the funds into QLICIs within 5 years of the corresponding date of allocation and within 1 year after receipt from an investor, (3) the CDE must invest substantially all funds received into QALICBs, and (4) the QLICI funds invested in

[17] WCDLF received NMTC allocations of $100 million and $120 million in CYs 2003 and 2007, respectively, which were not within the scope of this audit. GWOF received a $75 million NMTC allocation in CY 2016 that was also not within the scope of this audit.
[18] 26 CFR § 1.45D-1, "New Markets Tax Credit"

non-real estate QALICBs must not be used for real estate development.

We found that WHEDA CDEs designated 21 QEIs under their CYs 2008-2013 NMTC allocations in accordance with Treas. Reg. §1.45D-1 and the *Allocation Agreement(s)*. Specifically, we confirmed that WHEDA CDEs did the following: (1) invested the funds after the date of allocation by comparing QLICI loan documents to the *Allocation Agreement(s)*; (2) designated QEIs within 5 years of allocation by comparing the investor's promissory notes to the *Allocation Agreement(s)* dates and made QLICIs within 1 year of receipt from an investor by comparing the investor's promissory notes to the CDEs to the *Allocation Agreement(s)* and QLICI promissory notes; (3) invested substantially all (i.e., at least 85 percent) funds received into QALICBs by comparing and analyzing the amount of QLICI promissory notes and investor's promissory notes to the CDEs; and (4) did not invest in real estate development for non-real estate QALICBs by reviewing WHEDA CDEs' Transaction Level Report (TLR)[19] to the CDFI Fund to identify non-real estate QALICBs and WHEDA CDEs' QLICI promissory notes to ensure at least 85 percent of the value of a QLICI was used for non-real estate development.

WHEDA CDEs Made QLICIs

For an investment to meet the requirements of a QLICI, it must satisfy the following Treas. Reg. §1.45D-1 stipulations: (1) the recipient business is a qualified business, meaning it did not participate in certain prohibited business activities;[20] (2) those businesses engaged in the rental or development of real estate perform substantial improvements to the property and do not primarily rent residential property; (3) the CDE "reasonably expects" that the business would satisfy the requirements of a

[19] The *Allocation Agreement(s)* requires a CDE to annually provide a TLR to the CDFI Fund which is a report containing, among other things, specific data elements on each of the CDE's QLICIs, including their location, type and amount, and any other information required to confirm the CDE's compliance with the *Allocation Agreement*, IRC § 45D, and Treas. Reg. §1.45D-1.

[20] Prohibited business activities include the following: trade involving intangibles, golf courses, country clubs, massage parlors, hot tub facilities, sun tanning facilities, gambling, the sale of alcoholic beverages for consumption off premises, and farming.

QALICB, or the QLICI must be made in "Targeted Populations;"[21] and (4) the QLICI loan(s) must be bona-fide debt without intent to forgive the loan.

We determined that all 26 QLICIs complied with Treas. Reg. §1.45D-1. To ensure recipient businesses were qualified, we reviewed the QALICB tax opinions by third-party law or accounting firms, which the WHEDA CDEs used to support the eligibility of their investments. The third-party opinions found that each business would meet both the qualified business and the QALICB requirements. These conclusions were reached based on recipient businesses' self-reported financial data and certifications. In the case of one project within the farming industry, we referenced IRC §2032A(e)(5)(A and B) to determine that the business activity was not defined by the IRS as farming (an ineligible trade for NMTC purposes).[22] As discussed in the Matters of Concern section, WHEDA relied on these opinions even when the internal and external underwriters revealed potential concerns.

For businesses that developed real estate, mixed use property is not considered residential rental property (a prohibited use) if less than 80 percent of the gross rental income is from residential units.[23] According to CDFI Fund management, 20 percent or more of the gross rental income from mixed use property can derive from retail, office, or other commercial space. Two of the 26 QLICIs

[21] To satisfy "Targeted Populations" requirements, a business must: (1) derive at least fifty percent of gross income from sales, rentals, services, or other transactions with individuals who are low-income persons (meaning no more than eighty percent of median income according to geographic areas), or at least forty percent of the employees or fifty percent of the owners are low-income persons; (2) cannot be located in a population census tract with median family income exceeding one hundred twenty percent of statewide or metropolitan median family income, except if the census tract's population is under 2,000, or more than seventy-five percent of the area's zoned commercial or industrial; and (3) does not (a) derive at least fifty percent of total gross income within non-qualifying census tracts, (b) maintain at least forty percent of the tangible property within non-qualifying census tracts, and (c) perform at least forty percent of its services for the business by its employees within a non-qualifying census tract.

[22] IRC Section 2032A(e)(5)(A and B) defines farming purposes as the cultivation or harvesting of an agricultural and horticultural commodity, or the handling or storage on a farm in its unmanufactured state but only if the owner or operator of the farm produces more than one-half of the commodity. Related business activities in the agricultural industry are permitted.

[23] IRC §168(e)(2)(A) defines residential rental property as "any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units."

were in such mixed used properties. We confirmed that the projected gross rental income from residential rental real estate in these properties fell below the required 80 percent through examination of third-party opinions and our analysis of financial projections provided by the QALICBs.

We reviewed the QALICB opinions from third-party attorneys or accounting firms to confirm that there was reasonable expectation that businesses were QALICBs. According to Treas. Reg. §1.45D-1, if a CDE "reasonably expects" at the time of its investment that a business will satisfy the requirements of a QALICB throughout the entire investment period, then that business will be treated as qualified throughout that period. Therefore, the related tax credit would not be subject to recapture regardless of the business' subsequent failure to satisfy those requirements. We noted one business that was not located in a qualified low-income census tract, but it was still a QALICB as it met the "Targeted Population" requirements. Furthermore, we verified that the QLICI loans were bona fide debts by ensuring the QLICI promissory notes did not include a loan forgiveness clause. We also reviewed the related third-party tax opinions that concluded that the loans were bona-fide debts.

WHEDA CDEs Complied With *Allocation Agreement(s)*

The CDFI Fund imposes additional requirements beyond Treas. Reg. §1.45D-1 within the *Allocation Agreement(s)*. We identified and tested WHEDA CDEs' compliance with the additional requirements of section 3.2 "Authorized Uses of NMTC Allocation," which contains the following:

a. Eligible Activities – specific allowances for:
    1. Investment in, or loans to, non-real estate QALICBs;
    2. Investment in, or loans to, QALICBs whose principal activities involve the development or rehabilitation of real estate;
    3. Investments in, or loans to, other CDEs;
    4. Purchase of loans from other CDEs; and
    5. Financial Counseling and Other Services.

b. Service Area (i.e., for WHEDA CDEs, the State of Wisconsin);
c. Subsidiary Allocatees (i.e., a list of legal entities through which WHEDA can pass-through NMTC allocations);
d. Unrelated Entities (requirement that QLICIs be made in entities unrelated to the CDE);
f. Flexible Products (i.e., the Allocatee's QLICIs must (a) be equity or equity-equivalent financing, (b) have interest rates that are 50 percent lower than either the prevailing market rates for the particular product or lower than the Allocatee's current offerings for the particular product, or (c) satisfy at least five of the indicia of flexible or non-traditional rates and terms, such as lower than standard origination fees or nontraditional forms of collateral);
g. Non-Metropolitan Counties (e.g., 50 percent of NMTC allocations must be used in non-metropolitan counties);
h. Targeted Distressed Communities (e.g., CDE must make 75 percent of QLICIs in defined "distressed" communities per 3.2(h) of the *Allocation Agreement(s)*);
i. Loan Purchases Re-investment (i.e., the Allocatee shall require other CDEs from which it purchases loans to invest at least a designated percent of the proceeds of such loan sales in QLICIs);
j. Qualified Equity Investment Usage (specifies the amount of QEI proceeds that must be used for QLICIs made, e.g., 98 percent); and
k. Affordable Housing (i.e., if applicable, specific percentage of rehabilitated residential units made available for low-income persons).

We also confirmed that WHEDA CDEs complied with their *Allocation Agreement(s)* section 3.3 "Restrictions on the Use of NMTC Allocation." Specifically, we reviewed the TLR provided to the CDFI Fund, which included the compliance information (such as loan terms, service area income, QALICB type, metropolitan areas, and project address) reported by WHEDA for the NMTC allocations received during CYs 2008 through 2013. We also reviewed source documents, such as the "Independent Accountants' Report On Applying Agreed-upon Procedures," investment promissory notes, and third-party legal opinions used by WHEDA to establish QALICB

eligibility. We concluded that all 26 QLICIs made by WHEDA CDEs complied with their *Allocation Agreement(s)*.

Under their *Allocation Agreement(s),* WHEDA CDEs were also required to submit reports to the CDFI Fund within specific periods. We reviewed the "Notice of Receipt of Qualified Equity Investment," Institution Level Report, the CDEs' annual audited financial statements, and TLR, and found that WHEDA's CDEs generally met their reporting requirements.[24]

Matters of Concern

During the course of this audit, we became concerned with WHEDA's administration of its NMTC allocations that led to the decision to invest part of the proceeds from its WCDLF CDE's CYs 2008 and 2009 NMTC allocations in Kestrel, an airplane manufacturer. That is, Kestrel did not achieve its stated business plan in that it did not produce new aircraft, obtain Federal Aviation Administration approval, or create approximately 600 jobs related to the manufacturing of planes and composite material parts. We identified several "red flags" as to the viability of Kestrel that called into question why a loan was made to the company. Considering the "red flags," we referred these matters to our Office of Investigation, which reviewed them but could not open an investigation because the statute of limitations had expired. As a result, we expanded our audit procedures to review the deal with Kestrel in more depth.

As part of our expanded audit procedures, we interviewed WHEDA personnel involved in the selection of Kestrel, analyzed additional underwriting documentation, reviewed WHEDA's correspondence regarding Kestrel, and other relevant documents to include WHEDA's external attorney's opinion. We inquired of WHEDA

[24] As part of the *Allocation Agreement(s)*, a CDE agrees to provide the CDFI Fund with the following: (1) Notice of Receipt of Qualified Equity Investment - within 60 days after an investor makes a QEI in a CDE, the CDE shall notify the CDFI Fund of that QEI using the CDFI Fund's electronic Allocation Tracking System; (2) Institutional Level Report - CDEs must annually submit this report that includes, but is not be limited to, organizational, financial, portfolio and impact information; and (3) Audited Financial Statements - the CDE shall deliver within 180 days, and annually thereafter, to the CDFI Fund copies of the CDE's most recent statements of financial condition audited by an independent certified public accountant covering the CDE's fiscal year end.

officials as to why its CDE invested in Kestrel. WHEDA's Business Director stated that the decision to invest in Kestrel was supported by three main factors: (1) geographic need and community support, (2) substantial third-party funding invested in the deal, and (3) strong Kestrel management team expertise. In addition, WHEDA determined that it limited its financial risk by collecting their administrative fees from Kestrel in advance. However, in relying on these factors, WHEDA disregarded several risks related to the investment to include, among other things, the external underwriter's recommendation *not* to invest in the Kestrel project, including an email advising that doing so "completely disregards [WHEDA's] fiduciary role to the CDFI" [Fund] since Kestrel's: (a) collateral would be worthless if used as planned, (b) Federal Aviation Administration approval was not guaranteed, (c) ability to raise needed future equity was not guaranteed, (d) business development and plane-building capacity had already failed twice, and (e) the management team had no personal capital at risk. Furthermore, WHEDA disregarded Kestrel's previous failure in a NMTC deal with a Maine CDE, which included technical defaults and intellectual property concerns which delayed and nearly disrupted closing of the Wisconsin deal. Kestrel also provided largely inconsistent (various versions with large differences) and unreconciled financial data, none of which was independently audited.

WHEDA obtained opinions on the status of Kestrel as a QALICB from both a tax attorney and a large accounting, advisory, and tax company. With the caveat that the information provided by Kestrel's management was presumed to be generally accurate, both the tax attorney and accountant's opinions found that Kestrel should be eligible as a QALICB, and thusly, be considered by WHEDA as a QALICB for the full investment period. WHEDA relied on these opinions in making its QLICI in Kestrel. Since it was common practice for CDEs to use such opinions in conjunction with internal analysis to determine QALICB eligibility, we could not determine definitively whether or not WHEDA could reasonably expect (as defined further below) Kestrel to meet the requirements of a QALICB.

WHEDA Management Response

In a written response to this report, WHEDA management expressed appreciation that the audit confirmed WHEDA CDEs complied with their *Allocation Agreement(s)* with the CDFI Fund and federal regulations. WHEDA also provided the following comments specific to our concerns identified with the Kestrel project:

- Kestrel was anticipated to create more than 590 permanent, high paying jobs in a rural, highly stressed census tract. If the project had been successful, it would have been catalytic for an area of Wisconsin that had been devastated by the economic downturn and loss of manufacturing jobs. From the start, it was known that this was a high-risk investment that offered a transformational opportunity for the City of Superior and the surrounding region.
- Multiple iterations of financial projections for a start-up business are common as the business plan is evolving. WHEDA engaged an independent consultant to prepare and review the projections for reasonableness, however, traditional auditable numbers were not available given the start-up nature of the project.
- WHEDA management decided to pursue the Kestrel allocation for the following reasons: (1) the project met the objectives of the NMTC program which were, according to WHEDA, to provide a funding mechanism for deals in highly distressed census tracts that were otherwise unable to move forward, resulting in significant and measurable community development and economic impacts and creating jobs; (2) the project had strong financial support from state government, local municipalities, and private entities in addition to the NMTC allocation; (3) although Federal Aviation Approval was not guaranteed, as noted by the external underwriter, the management team had a proven track record with previous success in the aviation industry; (4) the intellectual property pledged as collateral was determined to have value. As a result of the external underwriter's report stating its limited value, WHEDA management contracted with an outside aviation specialist to evaluate the pledged intellectual property; (5) the project

had an outside investor and it received subsequent capital infusions from a private investor; and (6) owner equity was included in the transaction. Although the external underwriter's report indicated that management had no personal capital at risk, the Kestrel management team had previously invested personal funds in the business.

WHEDA management's response, in its entirety, is provided in appendix 2 of this report.

OIG Comment

In evaluating WHEDA's management response, we found that, with the exception of receiving support from state government, local municipalities, and private entities, management's reasons for pursuing the Kestrel allocation are still questionable. While we concluded that WHEDA complied with Treas. Reg. §1.45D-1, this determination was partially due to unclear NMTC program definitions and guidance, as noted in finding 1. Although WHEDA management may have anticipated that its investment in Kestrel would create measurable job increases and transform the community, there were "red flags" (described above) that were indicators of the project's impending failure and were known at the time WHEDA decided to invest. WHEDA's external underwriter recommended the funds be invested elsewhere. Furthermore, the independent consultant that compiled Kestrel's financial projections clarified in its report that a compilation is limited to presenting projected information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. As such, the independent consultant did not express an opinion or any other form of assurance on the projected schedules or assumptions.

Regarding WHEDA management's reasons for pursuing the "Kestrel allocation," the Kestrel project did not result in measurable community development and significant economic impacts even though WHEDA provided a mechanism to fund a project in a highly distressed area. As noted in this report, Kestrel did not produce new aircraft, obtain Federal Aviation Administration approval, or create approximately 600 jobs. While WHEDA management recognized the Kestrel management team's experience in the

aviation industry, WHEDA management disregarded the fact that Kestrel had already failed to achieve Federal Aviation Administration certification and stand-up production of its aircraft design in other markets. In fact, the external underwriter noted failures in getting the aircraft certified in Europe and in Maine.

As for the intellectual property, Kestrel agreed to share it with its subsidiary operations in Maine, which was previously expected to produce the same aircraft but did not. While the external aviation specialist stated that the intellectual property had value, Kestrel did not have rights to the full value of it.

Finally, it is standard practice for any NMTC deal to have an outside investor whose capital flows through a CDE to a qualified business. Although there was an outside investor, the owners of Kestrel did not have equity in the project prior to WHEDA's initial review of the deal, which resulted in the decision to require the owners to contribute $1.5 million of their personal funds as capital at risk.

Overall, WHEDA's management response did not provide new or clarifying information, and as such, we maintain that WHEDA overlooked several "red flags" regarding the Kestrel deal. With respect to the concerns noted, we identified opportunities for the CDFI Fund to provide more guidance to CDEs in the *Allocation Agreement(s)* and to strengthen monitoring of CDEs' NMTC Program compliance through ongoing coordination with the IRS. Accordingly, we are reporting two findings below related to the *Allocation Agreement(s)'* lack of clearly defined requirements and guidance and the CDFI Fund's MOU with the IRS being outdated.

Finding 1 ***Allocation Agreement(s)*** **Lack Clearly Defined Requirements and Guidance for CDEs**

In our in-depth analysis of WHEDA CDE's QLICI in Kestrel, we identified the following areas in which the *Allocation Agreement(s)* lack clear requirements and guidance for CDEs' investments in and determinations of QALICBs.

Guidance for Selecting Businesses to Receive QLICIs

Our audit found that all 26 QLICIs made by WHEDA's CDEs complied with the applicable *Allocation Agreement(s)*, Treas. Reg. §1.45D-1, and WHEDA's policies and procedures. However, the CDFI Fund does not require CDEs to adhere to their own NMTC-specific procedures for making investment decisions.

Certification, Compliance Monitoring and Evaluation (CCME) officials stated that the CDFI Fund does not require or provide guidance for CDEs to establish and follow specific policies and procedures governing their selection of businesses when making QLICIs. CDEs may use any underwriting process of their choosing. A WHEDA official told us this allowed WHEDA the discretion to select risker projects that they perceive as potentially having a greater impact on the community than a more viable project. Additionally CDEs are not required to justify the reasons for selecting a particular QLICI, as long as a QALICB does not participate in non-qualified business activities and the CDEs can demonstrate a reasonable expectation the business will meet Treas. Reg. §1.45D-1 requirements (detailed more below). During follow up interviews, CDFI Fund officials agreed that they should probably establish a stipulation requiring selection methodology/procedures, and noted that they could do so in their *Allocation Agreement(s)*.

While reviewing WHEDA CDE's deal with Kestrel, we noted several issues with Kestrel's business plan, including largely inconsistent financial data and a recommendation from a third-party underwriter not to invest in the deal. WHEDA's internal email correspondence revealed that personnel reviewing the Kestrel deal shared many of the same concerns as that third-party underwriter. Ultimately, WHEDA officials' decision to invest in Kestrel was partially reliant on their determination that WHEDA was not exposed to financial risk since it gathered its fees from Kestrel up front. WHEDA made a risky investment regardless of the impact to taxpayers. This perspective breaches WHEDA's fiduciary duty to the CDFI Fund, and runs counter to the objectives of the NMTC program, the main goal of which is the investment in and development of successful QALICBs. However, since the CDEs were given flexibility to make

QLICIs, the appropriateness of any particular QLICI selection is difficult to assess.

Definition of Reasonable Expectation is Lacking

Kestrel failed to materially achieve its stated business plan, yet that did not have any impact on WHEDA's *Allocation Agreement(s)* because WHEDA's CDE established, at the time of the investment, that it "reasonably expected" that the business would be an eligible QALICB. Treas. Reg. § 1.45D-1(d)(6)[25] stipulates that if a CDE "reasonably expects" at the time it makes a QLICI that a business will satisfy the QALICB compliance requirements, then that project is considered compliant with the related requirements for the full duration of the investment or loan, including the 7-year tax credit period of the NMTC program. CDFI Fund officials told us that CDEs commonly use third-party accounting and tax opinions to establish reasonable expectation However, the practice of using such opinions is not required by Treas. Reg. §1.45D-1 or the *Allocation Agreement(s)*. For each of the 26 QLICIs reviewed, WHEDA's CDEs obtained reasonable expectation from third-party accounting and legal opinions, which were made without independent verification of the claims made by the managements of the businesses requesting the CDEs' investment. In the case of Kestrel, WHEDA relied on the unverified opinions in spite of marked underwriting concerns and several iterations of unaudited financial data that did not reconcile.

While Treas. Reg. §1.45D-1 establishes several compliance requirements for a business to qualify as a QALICB, it does not clearly define what is meant by "reasonably expects." During interviews with officials from CDFI Fund's CCME division and the IRS' Large Business & International division, it was confirmed that a clear definition for "reasonably expects" does not exist and there is no promulgated guidance detailing how a CDE can obtain such

[25] The IRS uses the term "reasonably expects" in Treas. Reg. §1.45D-1(d)(6)(i) "Qualifications," (d)(4)(i) "Qualified Active Low-Income Community Business," and (d)(4)(iii) "Portions of a business."
An entity is treated as a qualified active low-income community business for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business throughout the entire period of the investment or loan.

expectation. CDFI Fund officials agreed with our suggestion that a definition for reasonable expectation is needed.

In general, CDEs can treat businesses as compliant with QALICB requirements for the full duration of their investment, even if the business subsequently fails to meet those requirements. As such, there is a large compliance incentive for CDEs to establish that they "reasonably expect" their investments to meet the requirements of QALICBs in order to protect the related tax credits against recapture. Without clarification from the IRS on Treas. Reg. §1.45D-1 detailing how CDEs should acquire that reasonable expectation, CDEs could make QLICIs in businesses that might otherwise be found unqualified.

The CDFI Fund should further define its internal control related to its administration of the NMTC program. According to the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government*[26] (Green Book), "management is responsible for designing the policies and procedures to fit an entity's circumstances and building them in as integral part of the entity's operations." Green Book Principle 10, *Design Control Activities,* requires that "management should design control activities to achieve objectives and respond to risks." Attribute 10.02, *Response to Objectives and Risk,* provides suggested guidance that "management designs control activities in response to the entity's objectives and risks to achieve an effective internal control system. Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives to achieve the entity's objectives and address related risks." As part of those controls, management should "define responsibilities, assign them to key roles, and delegate authority to achieve the entity's objectives." Additionally, Principle 12, *Implement Control Activities,* requires that "management should implement control activities through polices." Attribute 12.05, *Periodic Review of Control Activities,* provides suggested guidance that "management periodically reviews policies, procedures, and related control activities for continued relevance and effectiveness in achieving the entity's objectives or addressing related risks. If there is a significant change in an entity's process, management reviews this

[26] GAO, *Standards for Internal Control in the Federal Government,* (September 2014)

process in a timely manner after the change to determine that the control activities are designed and implemented appropriately."

Recommendations

We recommend that the Director of the CDFI Fund do the following:

1. Include as part of *Allocation Agreement(s)* a requirement that CDEs establish and adhere to written policies and procedures governing the selection of entities for NMTC program investments or loans.

   Management Response

   In its written response, CDFI Fund management concurred with this recommendation and stated it will implement the requirement in October 2022. Although this specific requirement is not currently in the Allocation Agreement, the CDFI Fund currently requires Applicants for an NMTC Allocation to describe the following as part of the Allocation Application:

   - the roles and responsibilities of key personnel in identifying borrowers or investees and evaluating their ability to remain financially viable and operational for the term of the QLICI;
   - how the Applicant will ensure that QLICI proceeds are used to finance the assets for which they are intended, how the Applicant identifies borrowers at greater risk, and how the Applicant responds when assets are at greater risk;
   - if the Applicant (or Controlling Entity) has written asset management and collection policies and whether it has ever deviated from those policies in the past five years and, if so, why;
   - the Applicant's strategy for minimizing defaults and managing delinquencies to mitigate against write-downs or write-offs going forward; and

- any delinquent, defaulted, or impaired loans or Equity Investments from prior NMTC investments in the last ten years.

Management noted that the CDFI Fund evaluates this information, along with data from the TLRs submitted by prior Allocatees, as part of its review process prior to making an NMTC Allocation decision.

In addition, the CDFI Fund has added new questions to the CY 2021 Application as result of a public comment process related to the renewal of the Allocation Application under the Paperwork Reduction Act. These questions require additional information from Applicants on the types of due diligence they will conduct to ensure the financial viability of the QALICBs they plan to invest in.

Applicants will be required to describe the due diligence that the Applicant will conduct to determine, prior to making a QLICI, a QALICB's ability to remain financially viable and operational during the term of the QLICI and through a successful exit of the QLICI. Applicants will be required to describe any documents that will be required from borrowers/investees and the types of analysis that will be performed on projected NMTC investments to make this determination. Applicants will also be required to describe the types of due diligence that the Applicant (or its Controlling Entity) conducted based on its track record of past financing activities. In order to be evaluated favorably, Applicants are expected to address due diligence activities including but not limited to: 1) financial considerations of the borrower or investee; 2) the likelihood of project completion; 3) management team; and 4) market demand or other economic analysis. The Applicant must also explain how the analyses are documented. Management's written response, in its entirety, is included as appendix 3 of this report.

OIG Comment

Management's planned corrective action, if implemented as stated, meets the intent of our recommendation.

2. Request that the IRS establish guidance for CDEs to assess reasonable expectation that an entity receiving an investment or loan will satisfy the requirements to be a QALICB throughout the entire investment period.

   Management Response

   In its written response, CDFI Fund management concurred with this recommendation. Management noted that NMTCs are jointly administered by the CDFI Fund and IRS. The CDFI Fund's responsibilities are specifically related to certifying CDEs, administering the competitive Allocation Application process, including compliance related to those matters, and the designation of low-income communities. The IRS is responsible for issuing tax regulations and monitoring compliance with the tax code and IRC Section 45D. Given that the "reasonable expectation" criteria is established in the IRS NMTC regulation, the CDFI Fund does not have the authority to issue guidance interpreting it. CDFI Fund management stated it will request that the IRS establish guidance for CDEs to assess the "reasonable expectation" requirements after publication of this audit report and will work with the IRS providing input and reviewing any guidance developed by the IRS related to Section 45D. Management's written response, in its entirety, is included as appendix 3 of this report.

   OIG Comment

   Management's planned corrective action, if implemented as stated, meets the intent of our recommendation.

3. Ensure that deficiencies identified in WHEDA's administration of NMTC allocations are considered as part of the CDFI Fund's future awards.

   Management Response

   In its written response, CDFI Fund management stated it concurred and currently complies with this recommendation. Management noted that the NMTC Program currently takes any identified deficiencies into account in its evaluation of past NMTC Allocatees for future allocation awards, including evaluating portfolio quality, financial health of the CDE, asset management, explanation of NMTC delinquencies and charge-offs, and will continue to do so for all Applicants as necessary. Management's written response, in its entirety, is included as appendix 3 of this report.

   OIG Comment

   Management's corrective action, if implemented as stated, meets the intent of our recommendation.

Finding 2 CDFI Fund's MOU with IRS is Outdated

The CDFI Fund's administration of the NMTC program has evolved since the execution of its MOU with the IRS in August 2004. Since that time, the CDFI Fund implemented its Awards Management Information System and the IRS reorganized its Large and Mid-Size Business Division responsible for NMTC program compliance. Additionally, coordination between CDFI Fund and the IRS has not been consistent under the MOU. Although agreed on in the MOU, CCME officials stated that they do not regularly receive any quarterly notices from the IRS of CDEs that failed to meet the provisions of Treas. Reg. §1.45D-1. While CCME officials stated they can request that the IRS review potentially non-compliant QLICIs, this understanding is not documented in the MOU.

The CDFI Fund established the MOU with the IRS for compliance monitoring of the NMTC program. Under that MOU, the CDFI Fund and IRS' respective responsibilities include:

a. the CDFI Fund will monitor each allocation recipient's compliance with the terms of its *Allocation Agreement(s)* (except for the tax provisions of IRC § 45D), and the IRS will be responsible for establishing procedures and processes to ensure that taxpayers are in compliance with IRC §45D;

b. the CDFI Fund designated IRS staff access to the following electronic databases maintained by the CDFI Fund for the sole purpose of assisting the IRS with monitoring compliance with the tax provisions of 26 U.S.C. § 45D: (i) Allocation Tracking System (ATS) and Administrative Interface, and (ii) NMTC Compliance Monitoring System (NCMS). The CDFI Fund will also permit the IRS to have access to the allocation and certification applications of allocation recipients. The IRS also will assist the CDFI Fund in developing CDFI's policies and procedures and management systems, as needed; and

c. the CDFI Fund will provide the IRS with the relevant findings and assessments of any site visits of allocation recipients conducted by CDFI Fund staff and the IRS will provide quarterly notices of any CDEs that fail to meet requirements of Treas. Reg. §1.45D-1.

As of December 2021, the CDFI Fund had not updated this MOU with the IRS since its original execution. CDFI Fund officials stated that they held a conference call with IRS officials in February 2021 to discuss potential updates to their MOU and an internal draft was completed to address re-establishing specific agency contacts, identify specific data to be exchanged, and outline the frequency of such data exchanges.

According to Green Book Principle 12, *Implement Control Activities,* "management should implement control activities through polices." Attribute 12.05, *Periodic Review of Control*

Activities, provides suggested guidance that "management periodically review policies, procedures, and related control activities for continued relevance and effectiveness in achieving the entity's objectives or addressing related risks. If there is a significant change in an entity's process, management reviews this process in a timely manner after the change to determine that the control activities are designed and implemented appropriately."

The CDFI Fund's monitoring of NMTC program compliance may not be efficient without an updated understanding and ongoing communications with the IRS due to an outdated MOU. As such, CDEs' NMTC program noncompliance may not be identified and addressed to ensure program objectives are being achieved.

Recommendations

We recommend that the Director of the CDFI Fund do the following:

4. Update the MOU with the IRS to include compliance monitoring of the NMTC program with current processes and systems and language permitting CDFI Fund requests of specific Treas. Reg. §1.45D-1 compliance reviews by the IRS.

   Management Response

   In its written response, CDFI Fund management concurred with this recommendation. Management stated that the CDFI Fund began discussions with representatives from the IRS (Enterprise Activities – Energy and Investment Tax Credit Practice Network) about changes to the MOU in July of 2019. The CDFI Fund provided draft edits of the MOU to IRS in March 2021 and is awaiting a response. Ultimately, however, any changes to the MOU will require IRS concurrence. Management's written response, in its entirety, is included as appendix 3 of this report.

OIG Comment

Management's planned corrective action, if implemented as stated, meets the intent of our recommendation.

5. Update the MOU with the IRS to incorporate improved communication strategies for any completed Treas. Reg. §1.45D-1 compliance reviews.

   Management Response

   In its written response, CDFI Fund management concurred with this recommendation. Management stated that the CDFI Fund is currently engaged with the IRS to update the MOU. The CDFI Fund's requested revisions to the MOU are aimed at providing structure and timelines around information exchanges. Ultimately, however, any resulting changes to the MOU will require IRS concurrence with the proposed revisions. Management's written response, in its entirety, is included as appendix 3 of this report.

   OIG Comment

   Management's planned corrective action, if implemented as stated, meets the intent of our recommendation.

* * * * * *

We appreciate the courtesies and cooperation extended by your staff during this audit. Major contributors to this report are listed in appendix 4. A distribution list for this report is provided as appendix 5. If you have any questions, you may contact me at (202) 927-5621 or Nick Slonka, Audit Manager, at (202) 486-1721.

/s/

Lisa DeAngelis
Audit Director

As part of our oversight of the Community Development Financial Institutions (CDFI) Fund's New Markets Tax Credit (NMTC) Program, we initiated an audit of NMTC allocations awarded to Community Development Entities (CDE) based in Wisconsin. The objective of our audit was to assess Wisconsin-based CDEs use of NMTC allocations and proceeds to make Qualified Low Income Community Investments (QLICI) and designate Qualified Equity Investments (QEI) in accordance with their *NMTC Program Allocation Agreement(s)* (hereinafter referred to as *Allocation Agreement(s)*) and applicable regulations, policies and procedures.

The scope of our audit covered two CDEs established by the Wisconsin Housing and Economic Development Authority (WHEDA), the Greater Wisconsin Opportunities Fund, Inc. (GWOF) and its predecessor the Wisconsin Community Development Legacy Fund, Inc. (WCDLF), which were awarded $280 million in NMTC allocations during the allocation rounds in calendar years (CY) 2008, 2009, 2010, 2012 and 2013. There were no NMTC allocations to a WHEDA CDE in 2011. WCDLF received a total of $195 million during the CYs 2008, 2009, and 2010 allocation rounds, and GWOF received a total of $85 million during the CYs 2012 and 2013 allocation rounds. In all, this comprised 26 QLICIs made in 21 Qualified Active Low Income Community Businesses (QALICB) equaling the $280 million of NMTC authority provided to the CDEs. Since investors can take a tax credit totaling 39 percent of the applicable NMTC allocation, the $280 million of NMTC authority provided to WHEDA resulted in $109.2 million in Federal new markets tax credits. We reviewed all 26 QLICIs and the related 21 QALICBs made by GWOF and WCDLF within the scope of this audit.

To achieve our audit objective(s), we performed the following:

i. reviewed NMTC program legislation, regulations, and policies and procedures, to include:
    A. *Riegle Community Development and Regulatory Improvement Act of 1994* (P.L. No. 103-325, 108 Stat. 2160 (September 23, 1994);
    B. *Community Renewal Tax Relief Act of 2000* (P.L. No. 106-554, 114 Stat. 2763A (December. 21, 2000);
    C. Internal Revenue Code of 1986 (IRC), Section(s) 45D - *New markets tax credit*, 168 - *Accelerated cost*

recovery system, and 2032A - *Valuation of certain farm, etc., real property*;

D. Department of the Treasury Regulation (Treas. Reg.) §1.45D-1 *New markets tax credit;*
E. CDFI Fund's *Policies and Procedures: New Markets Tax Credit Program* for the CY 2008 through CY 2013 allocation rounds; and
F. Greater Wisconsin Opportunities Fund *Procurement Policy* (August 14, 2013), WHEDA's *Procedures for Institution Level Report* and *Procedures for Transaction Level Report,* and *Allocation Agreement(s)* for each year within audit scope;

ii. interviewed CDFI Fund officials, including the Program Manager for Certification, Compliance Monitoring and Evaluation (CCME), the Senior Resource Manager, Associate Program Manager, and Financial and Program Analysts;

iii. conducted site visits to WHEDA's offices in Madison, Wisconsin, during July 10 through July 14, 2017, and September 9 through September 11, 2019, wherein we preformed the following:

A. interviewed the following key personnel and contractors:
    a. former Executive Director;
    b. Chief Financial Officer;
    c. former Manager for Economic Development;
    d. Business Director;
    e. former Chairperson of the Board;
    f. Controller;
    g. Director of Risk and Compliance;
    h. Commercial Underwriter;
    i. WHEDA's external legal counsel, Foley & Lardner LLP;
    j. WHEDA's external underwriters, Waveland Ventures and Baker Tilly;
    k. WHEDA's external compliance contractor, Impact 7; and
    l. WHEDA's external accounting services provider, Cohn Reznick, LLP;
B. reviewed e-mails and other related correspondence, to include CDE Board of Directors meeting minutes;
C. reviewed the following documentation:

a. Wisconsin statutes, WCDLF's *Bylaws*, and GWOF's *Second Amended and Restated Bylaws*;
b. *Allocation Agreements* between the CDFI Fund and WCDLF and GWOF;
c. *Notices of Qualified Equity Investment for New Markets Credit* (IRS Form 8874-A);
d. *QALICB* related documents:
    1. QALICB organizational documents,
    2. Sub-CDE organizational documents,
    3. Allocatee organizational documents,
    4. QALICB opinions from third-party legal firms,
    5. QALICB reports prepared by third-party legal or audit firms,
    6. QLICI *Loan Agreement(s)* between WHEDA CDEs and QALICBs,
    7. QEI entity organizational documents, and
    8. CDEs' internal underwriters' reports incorporating external underwriters' reports from contractors, Waveland Ventures and Baker Tilly;
e. Kestrel-specific documents:
    1. *Valuation of Intellectual Property* and *Independent Review of Kestrel Manufacturing Corporation Business Plan* reports,
    2. Draft external underwriter's report, Waveland Ventures,
    3. Pro forma financial statements, and
    4. Publicly available news articles;

iv. reviewed the following WHEDA-related documentation from the CDFI Fund:
    A. Transaction Level Reports for fiscal year 2016;[27]
    B. Institution Level Reports for fiscal years 2011 through 2015;
    C. Notices of receipt of QEI;
    D. CDEs' audited financial statements; and
    E. CDFI Fund's approval letter of certification for WHEDA's CDEs;

[27] CDEs' TLR includes data on QLICIs data from multiple allocations.

v. consulted with the following Internal Revenue Service personnel regarding conflict of interest and definition of reasonable expectation:
    A. Special Counsel;
    B. Branch Chief for Counsel;
    C. Senior Counsel;
    D. Senior General Engineer;
    E. Senior Program Manager in the Energy and Investment Tax Credit Practice Network; and
    F. officials from the Large Business and International Large Business division; and

vi. consulted with Department of the Treasury (Treasury) Office of Inspector General's (OIG) Office of Counsel in reference to conflict of interest and the definition of reasonable expectation.

We performed our fieldwork between April 2017 and March 2021 primarily in Treasury OIG offices located in Washington, D.C.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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November 12, 2021

Ms. Lisa DeAngelis
Audit Director
Treasury-Office of Inspector General
875 15th Street, NW
Washington D.C. 20005

RE: OIG Draft Audit Report – New Markets Tax Credit Program

Dear Ms. DeAngelis:

Thank you for providing a draft of the Office of the Inspector General Audit Report related to the CDFI Fund's New Markets Tax Credit ("NMTC") allocations to the Wisconsin Community Development Legacy Fund ("WCDLF") and the Greater Wisconsin Opportunities Fund ("GWOF") both of which are subsidiaries of the Wisconsin Housing and Economic Development Authority.

The $575 million of NMTC allocations to WCDLF and GWOF created over 8,000 jobs in the State of Wisconsin. We appreciate that the audit confirms that the WHEDA CDEs complied with the requirements set forth in both our Allocation Agreements with the CDFI Fund and Federal regulations outlined in Section 45D of the Internal Revenue Code of 1986.

WHEDA would like to provide specific comments in response to concerns identified in Finding 1 of the audit:

- The single transaction being evaluated in the audit, Kestrel, was anticipated to create more than 590 permanent, high paying jobs in a rural, highly distressed census tract. If the project had been successful, it would have been catalytic for an area of Wisconsin that had been devastated by the economic downturn and loss of manufacturing jobs. From the start, it was known that this was a high-risk investment that offered a transformational opportunity for the City of Superior and the surrounding region.
- Financial projections of start-ups are fundamentally different than financial projections of going concerns. Multiple iterations of financial projections for a start-up business are common as the business plan is evolving. WHEDA engaged an independent consultant to prepare and review the projections for reasonableness, however traditional, auditable numbers were not available given the start-up nature of the project.

Tony Evers, Governor

A public body corporate and politic created under Chapter 234, Wisconsin Statutes

- WHEDA decided to pursue the Kestrel allocation for the following reasons:
    1. The project met the objectives of the NMTC program. WCDLF's role in administration of the NMTC Allocation Agreement was to ensure that investments were in compliance with program requirements and met the objectives of the program. The program objectives were to provide a funding mechanism for deals in highly distressed census tracts where if not for the inclusion of NMTCs, the deals would not be able to move forward, achieving significant and measurable community development and economic impacts and creating jobs.
    2. The project had strong financial support from state government, local municipalities, and private entities in addition to the NMTC allocation. This support included loans from the State of Wisconsin, City of Superior and Douglas County, the donation of land by the City of Superior and the pledge of TIF increment. This support was considered in approving the allocation.
    3. The management team had a proven track record in the aviation industry. Although Federal Aviation Approval was not guaranteed as noted by the external underwriter, the management team had previous success in this area. One member had previously founded Cirrus Design where two models of planes were certified and over 5,000 planes delivered.
    4. The intellectual property pledged as collateral was determined to have value. Upon receipt of the external underwriter's report citing the intellectual property had no value, WCDLF contracted with an outside aviation specialist to evaluate the value of the pledged intellectual property. This additional information, which was acquired after the external underwriter's report was completed, was considered in the final approval process.
    5. The project had an outside investor. While the ability to raise future capital was not guaranteed, the business did receive subsequent capital infusions from a private investor.
    6. Owner equity was included in the transaction. Although, the external underwriter's report indicated that management had no personal capital at risk, the management team had previously invested personal funds in the business.

WCDLF officials were aware of the risk associated with the Kestrel project and made a good faith decision to proceed with the NMTC allocation after carefully weighing the risk against the potential transformational community impact – significant job creation and economic growth in a severely distressed rural community. While it is disappointing to WHEDA, the State of Wisconsin and the community of Superior that Kestrel was not successful, prudent underwriting and approval steps were taken.

Sincerely,

Kimberly M. Plache
Interim Executive Director/Deputy Executive Director

COMMUNITY DEVELOPMENT
FINANCIAL INSTITUTIONS FUND

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 21, 2022

Ms. Lisa DeAngelis
Deputy Assistant Inspector General for Audit
Office of the Inspector General
U.S. Department of the Treasury
1500 Pennsylvania Ave., N. W.
Washington, D.C. 20220

RE: CDFI Fund Management Response to Recommendations in the Audit Report on Wisconsin Housing and Economic Development Authority's (WHEDA) New Markets Tax Credit (NMTC) Allocations

Dear Ms. DeAngelis,

At your request, below are the Community Development Financial Institutions Fund's (CDFI Fund) responses to the recommendations listed in the Audit Report on Wisconsin Housing and Economic Development Authority's (WHEDA) New Markets Tax Credit (NMTC) Allocations.

OIG Recommendation 1

Include as part of Allocation Agreement(s) a requirement that CDEs establish and adhere to written policies and procedures governing the selection of entities for NMTC program investments or loans.

Management Response

The CDFI Fund concurs with this recommendation and will implement the requirement in October 2022.

Although this specific requirement is not currently in the Allocation Agreement, the CDFI Fund currently requires Applicants for an NMTC Allocation to describe the following as part of the Allocation Application:

- the roles and responsibilities of key personnel in identifying borrowers or investees and evaluating their ability to remain financially viable and operational for the term of the Qualified Low-Income Community Investment (QLICI);
- how the Applicant will ensure that QLICI proceeds are used to finance the assets for which they are intended, how the Applicant identifies borrowers at greater risk (e.g.,

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risk rating system for a loan portfolio, Qualified Active Low-Income Community Business (QALICB) reporting, etc.), and how the Applicant responds when assets are at greater risk;

- if the Applicant (or Controlling Entity) has written asset management and collection policies and whether it has ever deviated from those policies in the past five years and, if so, why;
- the Applicant's strategy for minimizing defaults and managing delinquencies to mitigate against write-downs or write-offs going forward;
- any delinquent, defaulted, or impaired loans or Equity Investments from prior NMTC investments in the last ten years, including the Applicant's strategies for managing these troubled investments, including any work-out strategies (e.g. restructuring, forbearance agreements, etc.), as well as any administrative changes implemented to minimize future delinquencies and write-offs.

The CDFI Fund evaluates this information, along with data from the Transaction Level Reports submitted by prior Allocatees, as part of its review process prior to making an NMTC Allocation decision.

In addition, the CDFI Fund has added new questions to the CY 2021 Application as result of a public comment process related to the renewal of the Allocation Application under the Paperwork Reduction Act. These questions require additional information from Applicants on the types of due diligence they will conduct to ensure the financial viability of the QALICBs they plan to invest in.

Applicants will be required to describe the due diligence that the Applicant will conduct to determine, prior to making a QLICI, a QALICB's ability to remain financially viable and operational during the term of the QLICI and through a successful exit of the QLICI. Applicants will be required to describe any documents that will be required from borrowers/investees and the types of analysis that will be performed on projected NMTC investments to make this determination.

Applicants will also be required to describe the types of due diligence that the Applicant (or its Controlling Entity) conducted based on its track record of past financing activities (which may not include NMTC investments), including typically required documents from borrowers/investees and the criteria for determining the financial viability of the business.

In order to be evaluated favorably, Applicants are expected to address due diligence activities including but not limited to: 1) financial considerations of the borrower or investee; 2) the likelihood of project completion; 3) management team; and 4) market demand or other economic analysis. The Applicant must also explain how the analyses are documented.

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OIG Recommendation 2

Request that the IRS establish guidance for CDEs to assess reasonable expectation that an entity receiving an investment or loan will satisfy the requirements to be a QALICB throughout the entire investment period.

Management Response

The CDFI Fund concurs with this recommendation.

New Markets Tax Credits are jointly administered by the CDFI Fund and Internal Revenue Service (IRS). The CDFI Fund's responsibilities are specifically related to certifying Community Development Entities (CDEs), administering the competitive Allocation Application process, including compliance related to those matters, and the designation of low-income communities.

The IRS is responsible for issuing tax regulations and monitoring compliance with the tax code and section 45D. Given that the "reasonable expectation" criteria is established in the IRS NMTC regulation, the CDFI Fund does not have the authority to issue guidance interpreting it.

However, the CDFI Fund will request that the IRS establish guidance for CDEs to assess the "reasonable expectation" requirements after publication of this audit report and will work with the IRS to provide input and review any guidance developed by the IRS related to Section 45D.

OIG Recommendation 3

Ensure that deficiencies identified in WHEDA's administration of NMTC allocations are considered as part of the CDFI Fund's future awards.

Management Response

The CDFI Fund concurs, and currently complies, with this recommendation. The NMTC Program currently takes any identified deficiencies into account in its evaluation of past NMTC Allocatees for future allocation awards, including evaluating portfolio quality, financial health of the CDE, asset management, explanation of NMTC delinquencies and charge-offs, and will continue to do so for all Applicants as necessary.

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OIG Recommendation 4

Update the MOU with the IRS to include compliance monitoring of the NMTC program with current processes and systems and language permitting CDFI Fund requests of specific Treas. Reg. §1.45D-1 compliance reviews by the IRS.

Management Response

The CDFI Fund concurs with this recommendation. The CDFI Fund began discussions with representatives from the IRS (Enterprise Activities – Energy and Investment Tax Credit Practice Network) about changes to the Memorandum of Understanding (MOU) in July of 2019. The CDFI Fund last provided draft edits to the MOU to IRS in March 2021 and await response from IRS. Ultimately, however, any changes to the MOU will require IRS concurrence with the proposed revisions.

OIG Recommendation 5

Update the MOU with the IRS to incorporate improved communication strategies for any completed Treas. Reg. §1.45D-1 compliance reviews

Management Response

The CDFI Fund concurs with this recommendation. As mentioned in the Management Response to Recommendation 4, the CDFI Fund is currently engaged with the IRS to update the MOU.

The CDFI Fund's requested revisions to the MOU are aimed at providing structure and timelines around information exchanges. Ultimately, however, any resulting changes to the MOU will require IRS concurrence with the proposed revisions.

The CDFI Fund appreciates all the work of your staff, and the opportunity to review and provide responses to the recommendations in the report. If you have any questions, please contact Denise Noel at 202.653.0351 or noeld@cdfi.treas.gov.

Sincerely,

Jodie L. Harris Digitally signed by Jodie L. Harris Date: 2022.01.21 09:41:32 -05'00'

Jodie L. Harris
Director
CDFI Fund

Lisa DeAngelis, Audit Director
Nick Slonka, Audit Manager
Gerald Kelly, Auditor-In-Charge
Kirk Solomon, Auditor
Ken O'Loughlin, Referencer
Anita Smith, Referencer

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Wisconsin Housing and Economic Development Authority

Executive Director

United States Senate

Committee on Banking, Housing, and Urban Affairs
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United States House of Representatives

Committee on Financial Services
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