

July 19, 2017

TO: Acting State Directors
Rural Development

ATTN: Business Programs Directors

SUBJECT: Treatment of Leasehold Improvements on Publicly-Held Lands

PURPOSE:

The purpose of this unnumbered letter is to provide guidance to State Offices when requesting use of the Administrator's exception authority regarding the treatment of leasehold improvements located on publicly-held land. A significant amount of land across the Nation is owned by governmental or tribal entities, who often lease portions of their property to businesses as a means to promote economic development and provide needed services to their communities. Examples of land with title restrictions include: Tribal Trust Lands and Individual Allotted Trust Lands that are owned by the Federal Government and either held in trust for the use of an Indian Tribe or an individual Native American; land owned by a governmental entity, such as a municipality, Port Authority, or Airport Authority; and land owned by a sovereign territory and located in a State as defined in RD Instruction 4279-A, section 4279.2.

The current treatment of leasehold improvements on tribal or governmental lands has negatively impacted the ability of certain entities to participate in the B&I Guaranteed Loan Program. A regulation change is being proposed that will alleviate this issue. Until that time, the Administrator, on a case-by-case basis, will consider granting an exception under the authority of RD Instruction 4279-A, section 4279.15, to waive the requirements of RD Instruction 4279-B, sections 4279.131(b)(3) and 4279.131(d)(2), that precludes intangible assets from serving as primary collateral and requires tangible balance sheet equity to be determined based upon financial statements prepared in accordance with GAAP. This exception would allow those permanently-affixed assets to be used as primary collateral for a B&I guaranteed loan, discounted in accordance with RD Instruction 4279-B, section 4279.131(b), using the same discount factor as those assets with fee simple ownership. Such permanently-affixed assets will also be considered a tangible asset for calculation of the borrower's minimum tangible balance sheet equity required at loan closing.

EXPIRATION DATE:
July 31, 2018

FILING INSTRUCTIONS:
Community/Business Programs

BACKGROUND:

The Business and Industry (B&I) Guaranteed Loan Program uses Generally Accepted Accounting Principles (GAAP) for the presentation of financial statements. Under the current interpretation of GAAP, leasehold improvements, which are physical enhancements made to property by the lessee, are considered an intangible asset of the lessee. When improvements are made to real property and those improvements are permanently affixed to the property, the title to those improvements automatically transfers to the owner of the property at the end of the lease. The rationale behind this is that improvements, when permanently affixed, are inseparable from the real estate.

In most situations, there is no legal restriction precluding the transfer of privately-held property to the lessee entity that is leasing the property housing its assets. Physical improvements, such as buildings and permanently-affixed equipment, are considered tangible assets in accordance with GAAP if the underlying property is owned by the same entity. However, in certain situations where the underlying property is located on publicly-held lands, the land cannot be legally transferred to private ownership. Therefore, projects located on tribal reservations and trust lands, on land owned by governmental entities, or on land located in sovereign territories have assets that are considered intangible assets, thereby creating a barrier that prevents a borrower from meeting equity and collateral requirements of the B&I Guaranteed Loan Program.

IMPLEMENTATION:

The intangible asset exception can only be considered by the Administrator if the borrower has business assets located on leased land on tribal reservations and trust lands or land owned by a governmental entity or sovereign territory that has legal restrictions that prevent the transfer of ownership of that land during the full term of the loan guaranteed by the Agency under the B&I Guaranteed Loan Program. No exception will be granted for intangible or permanently-affixed assets located on leased property or land that is owned by individuals, non-profit entities, or privately-held entities. To mitigate credit risk to the Agency, the lender will be required to properly secure its lien position in the leasehold improvements, including the ability to transfer the lease and leasehold rights upon any default by the borrower.

State Offices requesting use of the Administrator's exception authority with regard to the treatment of leasehold improvements on publicly-held lands must submit a request in writing from the State Director with supporting documentation. The request must explain the adverse effect on the Federal Government's financial interest and how the exception would be in the best financial interest of the Federal Government, propose alternative courses of action, and explain how the adverse effect will be eliminated or minimized if the exception is granted. Requests for use of the Administrator's exception authority must also include the basic information outlined in the attached document. For loans that are granted an intangible asset exception by the Administrator, the lender must provide certification in accordance with RD Instruction 4279-B,

section 4279.131(d)(3), that the financial statements were prepared in accordance with GAAP, with the exception that the leasehold improvements will be considered tangible assets for the purpose of calculating tangible balance sheet equity. The lender must also certify that it acknowledges the leasehold improvement exception is not in accordance with GAAP standards.

Any exemption from the regulatory requirements will only be considered until the regulation can be changed to equitably treat leasehold improvements located on publicly-held lands.

If you have any questions, please contact the Business and Industry Loan Processing Branch at (202) 690-4103.

/s/ **CHAD PARKER**

CHAD PARKER
Acting Administrator
Rural Business-Cooperative Service

Attachment

Treatment of Leasehold Improvements on Publicly-Held Lands

To request use of the Administrator's exception authority with regard to the treatment of leasehold improvements on publicly-held lands, the State Director must submit a written request stating that the project meets the criteria described in the unnumbered letter for an exception and explaining the adverse effect on the Federal Government's financial interest and how making the exception would be in the best financial interest of the Federal Government, whether any alternative courses of action were considered, and how the adverse effect will be eliminated or minimized if the exception is granted.

All requests for use of the Administrator's exception authority must include the Project Summary and the lender's analysis, along with the current financial statement of the borrower and the pro-forma balance sheet projected for loan closing. Requests must also include detailed information about the following:

- Type(s) of leasehold improvement
- Owner of the underlying land
- Type of tribal or governmental entity
- Basis of land transfer restriction

- Lease expiration date (*with or without options*)
- Whether there is any lease extension options controlled by the lessee

- Fair market value of leasehold collateral
- Discount factor and resulting discounted collateral value of leasehold collateral

- Projected tangible balance sheet equity (TBSE) percentage at loan closing if the leasehold improvement is not considered a tangible asset
- Projected TBSE percentage if the leasehold improvement is considered a tangible asset