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Understanding Tax Credit Unwinds

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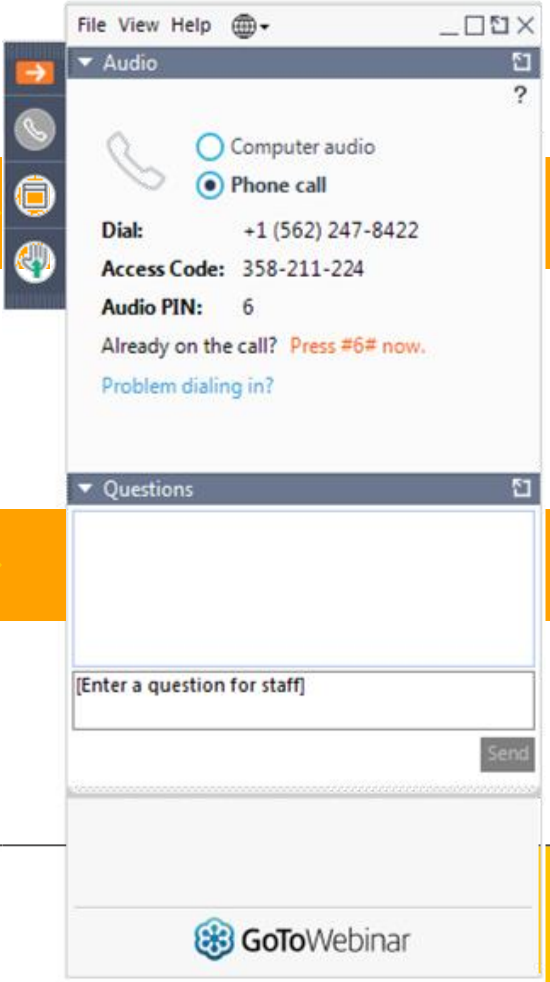
Submit your questions to the panelists here.



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Panelists

Seth Crone, *Moderator*
Vice President of Client & Business Development
The Bank of New York Mellon

Lillian Plata
Co-Founder and Member
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Lillian Plata

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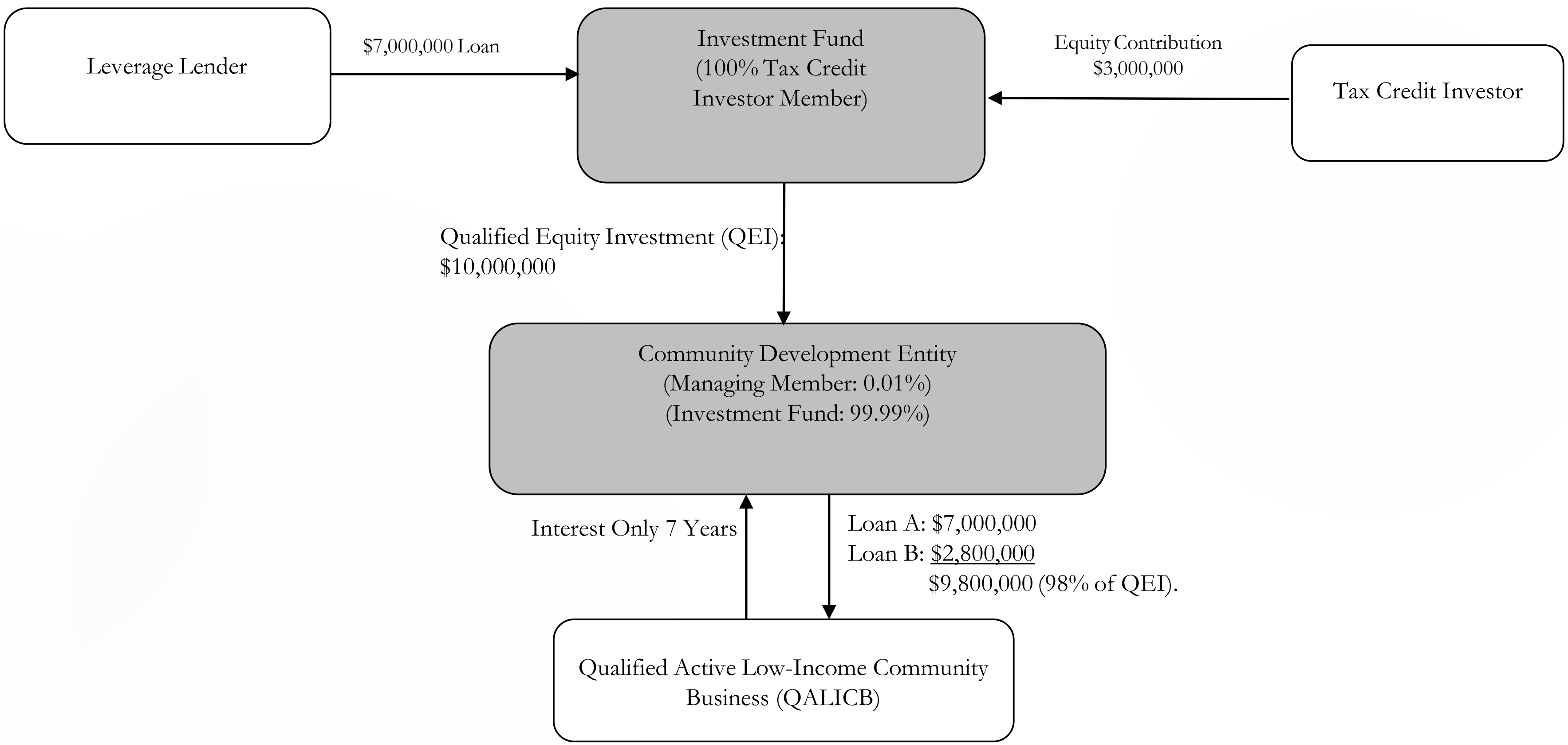
New Markets Tax Credits & Low Income Housing Tax Credit Exit Strategies

By: Lillian A. Plata

Overview - New Markets Tax Credits (NMTC)

- Created by Congress in 2000 to encourage investment in underserved areas – Section 45D
- Project must be in qualified census tract and serve low income community
- Credit is 39% tax credit over 7 year financing-Use of leverage structure most advantageous
- Tax credit investor through an investment fund makes a qualified equity investment **(QEI)** into a community development entity **(CDE)** (designated as such by CDFI Fund) who makes a loan to or investment in a qualified active low-income community business **(QALICB)**
- Loan is long term, 7 years interest only, below market interest rate, flexible terms in DSCR and LTV
- Estimate 15-20% economic advantage over conventional

Basic Leveraged Structure
NMTC Transaction Flow of Funds



What Is the Exit/Unwind?

- Following the end of the 7-year compliance period, when the Investor has claimed all of its NMTCs, the Investor and the CDE will want to unwind the transaction and “Exit” the structure.
- Put/Call Agreement – The structure is exited normally via the exercise of put/call options.
    - May generate a grant or subsidy to the QALICB – the reason the QALICB entered into the transaction
- **Note:** The NMTC subsidy is not tax free in many circumstances where the QALICB is a taxable entity (i.e. a Partnership or Corporation).
    - Non-Profit QALICBs may be able to avoid a tax impact, however, an Unrelated Business Income Tax (UBIT) analysis must be undertaken to determine whether the subsidy is indeed tax-free.

What Happens Following The Compliance Period?

- Investor will put its Interest in the Investment Fund to a QALICB Affiliate.
- The Sub-CDE will then liquidate and distribute the A Note and B Note to the Investment Fund.
- The Investment Fund in turn will assign the A Note to the Leverage Lender in satisfaction of the Leverage Loan.
- Investment Fund liquidates and distributes the B Note to the QALICB Affiliate.
- Note: QALICB Affiliate can be the same entity as the Leverage Lender.

Consequences of the Unwind

- COD income under Section 61(a)(12) constitutes gross income to the debtor.
- Does the distribution of the B Note trigger cancellation of debt (COD) income for the QALICB?
- Questions to ask:
  - Are the QALICB and the QALICB Affiliate considered Related Parties?
  - Was the B Note acquired at a deep discount?
  - Does or will the QALICB qualify for an exception to the realization of COD income?

**Qualified Real Property Business Indebtedness Exception

Strategy for Mitigating Tax Consequences

- Goal – Avoid COD income and mitigate tax consequences.
- May not be able to completely eliminate payment of taxes, but may be able to “kick the can down the road.”
- Options:
  - Put to an affiliate that is not a Related Party to the QALICB to avoid immediate COD. This allows for more flexibility and you can accomplish this by restructuring ownership of the various affiliates.
  - Convert B Note into equity before put is exercised – difficult.

Strategy for Mitigating Tax Consequences Cont'd

- Why putting to an affiliate that is not deemed a Related Party gives more flexibility?
  - Avoids immediate realization of COD income.
  - Can renegotiate the B Note on more favorable terms and differ the COD income to a later date, if any. Drawback is QALICB would continue to pay interest on the B Note.
  - Can convert the B Note into equity after the exercise of the put and structure collapses. Must make sure, however, the interest in the QALICB that the affiliate receives in return is equal to the fair market value of the B Note upon conversion.

Why Think of the Exit Now?

- By structuring the Exit at closing of the NMTC transaction the parties are able to plan ahead to mitigate tax impact.
  - Put to another party that is not considered a Related Party to the QACLIB and avoid the trigger of COD income.
  - Plan to convert the B Note to equity.
  - Change the QALICB to a nonprofit, depending on the goals of the parties.
- In addition, start preparing for the Exit before the end of the Compliance Period:
  - Start planning 6 months to a year prior to Compliance Period ending.
  - QALICB needs to be prepared to refinance and to Exit.
  - QALICB needs to have a contingency plan in the event the investor does not exercise the put and forces the QALICB to exercise its call.
    - Devaluing the price of the Investor Interest to lower the price of the call.

What to do to prepare for the Exit at Closing?

- Need to review the following transaction documents:
  - Put/Call Agreement
  - Investment Fund Operating Agreement
  - Leverage Loan Documents
  - CDE Operating Agreement
  - QLICI Loan Documents
  - Financial Projections – Want to see what the projected value of the call would be if the put is not exercised
- Think about your structure and what is best for you on Exit and discuss possibilities and alternatives with your Tax Counsel.

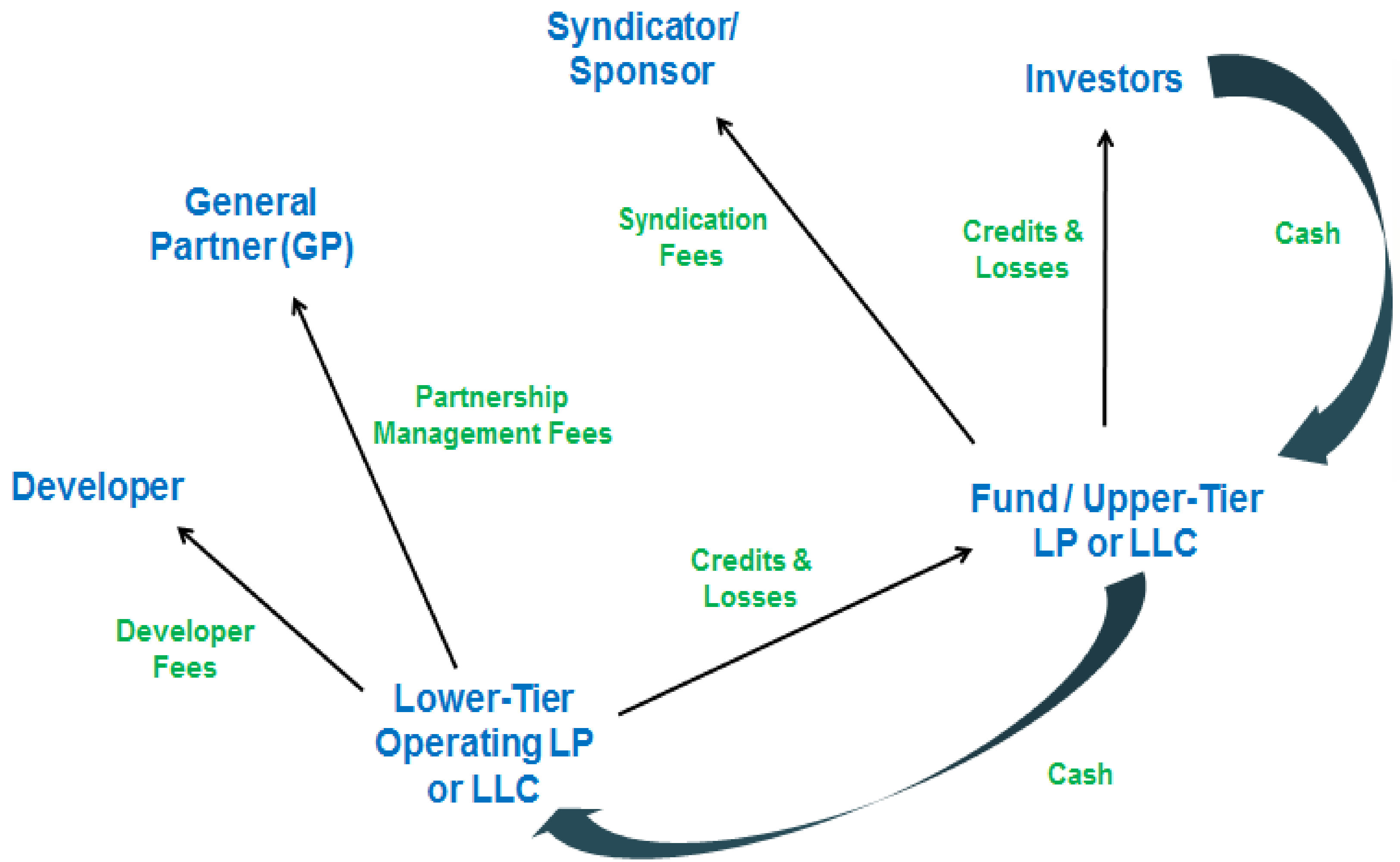
Overview - Low Income Housing Tax Credits (LIHTC)

- 9% competitive credit for new construction and substantial rehab
- 4% credit for acquisition cost or if 50% project costs financed with tax-exempt bonds
- Must be qualified low income housing project meeting either 20% units occupied by persons whose income is 50 percent or less of the area median gross income or 40/60 test
- Multiple IRS regulations/program restrictions for life of bonds
  - Must be residential rental property
- State financing agency is issuing entity and credit allocating agency
- Need to use eligible basis to determine qualified basis (based on low income units)- 4% or 9% is the tax credit rate multiplied against qualified basis to determine initial allocation
- Eligible costs must be depreciable

How Is A Deal Typically Structured?

- Limited Partnership Structure (generally):
  - General partner owns just 0.01%, but controls and operates the project
- Passive limited partner invests equity in return for 99.99% ownership
  - Sale to Investor Limited Partner of most of the tax credits and tax losses maximizes investor equity
  - More investor equity reduces other financing needs and helps project development
  - L.P. is a passive investor, and gets its return almost exclusively from the tax credits and losses

Basic LIHTC Structure
Transaction Flow of Funds



The LIHTC Exit – First Step

- **Know your deal at closing**
  - Current Agreements – Restrictions (CDBG Funds, LPA, Bond Financing etc)
  - When did Compliance Period begin – Multiple Buildings?
- **Evaluate Project up to and at Year 15:**
  - Physical conditions
  - Future uses, if any, of the Project
  - Continuing viability (Market Study)
- **Re-Syndicate**
  - Substantial Rehabilitation Test
  - 10 Year Look Back Rule
  - Anti-churning.

Initiating Exit

Following the end of the Compliance Period:

- Right of First Refusal or Purchase Options
  1. Non-Profits/Government Entities/Public Housing Agencies
  2. For-Profit Sponsors
- Purchase of Investor Partnership Interest
- Sale to a Third Party

Early Preparation

Generally need to review and be familiar with the following documents:

- Limited Partnership Agreement
- Extended Use Agreements
- Existing Loan Documents
- HUD Requirements
- State Housing Agency
- Tax-Exempt Bond Restrictions (4% Deals)
- Purchase Options

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