National Housing & Rehabilitation Association

2017 Annual Meeting & Symposium

February 22-25, 2017

Hyatt Regency Coconut Point

Bonita Springs, FL

Tax Issued Related to Year 15 and Debt Restructuring

I. DEBT MODIFICATION – common desire to modify debt at year 15

A. Reduce Loan Amount or Forgive Payment

B. Extend Term or Defer/Reduce Payments – For example, extend term an additional 15 years to have a new 30-year term in preparation as party of a resyndication

C. Change Interest Rate

D. Change Security – E.g, Nonrecourse → Recourse

E. Change Borrower – Assign Debt to Another Party

F. Change Lender – E.g. soft lender transfers promissory note to Project Sponsor

II. Original Issue Discount ("OID") Rules

A. Citation – IRS Regulation §1.1001-3

B. General Rule – if there is a significant modification of debt, then it is treated as if the modified debt is "new debt" and the "old debt" is exchanged for the new debt.

C. Impact of Rule – if the new debt is deemed to be worth less (have a lesser face amount) than the old debt, then there is **taxable income** equal to the difference in values. The borrower will be deemed to owe the lower amount.

1. Debt Forgiveness, Partial or Complete – Cancellation of Debt ("COD") income equal to the difference between the new debt amount and the old debt amount.
2. Other Changes – If there is a "significant" modification, then the OID Rules will apply and there will be a taxable exchange of the old debt for new debt which may result in taxable income.
3. Interest Rate Is Critical –
    a) **If Rate ≥ AFR, Then No Taxable Income** - Stated face amount of the debt will be respected and the old debt and new debt face amounts will be the same..
    b) **If Rate < AFR, Then Face Amount Restated & Taxable Income** – the loan will have AFR interest imputed to it. The face amount of the promissory note will be reduced to an amount that when combined with AFR is economically equivalent to the old loan.
        i. Because the new debt will have a lower face amount than the old debt, there will be taxable income.

c) Example 1

- $1,000,000 loan with 0% interest
- No payment due until maturity
- Originally had a 30-year term, 15 years left
- Loan is extended 15 years to a new 30-year term
- AFR interest will be imputed – current rate 2.81% annually compounding
- Result

  - Face Amount Deemed to be $431,656 because that amount bearing 2.81% interest for 30 years would equal the $1,000,000 actually owed in 30 years.

  - Taxable Income –

  $1,000,000 - $431,656 = $568,344

D. **<u>Avoid OID Impacts, Use AFR</u>** – when the debt is modified (e.g. loan term extended) increase the interest rate to AFR. The result is no taxable income

1. **<u>Watch Out for Bona Fide Debt Issues</u>** – It is critical that the Project have an ability to repay the debt at maturity. Adding AFR to a balloon loan, especially when combined with other soft debt, has the potential to create a situation where the debt due at maturity would exceed the value of the property.

E. <u>De Minimis Change = No Taxable Income</u> – Modification that are not significant will not trigger an exchange of the debt and there will be no taxable income

1. Small Change In Yield – a change in yield is significant if it exceeds the greater of:
   a) 25 basis points, or
   b) 5% x annual yield
2. <u>Smaller Extensions of Term</u> or Change in Timing of Payment – not significant if change is less than (a) 5 years, and (b) 50% of the term of the debt
3. Change in borrower on nonrecourse debt
4. Change in Collateral for Recourse Loans –Not significant if it doesn't change payment expectations
5. Change in Loan Priority - Not significant if it doesn't change payment expectations
6. Recourse → Nonrecourse - Not significant if it doesn't change payment expectations

7. Change in Borrower - Not significant if it doesn't change payment expectations

III. <u>**Acquisition Credit Issues – often a project will be resyndicated by selling the property to a new LIHTC partnership**</u>

A. <u>OID Scenario</u> – A transfer of a property to a partnership for resyndication is often accompanied with a modification of the debt and assumption of the modified debt.

1. <u>OID Impact</u> – if the loan modification triggers the OID rules, then when the buyer assumes the debt it will assume the lower deemed amount of the debt and **acquisition credit basis will be on the lower amount**

a) Example 2 – same facts as Example 1 where the $1,000,000 loan term was extended 15 years, except that a new partnership is assuming the debt after modification. Buyer will be deemed to have assumed only $431,656 of debt and will get acquisition credits based on $431,656 rather than $1,000,000

2. **Avoid OID Impact by Using AFR** - Increase Interest Rate to AFR

B. <u>Get a Good Appraisal</u> – The General Partner of to the new Partnership is often related in some way to the seller. This undermines the reliability of the sale price as being considered arms' length. As a result, an appraisal of the Project will be required and the selling price cannot exceed the appraisal.

1. <u>Identify Land Value</u> – The appraisal will need to break out the building value vs. land value and the acquisition price will be allocated between land and building. No acquisition credits for land.

C. <u>Account for Transferred Reserves</u> – if the Project is being transferred with reserves, then acquisition credits will be maximized if the sale price equals the appraised value of land and building plus the amount of reserves.

D. <u>Seller Financing</u> – it is very common for related party sales to have the seller provide seller financing.

1. Helpful because acquisition credits are funded from a non-cash source.

2. <u>**Seller Financing Must Carry AFR**</u> – the OID rules will impute AFR and reduce the loan amount if the loan doesn't carry AFR. The lower debt amount would reduce acquisition credits.

a) Set Interest Rate at AFR for month of acquisition.

E. <u>No Placement In Service for Prior 10 years</u> – should not be an issue for most existing LIHTC Projects.

F. Related Party Acquisition Credits Issues – the same parties cannot own more than 50% of both the seller and buyer.

G. No Acquisition Credits For Sales Prior To End of 15-Year Compliance Period

IV. CAPITAL ACCOUNTS & RELATED PARTY DEBT PROBLEMS

A. What Is a Capital Account? Each partner in a partnership receives a capital account. The capital account represents that partners' investment in the partnership. When the partnership liquidates, to the extent there is sufficient proceeds each partner must get back its remaining capital. The capital account is each investors' "piggy bank" for the deal.

B. Changes in Capital Accounts – A partner's capital accounts is increased by capital contributions by that partner and by that partner's share of partnership income. The partner's capital account is decreased by partnership distributions to the partner and by that partner's share of partnership losses.

C. Capital Account Problems – Capital Account problems come in 2 forms

1. **Zero Capital Account** – If a partner's capital account reaches zero, then its ability to be allocated further partnership losses and Credits will be restricted. In such situations, it may only be allocated additional losses and Credits if the partner has (i) a Deficit Restoration Obligation, or (ii) if the partner has sufficient Minimum Gain.

2. **Partner Minimum Gain** – Even if a partner has a positive capital account, if the Partnership is generating "Partner Minimum Gain", then losses and Credits must be allocated to the Partner that is generating the Minimum Gain.

3. **What is Minimum Gain?** – Minimum Gain is the difference between the nonrecourse debt on the Project and the adjusted basis of the Project. To the extent that the debt exceeds the Project's value, there is gain that must be eventually recognized. Even if the partnership gave the property to the lender for nothing, the partnership would be considered to have exchanged the property for the amount of the debt. Because the debt is higher than the property's basis, there will be gain equal to the difference. Because this gain is unavoidable, the IRS will allow a partner to go negative to the extent that it has minimum gain.

4. **Allocation of Minimum Gain –Related Party Debt Issues** – The allocation of Minimum Gain is determined by the nature of the debt. If a partner (or a party related to a partner) bears the risk of loss on the debt, then the debt is allocated to that partner. This is called "Partner Nonrecourse Debt". If no partner bears the risk of loss, then the debt is considered "Partnership Nonrecourse Debt" and can be allocated among the partners through the partnership agreement. The partnership agreement will then allocate 99.99% to the limited partner.

a) **79/21 Cure** – If the Project lender owns less than 80% of a partner in the Partnership, then it will not be considered a related party. This will allow the debt to be treated as Partnership Nonrecourse Debt.

b) **De Minimis Rule** – If the Project lender is a governmental entity (or an entity that regularly engages in the business of lending) and the lenders direct or indirect interest in the partnership is less than 10%, then the debt will be considered unrelated debt.

(1) **Must limit everything below 10%.** This means incentive management fees and residual interests must be capped at less than 10%. General partner fees or any other distributions to partners or related parties must be closely scrutinized.

V. YEAR 15 EXIT STRATEGIES

A. What Are Exit Taxes – If the Investor's capital account is negative, then when it exits the partnership it will have taxable income equal to the negative capital account. That taxable income will created federal and state taxes and is referred to as "exit taxes".

B. **Minimizing Too Small Capital Accounts - Exit Taxes** – Below are methods to minimize exit taxes after the completion of the 10-11 year Credit Period.

1. Year 12 Loss Flips – After the end of the 10-11 year Credit Period, losses can be flipped so that the GP gets 90% of losses and the Investor gets 10% (or 9.99%). This will substantially slow down the Year 12-15 losses to the Investor and help minimize exit taxes. This approach is fairly easy to incorporate as part of the equity closing. Harder to obtain for an operating Project.

2. Early Investor Exit – Exit taxes could be minimized by having the Investor sell its interest to the GP after credits are delivered, but prior to Year 15.

a) No Automatic Recapture – Since the change in law in 2008, there is no automatic recapture from the transfer of the Investor's interest or the building, if it is expected that the Project will continue to comply with the LIHTC restrictions through the 15-year Compliance Period.

b) Recapture Risk Continues – While there is no automatic recapture, if there is a recapture event prior to Year 15, then the Investor will still suffer that recapture even though it has transferred its interest to the GP.

ii. Need Sufficient Indemnities from the GP.

iii. GP Call Right Is Not Common – We don't normally see a GP Option to Buy out the Investor (a call right) prior to year 15. We do sometimes see language that would allow such a purchase with Investor consent. It is hard to predict exactly how the Project will be performing in 12 years and what guarantees the Investor would want before agreeing to be bought out. So it is not common to agree to a binding GP right for an early purchase.

iv. No Statute of Limitations on Recapture – In a strange quirk, the statute of limitation on recapture never runs in the case of an early buyout.

VI. **<u>Managing Too Large Capital Accounts at Year</u>** 15 – The Partnership tax rules provide that in order for allocations of income, losses and credits to be respected, it is required that the capital account rules must be followed. One requirement is that if a partner's interest is liquidated, then they have a right to receive back their remaining positive capital account. If the Investor's capital account is large at Year 15, this capital account requirement can create problems trying to give 90% of back-end to a GP.

A. <u>Issue More Common Now</u> – This issue is much more common now for 3 reasons:

1.<u>The 9% Credit Rate Floor</u> – Has increased the amount of equity a project can receive, resulting in larger Investor capital accounts.

2.<u>Discretionary Basis Boost in 9% Deals</u> – This also allows for more Investor equity.

3.<u>High Credit Pricing</u> – Record Credit pricing has lead to more equity.

B. <u>Section 42 Right of First Refusal</u> – This is the best approach for transactions which involve a qualified nonprofit. Section 42 requires that the price be no less than debt plus exit taxes. However, Investor usually want to see a price equal to **debt + taxes + unpaid adjusters and fees**.

C. GP Purchase Options

1. <u>Sale of Interest vs. Sale of Real Estate</u> – An Investor can be removed from a Project in 2 ways.

a) Sale of Investor's Interest to the GP.

b) <u>Sale of Real Estate to GP</u> – Followed by the Partnership liquidating and sales proceeds being distributed in accordance with positive capital accounts.

c) <u>Which way is better?</u> It is hard to say for certain which result will be preferable in 15 years. Purchase of the Investor interest for FMV may allow for some additional discounts for marketability and lack of control during the appraisal process. Also, a sale of the

real estate may trigger transfer taxes that sometimes are avoided in the sale of a limited partnership interest. How cash will flow through a sale and liquidation is usually hard to predict with certainty upfront because the sale price is not yet known and where capital accounts will be is also not known. Most agreements will include both options, thus giving the GP the flexibility to evaluate options down the road.

2. Minimum Purchase Price = FMV – Regardless of whether the real estate is being purchased or the Investor's partnership interest, the price cannot be less than fair market value. Generally the price is the greater of (i) FMV, or (ii) exit taxes + unpaid adjusters and fees. Because FMV could include appraisal discounts, it is possible that the foregoing price could be less than 10% of proceeds. It can be prudent to include that as a third prong in the "greater of" analysis.

3. Defining Fair Market Value – It is tempting to try and define how FMV will be determined. Determining fair market value is the professional expertise of appraisers. It is best to just say it will be determined by an appraiser.

    a) Making Information Available to the Appraiser – It is okay to state that the GP will provide the appraiser information about the physical needs of the building, use restriction on the building and information about cash flow and sale refinance sharing in the LPA. But one needs to be careful, you can't require the appraiser to account for these items. It is up to the appraiser to evaluate each item and determine if it would impact the price that a willing buyer and willing seller would reach.

    b) Picking Appraiser – One could give the GP some flexibility by letting the GP pick the appraiser. Some investors prefer to have the appraiser be picked with Investor consent or to have each party pick an appraiser and have the appraisers pick a third appraiser. All of these are possible from a strict tax perspective, but upper-tier sensitivities should be evaluated.

    c) Delaying Forced Sale – If the Investor does not have a right to force a sale, or if that right is delayed, that can reduce the FMV of the Investors interest when an appraiser decides whether a lack of control discount should be applied. However, upper-tier investors may not like to delay the forced sale.

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