

LIHTC – Planning for Year 15 From Day One

San Diego Housing Federation Roundtable
Thursday, March 3, 2011

Strategic Consulting Initiative



Presenters

- Amy DeVaudreuil – Attorney
Goldfarb & Lipman LLP
- Jahi Akobundu – Financial Consultant
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Agenda

- The Front-End (What You Should Do)
 - LIHTC Structure
 - Financial Structuring To Achieve Year 15 Objective
 - Managing Capital Accounts and LP Exit Taxes
- The Back-End (What the @#*%!! Did They Do? And What Should You Do Now?)
 - Legal Documents
 - Determine Organizational Objectives
 - Identify Potential Exit Strategies



The Front-End

- “An ounce of prevention is worth a pound of cure.”

Benjamin Franklin



LIHTC Structure

- Limited Partnership
 - Investor (Limited Partner) - 99.99% Ownership
 - Developer (General Partner) - 0.01% Ownership

Investor Benefits of Owning a LIHTC Project

- Tax Credits Over 10 years
- **Losses Over 15 years!!!!***
 - Potentially, Critical Back-End issue for Non-Profit GP.
 - (Since 1990) At end of Year 15, nonprofit developers may acquire property or Investor's interest under Right of First Refusal by assuming project debt and paying LP's Exit taxes .
- **Best Part** – We can manage Losses/Exit Taxes from Day 1.

What are Losses?

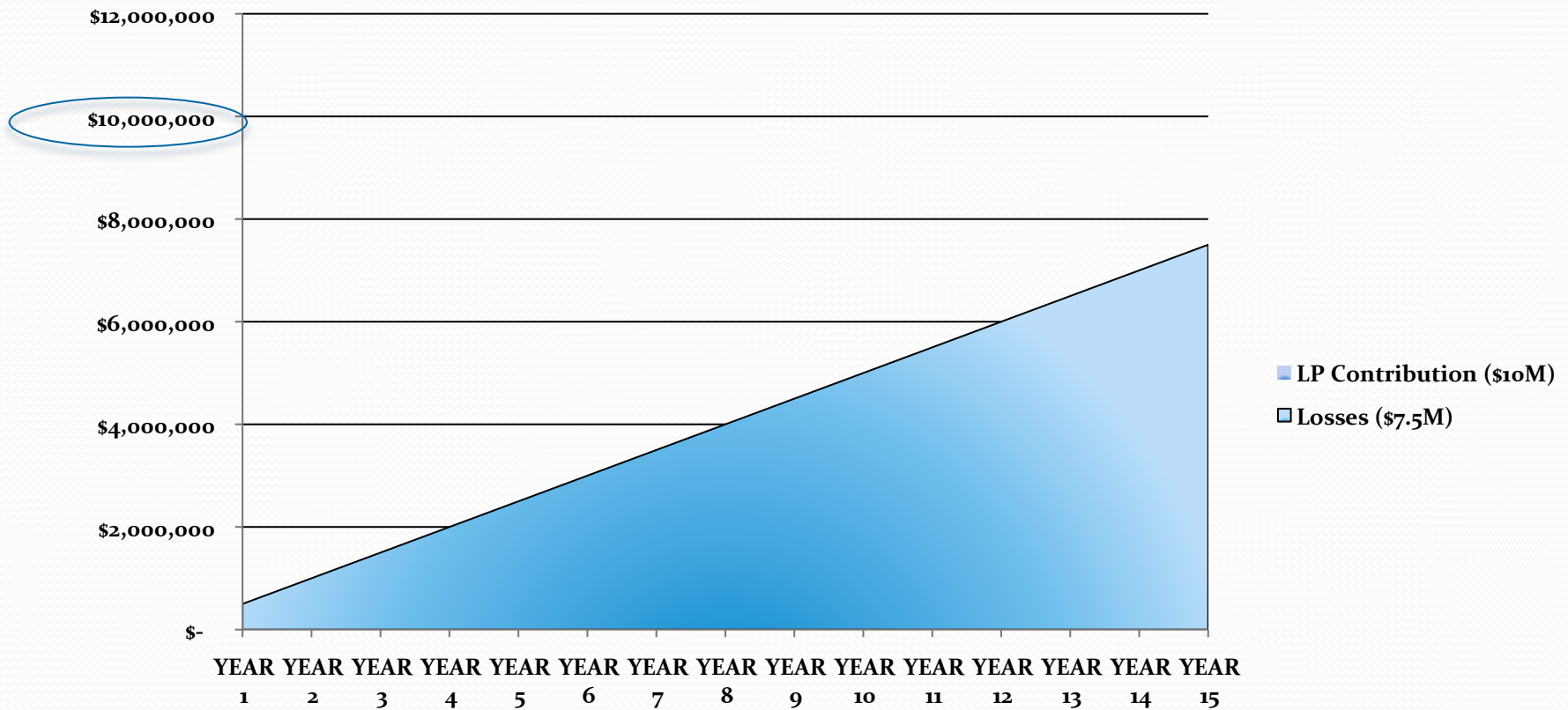
- Net Rental Income
 - Operating Expenses
 - Depreciation
 - Interest (on all debt – accruing or paid)
 - Other Deductions (i.e., GP Management Fee)

= Taxable Income/(Loss)

Investor (LP) Capital Account/ Losses/Exit Taxes

- If, at the end of Year 15:
 - Losses Allocated to Investor (99.99%) > Investor's Total Capital Contribution
 - Negative Capital Account - Investor Realizes Gain and must **pay Exit Taxes.**

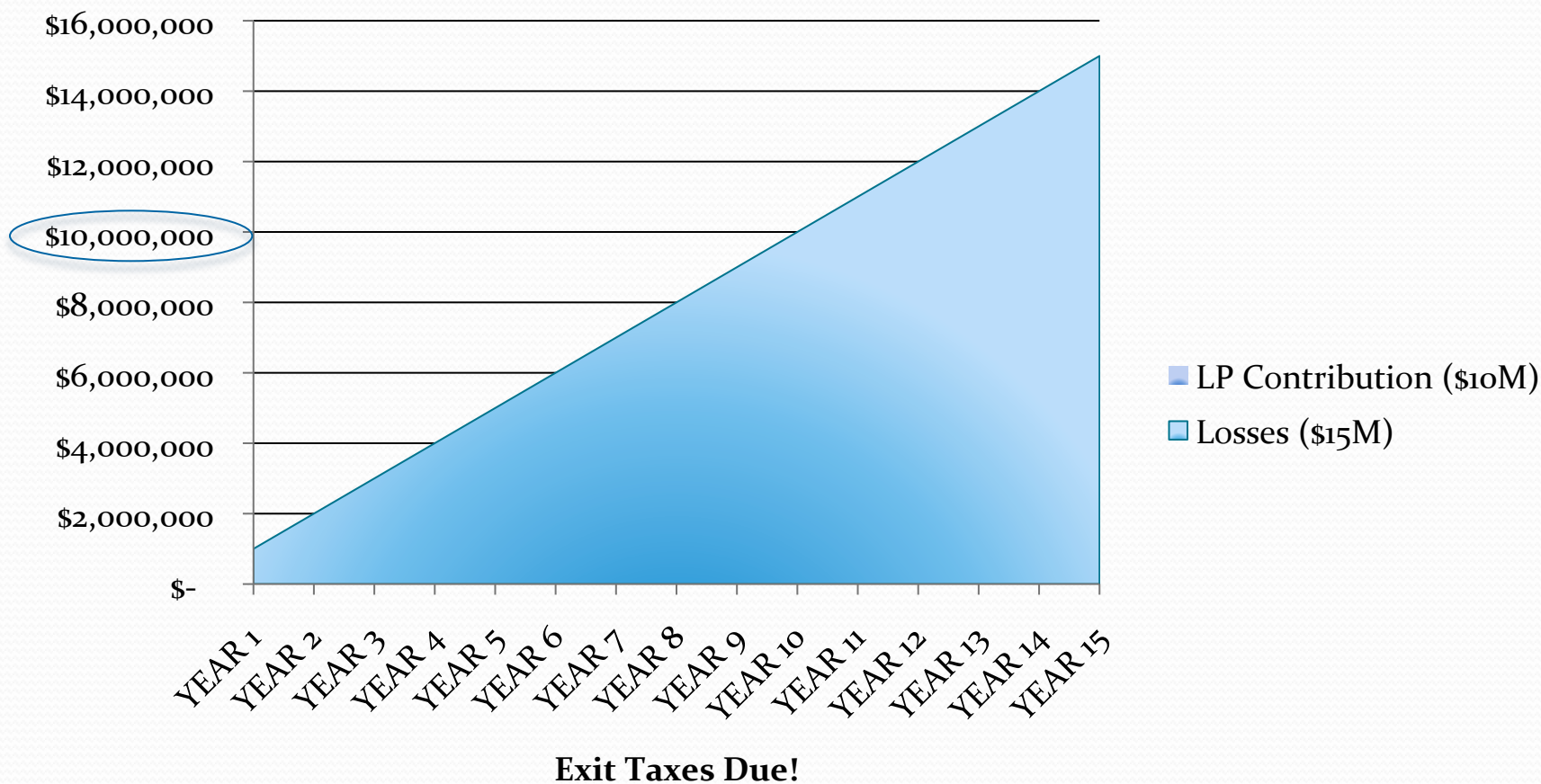
Capital Account Tracking (Ex.1)



No Exit Taxes Due

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Capital Account Tracking (Ex.2)



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When Are We More Likely to See Negative Capital Accounts?

- 4% Tax Credits
 - Smaller LP Capital Contribution than a 9% Transaction.
 - Larger Debts = Larger Losses
 - When tax credit price is low
- 9% Tax Credits
 - Current Environment - Large voluntary exclusion of eligible basis to maximize TCAC Tiebreaker.
 - Larger Debts = Larger Losses
 - When tax credit price is low

Common Strategies to Reduce Exit Taxes

- Slow down Depreciation (i.e., elect 40 years instead of 27.5)
- Ask Public Lenders to reduce the interest rate on their loans.
- Plan to reduce LP's ownership interest after Credit Delivery period (i.e., Year 10) by 1/3.



And Now

- THE BACK-END ...

Low Income Housing Tax Credits Planning for Year 15 From Day One

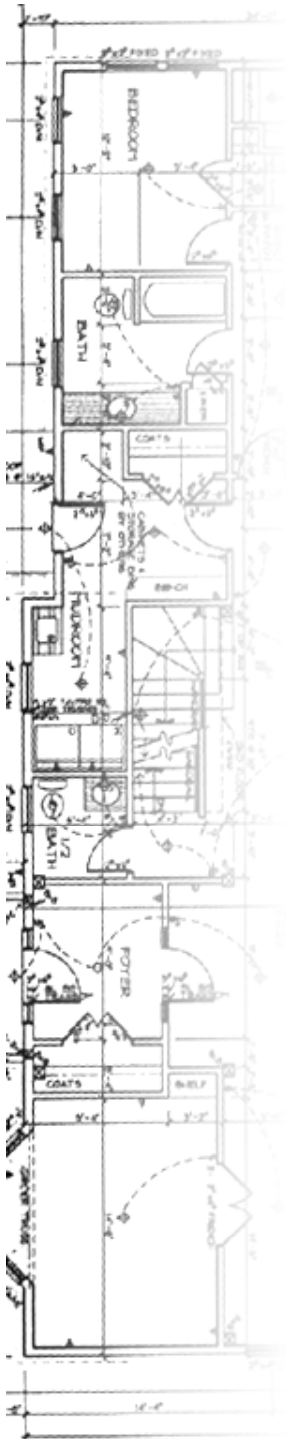
Amy DeVaudreuil - Goldfarb & Lipman LLP

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Three Stages in the Life of a Tax Credit Development

- Deal Structuring
- Operations
- Investor Exit Time



Deal Structuring: Legal Documents

- Limited Partnership Agreement
- Option to Purchase/Right of First Refusal
- Loan Documents
- Reserve Agreements

LPA

- Option/RoFR
- Reserve Requirements
- Capital Account (Projections)
- Cash Flow – Back End



Option to Purchase/RoFR

Price:

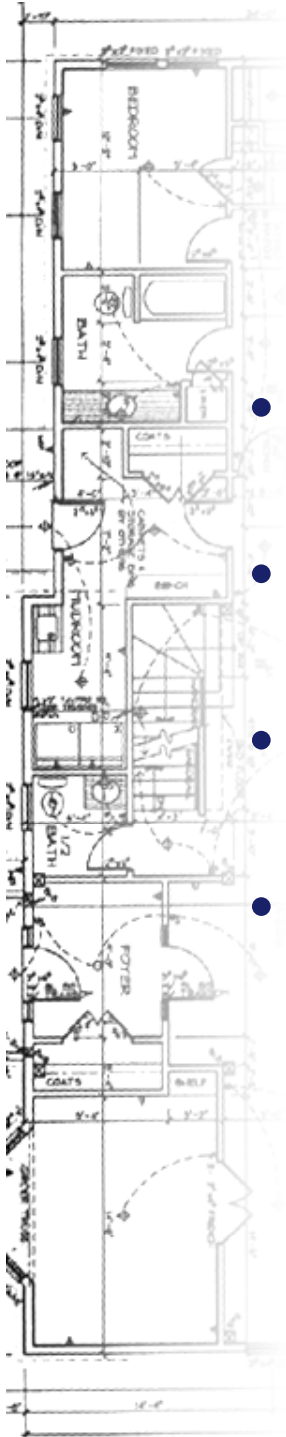
- Greater of:
 - Debt Plus Taxes
 - Fair Market Value

Option Period

- Trigger
- Term
- Notice

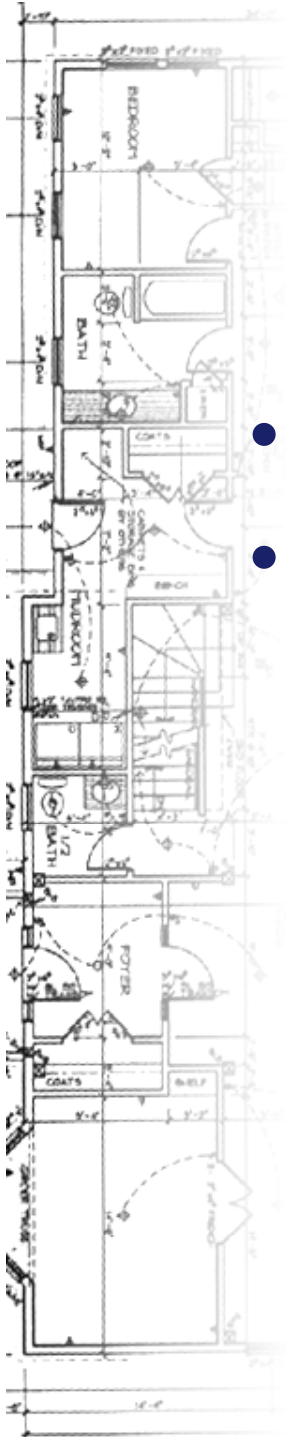
Loan Documents

- Options/RoR
- Notice/Approval
- Side Agreements
- Reserves



Reserve Agreements

- Control
- Release





Operation Stage Issues

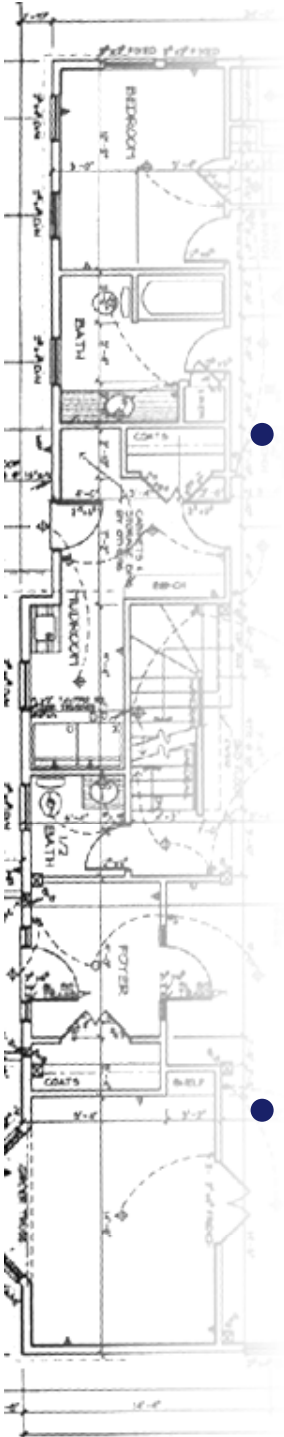
- Rent Levels
- Capital Account Tracking
- Reserve Build-Up
- Maintenance and Repairs
- Managing Exit Taxes
- Plan for Purchase

Rent Levels

- Maximum Increases
 - Hurts Affordability
 - May Reduce Soft Debt
- Meet Costs Only
 - Increases Affordability
 - Soft Debt Accrues of Increases
 - Back End FMV May Increase Based on Higher Potential Income Compared to Current Income
 - Increase Exit Taxes

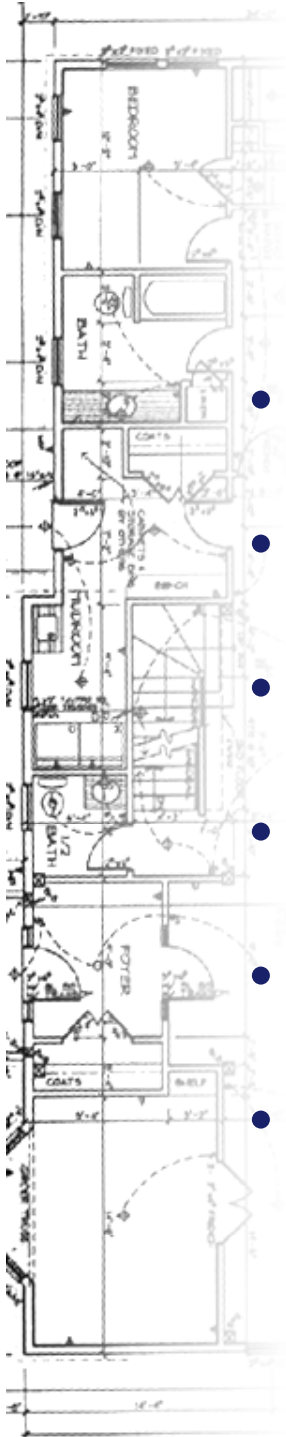
Capital Account Tracking

- Review K-1s
 - Losses
 - Capital Accounts
- Keeping Track for Back End



Reserve Build-Up

- Replacement Reserve
- Operating Deficit Reserve
- Section 8/Rental Assistance Transition Reserve
- Approvals Needed—Additions or Withdrawals
- Effect on Current Losses
- Effect on Back End





Maintenance and Repairs

- Deferral—Effect on Residents, Regulatory Issues and Investor
- Replacement Reserve Often Not Adequate
- Some Regulators Restrict Reserve Use to Detriment of Development
- Deferral—Lowers Back End Value and Increases Needed Rehabilitation Funds After Investor is Gone

Managing Exit Taxes

- Forgive debt—loans and accrued expenses
- Reduce LP interest by 1/3
- Freeze allocation of losses when required by tax code
- Relate qualified non-recourse debt and/or add security to debt
- Capitalize rather than expense repairs
- Improve operations



Plan for Purchase (cont.)

YEARS 13-14:

- Analyze Partnership Debt:
 - Can loans be assumed, forgiven or restructured
 - Lender affordability restrictions
 - Lender approval rights



Plan for Purchase (cont.)

YEAR 13-14:

- Determine Likely Purchase Price
 - Per Option or Right of First Refusal
 - Does the price make sense?
- Explore Sources of Funds to Meet Purchase Price and Capital Needs:
 - Resyndication
 - Refinance: Conventional debt or soft loans
 - Capital infusion
 - Reserves



Plan for Purchase (cont.)

YEARS 14-15:

- Consult with Accountant and Attorney
- Meet with Syndicator, if Resyndicating
- Negotiate Purchase Price
- Sign Letter of Intent
- Obtain Investor and Lender Approvals (if required)
- Draft Legal Agreements

Exercise Of Option

- Notice to Exercise
- Process
 - Appraisal—Method and Selection of Appraiser
 - Years 10-15—Change to Bond Requirement
 - Purchase of Property versus Purchase of Partnership Interests
 - Effect of Soft Debt
 - Effect of Back End Split
 - Treatment of Reserves

Failure to Exercise

- Can Try to Negotiate New Process and Terms
- Is There a Put—Requiring Purchase by GP?
- If Investor Demands Sale—Right of First Refusal



What Happens if One Party Does Not Cooperate?

- Failure to Respond - Appraiser Selection; Acceptance of Appraisal; Setting Price, Terms and Timing
- Duty of Good Faith and Fair Dealing
- Fiduciary Responsibility to Partners
- Remedies—Self-Help and Litigation



Funding Investor Payoff

- Assumption of Debt Only - Additional Funds Not Needed
- Payments Necessary - Exit Taxes or Fair Market Value
 - Saved or Borrowed Funds
 - New Equity - Resyndication

Resyndication

- 10 Year Rule
- Related Party Issue
- TCAC and CDLAC Policies
- Other Public Programs and Policies
- Amount Needed for Repairs or Upgrade
- Sources Available



Financial Issues

- Financial Condition
 - Will cash flow be sufficient to sustain future operations?
 - Are there any anticipated changes in the budget, such as loss of rental subsidies or tax abatements?
 - What are reserve balances and restrictions?
- Physical Condition
 - Are significant capital improvements needed?
 - Is there a current Capital Needs Assessment (CNA)?
- Market Conditions
 - Is the project marketable?
 - Is there competition from other projects?

Financial Issues (cont.)

- Mortgages
 - Are balloon loans or deferred interest payments due at or immediately after Year 15?
 - Does existing debt exceed fair market value?
 - Are lenders flexible with transfer of debt?
 - Can debt be refinanced or forgiven?
 - Are there sources for soft debt?

