VIRGINIA ASSOCIATION OF HOUSING AND COMMUNITY DEVELOPMENT OFFICIALS

LOW INCOME HOUSING TAX CREDIT (LIHTC) EXIT STRATEGIES

Planning for a Smooth Transition

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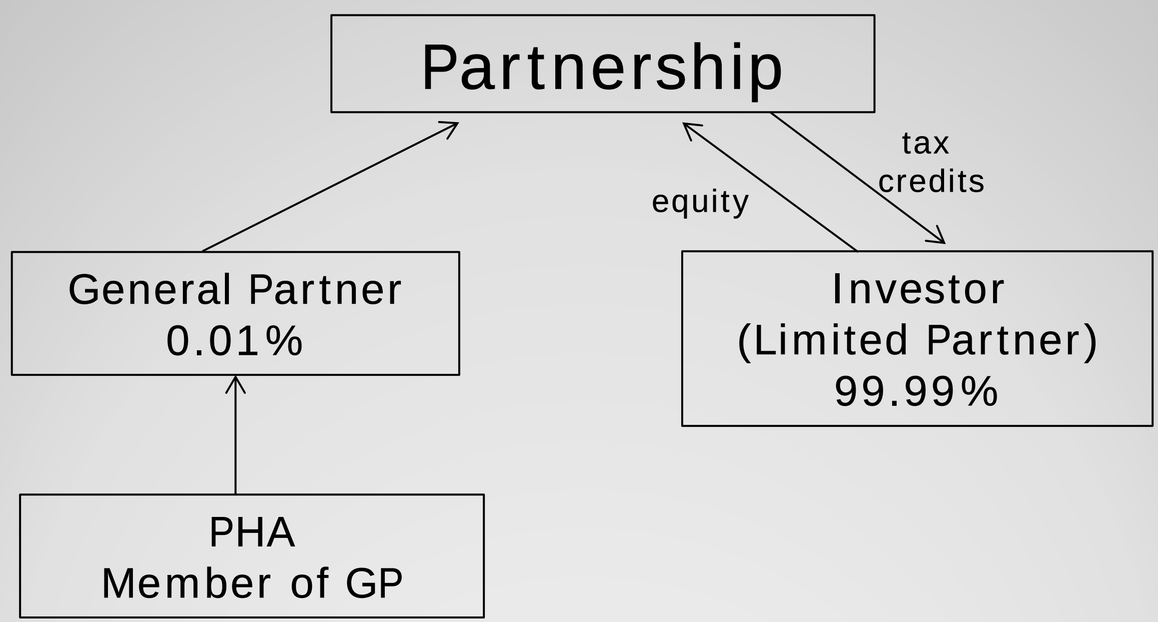
Agenda

- Basic LIHTC Structure
- LIHTC Compliance Period
- Extended Use Period
- Exit Options
- Exit Taxes
- Early Exit
- Sale to Third Party
- Refinancing Options
- Resyndication
- Avoiding Pitfalls

Low-Income Housing Tax Credit ("LIHTC")
Basic Structure



Compliance Period

- Tax credits *earned* over 15-year compliance period (the "Compliance Period") (IRC §42(i)(1))

- Acceleration
  - Tax credits *claimed* over 10 years (IRC §42(f)(1))
    - Attractive to investors
    - Encourages exit after Year 10 and before end of Compliance Period

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Determining the End of the Tax Credit Compliance Period

- Last day of the 15th year since the credits were first claimed (IRC §42 (f)(1))
- Date may differ for different buildings within one project
  - Date building placed in service
  - Date Partnership elects to start claiming tax credits
  - May simplify process by deferring sale until all buildings within project reach the end of their respective compliance periods

Extended Use Period

- Regulatory Agreement with Virginia Housing Development Authority (“VHDA”)
- Requires adherence to LIHTC rules for *at least* 15 years beyond end of Compliance Period
- *Caveat*: If transaction involves 4% LIHTC and Tax Exempt Bonds, same Bond restrictions will continue to apply through extended use period and possibly beyond

Preparation for Exit- Initial Considerations for PHA

- Issues to consider
  - End of tax credit Compliance Period
  - Provisions in existing agreements
  - Purchase Option and Right of First Refusal
  - State of Project
    - Existing debt/Existing Liens
    - Cash flow
    - Physical condition
  - Exit Taxes
  - Exit Options

Existing Agreements

- Right of First Refusal for the PHA or other entity
- Buyout option to purchase investor's partnership interest
- Put Option: Obligation to purchase investor's interest
- Other restrictions in partnership, lender or regulatory agreements that affect exit

Right of First Refusal

- IRC § 42(i)(7)(A): after close of compliance period, project will not lose federal tax benefit with respect to any qualified low-income building by reason of a ROFR held by tenants, management corporation or qualified nonprofit or government agency that purchases the property for a *defined minimum price*

- Minimum price = sum of the principal amount of outstanding indebtedness secured by the building (other than any indebtedness incurred within the five year period ending on the date of the sale to the tenants), plus all federal, state and local taxes attributable to the sale (i.e. exit taxes) (IRC §42(i)(7)(B))

Right of First Refusal

- Provides opportunity to purchase *the property*
- Seen most often in transactions involving 9% LIHTC
  - Extra points awarded for ROFR
- Gives PHA right to purchase the property
- Expensive option for PHA and therefore, rarely exercised
  - Formula price may exceed FMV

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Option to buy investor's interest

- Typically the price is the greater of FMV of investor's interest or unpaid benefits *plus* exit taxes
- FMV of investor's interest = value of the real estate property and benefits to investor if the partnership was liquidated
- Provisions that govern purchase vary depending on prior negotiations with investor
  - Check language in existing documents

State of Project

- Financial Health
  - Current performance and anticipated cash flow
  - Existing debt
  - Capital accounts
  - Fair market value
    - Property
    - Investor's interest
- Physical Condition
  - Extent of rehabilitation needed, if any

Exit Taxes

- Investor's Capital Account is comprised of:
  - Capital Contributions
  - *Less* distributions
  - *Less* taxable losses
  - *Less* Historic Tax Credits (if applicable)
  - *Less* syndication cost

- If investor has a positive capital account, a loss will be recorded as the investment is written off

- If investor has a negative capital account, a gain will be recorded since the benefits exceeded the investment
  - Triggers "exit taxes", i.e. taxable income to the investor
  - Payment of exit taxes by General Partner creates another taxable event

Negative Capital Account

Negative capital account means that the investor's adjusted basis in its partnership interest is less than the investor's share of partnership liabilities.

This can occur for a variety of reasons:

- Underperforming asset: less revenue from property, more losses than expected
- Non-cash deductions: such as accrued but unpaid fees or accrued but unpaid interest
- Low credit price

Management of Exit Taxes

Early planning can reduce exit taxes

- Forgive debt
- Reduce qualified non-recourse debt and/or add security to debt
- Capitalize rather than expense repairs
- Improve operations (reduce vacancies, limit expenses)

Early Exit of Investor

- Exit before Year 15
- Possible after Year 10 because of accelerated credit
- Ongoing compliance required until end of Compliance Period, so investor will require PHA to provide a Recapture Indemnity Bond
- Purchaser may be GP or PHA itself
- Often a better exit option for the PHA than ROFR

Early Exit of Investor- Documentation

- Letter of Intent
- Purchase and Sale Agreement (PSA)
  - Acquiring interest of both Investment Limited Partner and Special Limited Partner
  - Existing debt, if any
  - Purchase price
  - Remaining rights and responsibilities after sale
- Amendment to Limited Partnership Agreement
- Recapture Bond and Indemnity Agreement (required by PSA)

Early Exit of Investor

- Recapture Indemnity Bond
  - Required by Investor to protect against recapture until end of Compliance Period
  - Indemnity Agreement required by surety company before Recapture Indemnity Bond is issued
  - Recapture Indemnity Bond Premium
  - Risk: Not a concern if PHA continues to comply with LIHTC requirements after exit and until end of Compliance Period

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Early Exit of Investor-Post Closing

- Partial year tax return due to "technical termination"
- PHA may recapitalize the property
- PHA must continue to fulfill all LIHTC requirements until end of Compliance Period
- Investor may require certain reports post-exit until end of Compliance Period

Qualified Contracts

- Assistance in finding qualified buyer IRC § 42(h)(6)
- On day 1 of year 15, owner may submit a request to the allocating agency to sell property
- State must locate a buyer at formula purchase price
    - Outstanding debt secured by property
    - *Plus* capital invested adjusted by the Cost of Living Factor up to 5%
    - *Less* distributions and funds available for distribution
- If buyer not found within one year, extended use restrictions are TERMINATED

Sale to Third Party

- Generally at end of Compliance Period (not early exit)
- New owner must comply with requirements of Extended Use Agreement
- Can be with or without resyndication
  - Depends, in part, on availability of tax credits and rehabilitation needs (consider feasibility with 9% and 4% LIHTC)

Sale to Third Party

- Gain/loss to Partnership on sale
- Potential taxable income from depreciation recapture (if the gain on the sale is larger than the property's adjusted cost basis)
- Sale proceeds minus all liabilities will be available for distribution to partners (see LPA)
- Debt secured by the property needs to be paid first
- To facilitate sale to third party, soft lenders (such as a PHA) may agree to write down their loans (but that can trigger taxable income to the partnership)
- Consider also accrued but unpaid fees payable to related parties

Refinancing Options

- Availability and applicable interest rate of new debt, if needed
- Refinancing with state or federal housing agencies (HUD approved lenders)
- Restructure debt
- Refinancing/restructuring may provide funds to pay withdrawing investor, fund capital improvements, and /or pay deferred developer fee

Resyndication

- At end of Compliance Period, property may be sold and resyndicated with a new allocation of tax credits
- Consider financing options (9% LIHTC, 4% LIHTC and tax-exempt bonds). Resyndication often involves 4% LIHTC, i.e. tax credit equity may only make up one third of your capital stack and you will likely need soft debt
- Good option if the property needs rehabilitation
    - Minimum rehabilitation requirements in Virginia:
        - For 9% LIHTC: $15,000 minimum contractor construction rehab expenditures, on average, per unit to qualify
        - For 4% LIHTC: $10,000 minimum contractor construction rehab expenditures, on average, per unit to qualify

Resyndication

- Must comply with 10 year Look-back Rule
  - 10 years must have passed since the building was last placed in service
  - Exception for non-profit buyer or projects substantially financed, assisted or operated under HUD, USDA or state programs

- With 9% LIHTC, dependent on successful application for credits

- Even with non-competitive 4% LIHTC and tax-exempt bonds, transaction may take longer to close than standard sale to a third party because of complexity

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Avoiding Pitfalls

- Early preparation
  - Review applicable documents, including Extended Use Agreement
  - Be familiar with any special requirements/limitations
    - LPA
    - ROFR
    - Existing loan documents
    - Purchase options
    - Bond restrictions (4%)
    - Extended Use Agreement

Avoiding Pitfalls

- Careful assessment of state of project
  - Financial health of the project
  - Rehabilitation needs
- Consider all sale and refinancing options
  - Which is most feasible
  - Which ensures project viability
- Consult (early and often!) with CPAs, attorneys and the investor

Disclaimer

Please be advised that the specific circumstances of each LIHTC transaction will vary. This PowerPoint overview of potential LIHTC exit strategies is not meant to capture all potential exit scenarios or to dictate the best practice in any particular transaction or situation. Additional issues may exist outside the limited scope of any examples provided in this PowerPoint presentation. Individuals or entities contemplating structuring the exit strategy, or any other aspect of, a LIHTC transaction should seek advice from their tax advisors or accountants based on their individual circumstances.

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