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Exit Strategies for Low-Income Housing Tax Credit Projects

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As low-income housing tax credit (LIHTC) projects reach the last year of the mandatory 15-year compliance period, owners and investors face the challenge of defining exit strategies for their investments. In addition, many other LIHTC properties are having difficulties generating positive cash flow or significant tax benefits for their investors – either because of complications in the property's operations or because of the global economic downturn. Owners and investors in these properties may seek a change via some form of refinancing or restructuring, including getting a fresh allocation of tax credits, and there are several important steps that should be considered.

Evaluate the State of Your Project

Planning an exit strategy can be complicated and stressful, especially if it is not planned well in advance of year 15. For owners and investors, the first important step is to evaluate the state of the property.

There are a number of factors in evaluating the financial health of a property. First, assess the current fair value the property as well as a realistic cash flow the project can be expected to generate. Once these are known, the fair value of the owners' interests can be determined, and cost effective decisions be made.

Next, review the regulatory agreements – or any other agreement with a state agency and/or local government – to determine if there are restrictions on operations or refinance. Also, check if any state or local requirements apply to the property. Often, property owners have agreed to extended

compliance requirements as a condition of getting their LIHTCs or bonds. For example, in California many properties with a tax credit allocation in 1990 and later elected to extend the low-income use restrictions for 55 years to gain additional points during the application scoring process.

Define Your Exit Strategy

Troubled properties, or properties reaching the end of the 15-year compliance period, have various options and opportunities for refinance, recapitalization or resyndication. Aside from a straight refinance of the property, consider refinance opportunities with state or local housing finance agencies and federal government agencies, including the U.S. Department of Housing and Urban Development (HUD). In addition, HUD-approved lenders can help facilitate the purchase or refinancing of existing multifamily rental housing projects using HUD-insured loans. Also worth mentioning is the LIHTC credit exchange program under Section 1602 of the American Recovery and Reinvestment Act of 2009, which allows states to exchange a portion of their 2009 allocation for cash grants to be used to finance housing projects. There are proposals under consideration in Congress to extend the exchange program through 2010.

Alternatively, consider selling the property to a new developer, who could renovate the property with new debt and new investors. The new owners will receive a depreciation benefit based on their new purchase price and may also qualify for a low-income housing tax credit allocation if the property is rehabilitated.

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A like-kind exchange under Section 1031 might also be an exit strategy, albeit not a common one because of the difficulty in finding a matching property. That said, in recent years, some successful like-kind exchange practices have occurred between affordable housing properties and investment grade credit-tenant lease commercial properties. This type of like-kind exchange is ideal for older projects that have completed the required compliance period and have large negative capital accounts and low basis.

Because of the complicated nature of a sale or like-kind exchange, some owners and investors may prefer to get out of the deal more quickly by simply transferring their ownership to the other owners of the property. Sometimes, when the current partners do not get along well, the investor limited partner or the general partner in a transaction may want to buy out the others to become the sole owner, or to bring in new partners.

Manage the GAAP and Tax Matters

When the ownership of a property is changed, either partially or entirely, certain general accepted accounting principles (GAAP) and tax rules will apply. The complexity of the accounting depends on the status and circumstances of the project, owner and investor. Assuming the ownership entity of the transaction is a partnership or limited liability company, which are the most common legal structures for LIHTC projects, the basic GAAP and tax rules are as follows.

If the property is sold to a new developer and the partnership is dissolved, the partnership should first record an accounting entry to reflect the sale to bring the asset and liability accounts, including accumulated depreciation, to zero. If the consideration received exceeds the net assets on the books, the difference will be the gain from sale; or a loss if the net assets sold exceed the consideration received. The partnership then allocates the gain or loss to the partners based on the profit and loss sharing percentages specified in the partnership agreement. When the partnership is liquidated, cash is distributed to the partners in accordance with the provisions in the partnership agreement.

The partnership is required to file its final tax return and final Schedule K-1 form for its partners no later than three and a half months after dissolving the partnership. If the partnership sold the property on April 1, but waited until December 1 to make the final distribution, the three-and-a-half month period starts in December. The gain or loss from the sale of property is reported on Form 4797. Remember that the tax gain will usually differ from the GAAP gain due to differing depreciation methods used over the years. These gain or losses then will be allocated to each partner. Each partner recognizes gain on its own tax return if the distribution made in liquidation to that partner is greater than the adjusted basis of its interest in the partnership; and conversely recognizes loss if the distribution is less than the adjusted basis of its interest in the partnership.

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In the situation described earlier, in which a partnership does not sell the property but instead a partner elects to transfer its interest to another partner or to a third party, there is no accounting related to selling the property since the same partnership continues to own the property. When there is a change of a majority of partners' interest, for tax purposes the partnership is treated as terminating, followed immediately by the formation of a new partnership with the same name. For GAAP purposes, however, the partnership operations continue uninterrupted by the partner change. Thus, for GAAP purposes, all the partnership is required to do is establish an equity account for the new partner and reduce the old partner's equity account to zero, regardless of the cash payments made between these partners.

As described above, if more than 50 percent of the partnership interest is transferred through a sale or exchange, the section 708(b)(1)(B) technical termination rules apply. The partnership would then file a final return and final Schedule K-1 forms for its partners as of the date the transfer occurs, and also file an initial return for the period from the date of the transfer to the end of tax year. That is, two short period returns for the tax year are required. Generally, the transferor partner recognizes capital gain or loss for the difference between his adjusted basis of the partnership interest and the payment he receives. The transferee partner assumes the transferor partner's basis of the partnership interest, which may be different from the amount he paid (an "inside/outside basis difference") unless a section 754 election is made to adjust the basis of partnership assets to reflect the price paid by the new partner for its partnership interest. The election is made by filing a statement with the partnership's tax return. It is important to make this election for the transferee partner if the payment he made (outside basis) is higher than the basis of the partnership interest he purchased (inside basis). The adjustment would allow the new partner to take a depreciation deduction of the step-up assets, and a reduced tax liability on gain if the step-up asset is sold subsequent to the transfer of partnership interest.

Conclusion

As this discussion illustrates, the multiple layers of both accounting and tax concerns related to a given exit strategy from a LIHTC project can be quite complicated. To ensure complete compliance with GAAP and Internal Revenue Service requirements, consulting with an experienced tax advisor and proceeding with a good deal of caution and care are highly recommended. ❖



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