

Tax Issues With an Insolvent or Bankruptcy QALCIB

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This is the second of two articles addressing issues faced by a community development entity (CDE) and tax credit investor in managing a troubled qualified low-income community investment (QLICI). This article will focus on several technical tax issues that arise under the new markets tax credit (NMTC) statute or regulations, particularly in connection with a deeply insolvent or bankrupt qualified active low-income community business (QALCIB) borrower.

OID and CDE Distributions

If the project can be restructured, the CDE and QALCIB might work out a modification of the QLICI loan, perhaps allowing for interest accrual, cash-flow payments, principal reduction or other changes intended to allow the property to remain operational and meet its debt service obligations. If the modifications are significant, the revised QLICI loan will constitute a new debt instrument for tax purposes, and the CDE and QALCIB will be treated as engaging in a taxable exchange of the original instrument for this revised debt instrument. The CDE, as lender, generally would have gain or loss based on the difference between its basis in the QLICI loan and the adjusted issue price of the new debt.

The CDE needs to consider whether the revised debt instrument carries an original issue discount (OID), and the potential effect of such OID. The instrument will carry OID if it provides for interest payments other than interest payable in all events at least annually, including payments that are limited to available cash flow. The revised instrument will also carry OID if it provides for interest at a rate below the applicable federal rate (AFR) in effect at the time of the modification.

In that event, a portion of the stated principal amount of the new instrument will be recharacterized as interest. When originally issued, a QLICI need not provide for interest at the AFR because the instrument is issued for cash. However, upon a deemed exchange resulting from a modification, the new instrument is treated as issued in exchange for property (the old instrument), triggering the rules of Section 1274 of the Internal Revenue Code (IRC), and must carry adequate stated interest.

The OID rules require that interest be accrued on a constant yield to maturity method, regardless of the timing of cash payments. Thus, there may be a difference between the interest income to the CDE each year and the cash interest payments. As unpaid interest accrues, interest income will exceed interest payments. As deferred payments are made, interest payments exceed interest income.

This could lead to unexpected results under the "operating income" safe harbor test for avoiding redemptions. Because the current safe harbor regulations look solely to operating income in the year of a distribution by the CDE, a CDE may not be able to distribute under the safe harbor all of the cash available for a particular year, despite that it represents the receipt of interest income taken into account by the CDE in a prior year. Proposed regulations address the OID concern to some extent by allowing distributions to the extent operating income for the current year, and undistributed income for the prior year. A look back of one year may not be sufficient.

It is also possible to issue an instrument that has a mismatch of cash and OID income such that purported interest payments early in the term of the instrument

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exceed OID income. For example, an instrument with declining interest payments might have this result, and might create distribution problems even under the proposed regulations. Such an instrument might also create reinvestment issues by causing a portion of the purported interest payments to the CDE to be recharacterized as a return of principal. However, such an instrument is less likely to be issued in a restructuring.

Basis Reduction Where the QLICI is Worthless

The NMTC rules require that the taxpayer reduce its basis in a qualified equity investment (QEI) by the amount of the NMTC available with respect to the QEI. However, the basis reduction is not taken up front, but rather occurs on each credit allowance date.

If a QALICB goes into bankruptcy, or is otherwise insolvent, the QLICI may at some point become worthless. In the year the QLICI becomes worthless, the CDE has a taxable loss equal to the full amount of its basis in the QLICI. The mere filing of a bankruptcy will

not necessarily trigger worthlessness, but the entering of a bankruptcy plan allowing for no payment to the CDE with respect to the QLICI would likely create a worthlessness deduction. Outside of bankruptcy, a deeply insolvent QALICB might give rise to a worthlessness deduction for the CDE.

If the QLICI is not wholly worthless, the CDE may nevertheless receive only a fraction of its original investment in satisfaction of the QLICI. A bankruptcy plan may provide for payment of pennies on the dollar, or may provide for an exchange of a QLICI debt instrument for equity of little value. A similar fractional payment or equity exchange may occur in a workout outside of bankruptcy. In either of these situations (assuming the exchange is not a non-taxable reorganization), the CDE may be allowed a taxable loss for the difference between its basis in the QLICI and the value of the consideration received in the exchange.

Any deduction allowable to the CDE will primarily flow up to the investor and, under the partnership

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rules, reduce the investor's basis in its QEI. A deduction for worthlessness, by its nature, will eliminate the investor's entire remaining basis in the QEI. In fact, the deduction may exceed the investor's remaining basis.

For example, assume an investor makes a \$100 QEI for a 99.9 percent interest in a CDE, and the CDE makes a \$95 QLICI providing for payments of interest only during the NMTC compliance period. After the first two NMTC allowance dates, the investor's basis in the QEI will be reduced to \$90 (a \$5 reduction on each of the first two allowance dates). If the CDE then writes off the \$95 QLICI as worthless, a deduction of \$95 will be allocable 99.9 percent to the investor. This deduction will be allowed to the investor to the extent of the remaining \$90 basis, reducing basis to zero, and the excess will be suspended at the CDE level under the partnership rules.

A deduction arising out of a fractional payment or other workout that triggers a substantial loss, even if not a complete write-off, could also reduce the investor's basis in the QEI to an amount less than the remaining NMTCs to be taken by the investor. If the investor's basis is wiped out by a worthlessness deduction, or a loss on a partial payment or exchange, the question arises as to what effect, if any, that has on the investor's ability to take the remaining NMTCs as the allowance dates arise.

Can the investor take the NMTCs if it has no basis in its QEI to reduce as required? Neither the statute nor the regulations provide an answer, but the statute does not specifically condition the availability of the NMTC on having basis to reduce. Absent such a specific condition, it is unlikely that one can be imposed administratively. The regulations specifically provide that neither the nonpayment of the QLICI, nor the bankruptcy of the QALICB, impairs the ability of the investor to report the tax credits. Congress intended that the NMTC should not be recaptured or lost by reason of the economic failure of the QALICB. Reading a condition into the statute that would effectively prevent taking the credit where a QLICI has become worthless clearly would frustrate congressional intent and defeat in part the purpose of the statute of encouraging risky investments.

On the other hand, the analysis can't end there.

The various investment tax credits (such as the energy credit and the historic rehabilitation credit) also require a basis reduction when the tax credit is taken. For that reason, they may be referred to as "taxable credits," in that the loss of basis effectively requires that the tax credit investor eventually recognize income (or less loss) in the amount of the credit. However, the problem of having no basis to reduce does not arise in the context of investment tax credits (ITC), because the ITC is taken and basis is reduced at the time that the property that gives rise to the credit is first placed in service.

Like the ITC, the NMTC is intended to constitute a taxable credit. However, the taxable effect of the NMTC could be at least partially negated by a worthlessness deduction. To illustrate, in our example above of a \$100 QEI and a \$95 QLICI, the investor should, during the life of the investment (ignoring any residual cash), be entitled to \$39 of NMTCs and \$61 of overall net losses. However, where the QLICI becomes worthless after two NMTC allowance dates, the investor would take a worthlessness deduction of \$90 without loss of its credits of \$39, thereby receiving a greater after-tax benefit than if the QLICI had not failed.

If the workout is occurring later in the compliance period, the CDE may be able to defer the consequences until after the final NMTC allowance date. However, once a loss is triggered, either by worthlessness or a taxable cancellation or exchange of the QLICI, the loss is not optional or elective, and the basis reduction happens automatically under the partnership rules.

There are at least two strategies that can be used to avoid the basis issue and achieve a result comparable to a QLICI that does not become worthless. First, the investor could make a capital contribution to the CDE prior to each NMTC allowance date, and later distribute the funds. The contribution would increase the investor's basis in the QEI, which would then be decreased by the NMTC amount. The distribution of the contributed amount back to the investor, after reduction of the QEI basis back to zero, would trigger income. This approach raises some difficult practical issues if the money is retained in the CDE for any length of time, and seems rather superficial if not retained in the CDE.

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Alternatively, a corporate investor might sell the QEI to a consolidated affiliate for consideration equal to the remaining tax credit amounts, triggering the inter-company transaction rules. Under those rules, the buying affiliate should get a stepped-up basis in the QEI, and the selling affiliate would recognize income equal to the basis reduction the buying affiliate is required to take on each NMTC allowance date.

Absent a technical work-around, a couple of approaches might be appropriate to preserve the “taxable” nature of the credit. The investor might report income to the extent that the NMTC taken on any allowance date exceeds the basis available for reduction. This is the simplest approach. Alternatively, the investor might “preserve” partnership basis to the extent of unclaimed NMTCs by treating such basis as already reduced for the purpose of the partnership loss rules. However, this latter approach seems inconsistent with the regulations requiring basis reduction on each allowance date. At any rate, neither of these approaches is specifically authorized by the IRC or regulations, and the investor cannot be sure what approach it should take in filing returns. As written, the IRC and regulations allow the NMTCs to be taken without any income or loss adjustment arising from the lack of basis in the QEI.

Constructive Liquidation

In the situation where a CDE completely cancels a QLICI as uncollectable, or a QALICB undergoes a bankruptcy in which no payment is provided for the QLICI, the CDE will be left with no remaining assets or activities (other than compliance reporting). Under general tax principles, an entity that completely winds up its business activities could be viewed as having constructively liquidated. The question then is whether such a constructive liquidation theory, if applied to the CDE, could result in a recapture of the tax credits under the prohibition against redemptions of the QEI.

The use of a constructive liquidation to trigger a recapture would be contrary to the intent of the NMTC. As mentioned, the NMTC investor was not meant to be penalized by an economic failure of the investment; in fact, regulations provide specifically that the bankruptcy of the QALICB is not a recapture event. If the bankruptcy does not trigger recapture, the natural consequences of a bankruptcy (i.e., the tax loss on the CDE’s investment) should not be deemed trigger recapture.

Arguably, a CDE would not meet the standards for constructive liquidation if it is required to maintain records and compliance reporting for the remaining compliance period, since it would be engaging in some sort residual activity required by its prior business. On the other hand, if the Community Development Financial Institutions (CDFI) Fund agrees to allow the CDE to cease reporting for the remaining compliance period, the CDE may truly have no remaining activities. More technically, however, the IRC and regulations require a recapture where the QEI is “redeemed or otherwise cashed out” by the CDE. Arguably, even if the CDE meets the case law standards for having undergone a “constructive liquidation,” that should not be treated as a redemption or “cash out” of the investor if the CDE has no distributable cash or property.

The CDE and tax credit investor must consider carefully both the practical and technical implications of any steps taken in the case of a troubled loan or insolvent QALICB. ❖

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