LIHTC MONTHLY REPORT

A MONTHLY PUBLICATION OFFERING NEWS, OPINION, FEATURES AND COMMENTARY ON THE LOW-INCOME HOUSING TAX CREDIT INDUSTRY

June 2006, Volume XVII, Issue VI, Published By Novogradac & Company LLP

Year 15: Are You Ready?

By Lindsay Weiford, Staff Writer, Novogradac & Company LLP

As the compliance period for some low-income housing tax credit (LIHTC) projects expires, it is important for those involved in LIHTC partnerships to be prepared for Year 15. According to experts who have survived the Year 15 process, working with a sponsor of year 15 project transactions, examining previous Year 15 transactions and understanding the options available will help ensure that these projects are preserved as affordable housing.

During a web cast on May 10, hosted by Local Initiatives Support Corporation (LISC), a representative of the National Equity Fund (NEF) Inc., a sponsor of Year 15 project transactions, as well as experts from Twin Cities Housing Development Corp. and Capital Hill Housing Improvement Program offered suggestions on ensuring that those involved in the transaction are ready for Year 15. These suggestions included calculating the compliance period, understanding the qualified contract, the right of first refusal and exit strategies options, determining the payment of exit taxes, and discovering ways to preserve Year 15 projects as affordable housing.

NEF reports that, to date, 60 projects have been sold or approved for sale by its disposition committee. Of those, 87 percent are rollovers that assume existing debt and continue operations; 10 percent are re-syndications; and 3 percent are converting to market rate.

Exit Strategies

When the compliance period ends, there are various acquisition or transfer possibilities available to the partnership. Judy Schneider, senior vice president and chief underwriter at NEF, listed the following possibilities:

- **Transfer the real estate.** The right-of-first-refusal granted to not-for-profits in most cases pertains to the sale of the real estate itself. In this option, the limited partner(s), also referred to as the investor, can also sell their interest to the general partner or an affiliate of the general partner. Most dispositions are sales of the limited partner interests. Schneider told the audience that in NEF's experience, the deals in which the sponsor will continue operations have all been transfers of limited partner interests. The benefits of a sponsor acquiring interest include no real estate transaction and no cost involved in the transaction, the original limited partnership remains. The general partner and owns both the general partner and limited partner interests and continues to service the debt.
- **Rehabilitating through re-syndication or refinancing.** In the case of re-syndication, only 10 percent of the transactions NEF has sponsored have used re-syndication as an option. However, the overall industry has a much higher re-syndication rate, nearly 50 percent. Re-syndication can occur only if there is a minimum rehabilitation of $3,000 per unit. Some investors and some state agencies require higher minimum amounts. The re-syndication must be structured to generate acquisition credit or there may not be enough tax credit equity. The downside of re-syndication is that it depends on the availability of tax credits and the application process.
- **Homeownership in the form of lease-purchase deals.** Schneider notes that a large concentration of lease-purchase deals are being done in Ohio. The majority of these transactions were planned from the beginning as lease-purchase deals, but there are some situations in which the option of lease-purchase was not contemplated at the beginning and some of the units remain low-income affordable housing rental units and the remaining units converted to condominiums.

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- **Selling to a third party when the sponsor does not intend to stay in the deal.** In this strategy, the project can remain affordable, with restructuring/withdrawal by the investor(s). Refinancing/debt restructuring lowers debt service and may provide funds to pay the withdrawing investor(s) and or fund capital improvements.
- **Convert the project to market rate.** This exit strategy is less likely with a post-1989 transaction due to the 15 year extended use period and the right-of-first refusal.

Exit Taxes

Exit taxes occur when the losses of the limited partner(s) capital account have exceeded their original investment, resulting in a negative capital account. The investor(s) will face exit taxes if the property is sold or foreclosed upon. "When facing a severe exit tax liability using the original issue discount (OID) rules will help manage this liability. The rules say that if the entity is going to benefit from a significant modification of debt, by reducing the interest rate or extending the loan term, the entity has recognized a benefit for tax purposes called cancellation of debt income (COD income). This income increases the capital account and reduces the exit tax liability. If you are looking at a severe exit tax liability, recognize income during the compliance period instead of facing high exit taxes and running the risk of not having enough assets," said Schneider.

When faced with paying exit taxes, there are several options of payment. Options for paying exit taxes include:

- Bringing new financing to the deal through refinancing. "In many cases, loans on the project are at above market rate by today's standard. Refinancing these loans can generate proceeds," said Schneider.
- Applying cash reserves to pay taxes. Some or all of remaining operating and replacement reserves may be used to pay exit taxes. Use of sponsor assets may occasionally occur. If the sponsor wants to purchase, payment of exit taxes is required, the limited partner and the sponsor may negotiate and reach an agreement in which the sponsor pays the exit taxes.

According to Schneider, it is possible in some circumstances to mitigate exit taxes during years 11 through 14. Techniques to mitigate exit taxes can include the forgiveness of sponsor debt, which creates income each year the debt is forgiven, increasing the capital account; and reducing the limited partner interest by one-third, from 99 percent to 70 percent, helping to keep the negative amount of capital lower and reduce exit taxes. Capitalizing rather than expensing repairs and improving operations overall to reduce partnership losses also create fewer losses and less of a negative capital account.

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ISSN 1094-8684

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Keeping Projects Affordable

One issue faced as the compliance period ends on affordable housing projects is how to keep the projects affordable. NEF recommends that the investor(s) creates a thorough purchase proposal, which should include the intended use of the project, outstanding debt on the project, the purchase price offer, and any remaining cash assets in the partnerships.

"It's a good idea to approach Year 15 projects as though they are new projects and develop a plan for the next 15 years which focuses on determining limited partner(s) exit taxes, project reserves and project equity, all key elements to keeping projects affordable," said Barb McQuillan, executive director of Twin Cities Housing Development Corporation. The plan should address the capital requirements and operating requirements needed for the next 15 years; the current market, especially community needs; and financing options, including debt restructuring, tax credits, rent restructuring, reserves and any new debt. McQuillan also stresses the importance of knowing the details of the deal, including debt agreements and any restrictive covenants that may impact valuation, such as rent and income restrictions or terms upon the repayment of a first mortgage. Understanding the partnership agreement is another important factor of understanding the deal. The partnership agreement includes the option and right-of-first refusal, including terms and timing; the capital account deficit restoration obligation, if applicable; and allocation of losses.

Lessons Learned

"From experience, Twin Cities Housing has found that properties require capital improvements in excess of existing reserves, market rents are not achievable without some capital improvements, and several types of loans have restrictions that run with the land. If you are working with a limited partner that wants to maximize their value, determine any land restrictions," said McQuillan. "Investors typically don't expect to get equity out of a project and are generally willing to exit with taxes paid if the project remains affordable," says Chuck Weinstock, executive director of Capital Hill Housing. "However, if the property is sold at a profit, investors will expect their fair share.

"Start modeling the exit before the deal with the investor is closed. When evaluating the best price, consider the entire deal, including the back end. The partnership should ask questions such as; will there be a big exit tax exposure?" Weinstock added. Following the close of the deal the partnership should pull out the investor projection and create a table comparing projected versus actual rate of return and benefits/losses. "During the operating period, any deviations that may have occurred should be evaluated and understood and any corrective actions should be taken. As Year 15 approaches any constraints or flexibility the investors

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may have regarding the project should be made known," he said.

For those who are potential purchasers of a Year 15 project, NEF suggests exploring new sources of financing to meet purchase price and capital needs, such as re-syndication or new conventional debt and soft loan sources; consulting with accountants and attorneys and meeting with a syndicator. Strategies for completing a Year 15 transaction are deal specific and there are many other strategies that may be used aside from those listed above. Transactions should be evaluated on a project-by-project basis. The presentation packet and an archived recording of the web cast are both available from LISC's web site at http://www.lisc.org/content/calendar/detail/1735/.
