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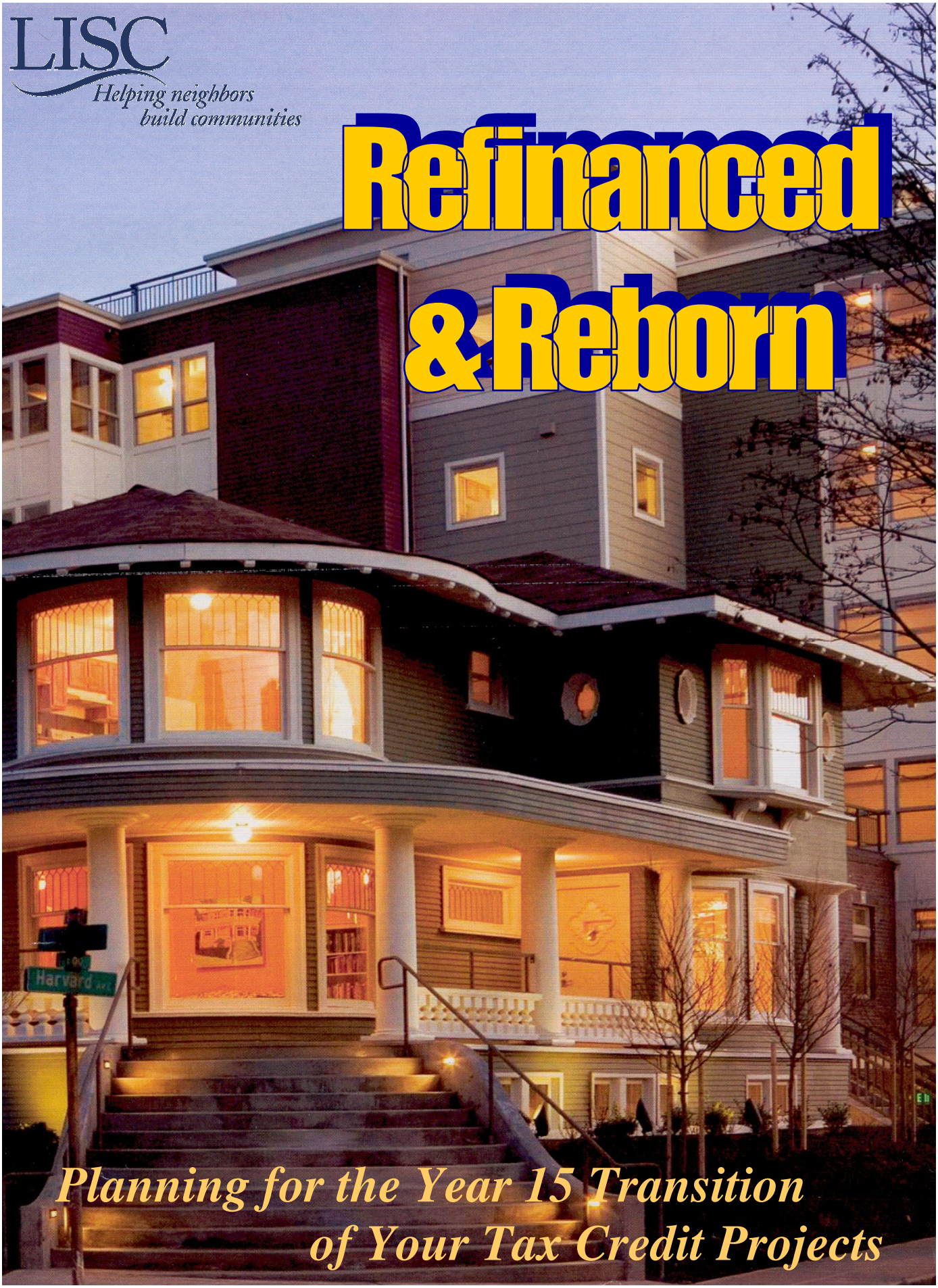

Planning for the Year 15 Transition of Your Tax Credit Projects

An ODI Publication

This Manual was prepared by New York City LISC for its CDCs but applies generally to all CDCs who have tax credit projects. It presents a general framework to help you formulate a plan to acquire your project at the end of the 15-year tax credit compliance period and preserve its affordability. You will learn how to consider the legal agreements, project performance, and market forces that will influence your acquisition plan. Working with your consultant, accountant and legal counsel, you can then carefully analyze the details of your project and formulate a purchase offer.

This Manual is just the starting point to help you navigate key Year 15 issues. Your purchase plan and ultimate offer will depend on your specific project dynamics, which will in turn be influenced by the outcome of your negotiations with your limited partner and any relevant government partners.

Your local LISC office will assist you with questions about general issues and the acquisition process.

Please note: This Manual is structured to assist CDCs in becoming educated consumers when they approach the National Equity Fund (NEF) to transition their tax credit projects. If you have partnered with a different syndicator, you must consult your own professionals about the best way to proceed.

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TABLE OF CONTENTS

1. ROLE OF LISC

YOUR CLOSE-TO-HOME RESOURCE

The overwhelming majority of Year 15 transitions so far have been "rollovers," where the sponsoring general partner, in most cases the CDC, has assumed the existing debt and simply continued operating the affordable housing. Approximately 10% have needed to resyndicate with new tax credits to continue as affordable housing, to cover the cost of necessary capital improvements and/or to pay off debt. A very small percentage (about 3%) have become market rate projects.

Your Local LISC Office will work with you to determine what strategy will be most advantageous for your CDC and your specific Low Income Housing Tax Credit (LIHTC) project. Then LISC and the National Equity Fund (NEF) will help you understand the basic elements involved in creating a plan to acquire your LIHTC project.

Finally, working closely with your consultant (if you choose to engage one), accountant and legal counsel, you will be able to formulate your acquisition plan and prepare the necessary documentation.

2. YEAR 15: WHAT IS IT & WHAT DOES IT MEAN FOR YOU?

WHAT IS YEAR 15?

Your partnership, operating affordable housing financed with Low Income Housing Tax Credits, is reaching the end of the 15-year federal tax credit compliance period (Year 15). After the end of Year 15, the limited partner typically will seek to exit the partnership because the project will have fulfilled its tax credit compliance obligations, and the limited partner will have realized its expected tax benefits. The terms of the limited partnership agreement govern the procedures for implementing the disposition of the project and the winding up of the affairs of the partnership.

The end of Year 15 is the last day of the tax year (usually December 31[1]) of the 15th year beginning with the first year in which any tax credits were claimed. Tax credits are claimed either in the year the qualified building was placed in service, or, at the election of the partnership, the next year (such election would be indicated on line 10(a) of the Form 8609 filed with the partnership's tax return). So, if the limited partnership first took tax credits in 1989, the end of the compliance period is December 31, 2003 (1989 + 14).

If your project has multiple buildings, you need to determine the tax credit period, and the Year 15, for each building. Although there may be more than one initial tax credit year for a multiple building project, the disposition will be most straightforward if the purchase transaction proceeds after all buildings reach the end of Year 15.

YOUR OPPORTUNITY

Your opportunity to seek to acquire ownership of the project increases when your project reaches the end of Year 15. If you seek to acquire the project, you will need to take the following steps to formulate a purchase plan:

1) Determine the purchase price
2) Determine the future financial viability of the project
3) Address any major ongoing capital needs of the project
4) Obtain all necessary lender consents, and
5) Satisfy the purchase price and all other conditions of sale.

YOUR RESPONSIBILITY

If you do not wish to acquire the project, you have a *fiduciary obligation* under your limited partnership agreement, as the managing general partner, to use best efforts to sell the property for its fair market value (FMV) to a third party (if this would be in the best financial interest of the partners).

[1] In this manual, we assume that the partnership's tax year is the same as the calendar year.

3. ELEMENTS OF A PURCHASE PLAN

STEPS

1) Determine when your project reaches the end of the compliance period (Year 15)
2) Identify a staff person responsible for coordination
3) Hire a consultant, if needed
4) Obtain input from your accountant and legal counsel
5) Gather and analyze your legal documents (see Chapter 4., p. 7)
6) Carry out the calculations and analyses described in this manual, and
7) Prepare and submit to the limited partner a purchase offer.

PURCHASE OFFER

NEF requests that prospective purchasers for projects in its funds submit a purchase offer covering the following key elements, explained in further detail below:

1) The intended ongoing **use** of the property
2) The amount and terms of outstanding partnership **debt**, and the method of satisfying such outstanding debt (*i.e.*, payment or assumption). See Chapters 6 and 7, pp. 12 and 14.
3) The proposed **purchase price**. Note that this price should be based on the price stated, if any, in your limited partnership agreement or any purchase option agreement. See Chapter 5, p. 8.
4) Your plan for the use of remaining project **reserves**. See Chapter 11, p. 21.

Other limited partners likely will request that your purchase offer contain similar items.

TIMELINE

Ideally, you should start planning the Year 15 purchase several years before Year 15 in order to have time to pursue strategies to reduce your out-of-pocket expense needed to cover an expected purchase price in excess of Debt. In any event, you should attempt to finalize a purchase plan at least one year in advance of the expected purchase date.

If you (or a party related to you) have a purchase option and/or right of first refusal (RFR) (both are defined in 5 below), you likely have a limited time to exercise the option and/or RFR. Exercise periods provided in the purchase option and/or RFR vary, and you should consult your legal counsel.

4. DOCUMENTS AND DATA

Examples in this manual are modeled on specific existing partnerships that were syndicated with NEF. Because every project is unique, you must consult the documents and data specific to your project. The starting point is to gather the following documents and data:

FINANCIAL INFORMATION

- ☐ Current outstanding balances due on debt and other partnership obligations (contained in most recent audited financial statements)
- ☐ Projected operating results (*i.e.*, 15-year pro formas)
- ☐ Investor exit tax on sale (this amount will be based on the limited partner's Schedule K-1 of its most recent Form 1065, see 8 below).[2]

LEGAL

- ☐ Limited Partnership Agreement
- ☐ Purchase Option Agreement and/or Right of First Refusal Agreement (if any)
- ☐ Note(s), Mortgage(s), Deed(s)
- ☐ Loan Agreement(s)
- ☐ Extended Use Agreement(s) (if any)
- ☐ Regulatory Agreement(s) (if any)
- ☐ Land Use Restriction Agreement(s) (if any)
- ☐ Funding and Disbursement Agreement(s) (if any)
- ☐ Land Disposition Agreement (if any)
- ☐ HOME Written Agreement (if any).

CAPITAL NEEDS

- ☐ In- house capital needs assessment
- ☐ Third-party capital needs assessment (if needed)
- ☐ Compare reserve levels to capital needs.

VALUATION OF FAIR MARKET VALUE

- ☐ Projected NOI (to the end of Year 15)
- ☐ Information regarding rents on comparable properties (subject to similar use restrictions).

[2] As discussed in 8 below, you should consult with your accountant to ensure there are no book and tax differences. One way to do this is to compare Box N on the limited partner's Schedule K-1 to the statement of the limited partner's capital account contained in the notes to the audited financial statements).

5. PURCHASE PRICE FORMULA

Objective: To identify the likely purchase price before you enter into negotiations.

Documents: If you have a purchase price agreement, it will be in your:

- ☐ Limited Partnership Agreement, and/or
- ☐ Purchase Option Agreement (if any), and/or
- ☐ Right of First Refusal Agreement (if any)

PURCHASE PRICE

Based on your legal agreements and the outcome of negotiations with your limited partner, the purchase price typically will be one of the following:

- ☐ Fair Market Value (FMV)
- ☐ Greater of FMV or Debt + Taxes
- ☐ Debt + Taxes

For the purpose of determining the sale price:

- "FMV" is discussed in Chapter 10, p. 20.
- "Debt" is equal to the total outstanding partnership debt (including all accrued and unpaid interest). See Chapters 6 and 7, pp. 12 and 14.
- "Taxes" is used in this manual to refer to the exit tax projected to be imposed as a result of the sale. It is actually a capital gains tax which is owed by the investor if the amount of taxable losses, historic credits and cash distributions taken by the limited partner over the 15- year tax credit compliance period exceed the amount which the limited partner contributed to the partnership. See Chapter 9, p. 17.

PURCHASE OPTION

Definition: A purchase option provides the general partner (or a related party) with an option to purchase the property (at its sole discretion) from the limited partnership under specified terms. Sometimes the option is to purchase the limited partner interest from the limited partner. The option will have a stated purchase price formula and will likely specify a time period in which to exercise the option. The typical purchase price in a purchase option is equal to the greater of (i) FMV or (ii) Debt plus Taxes.

RIGHT OF FIRST REFUSAL (RFR)

Definition: A RFR gives the general partner (or a related party) a right to purchase (at its sole discretion) the project from the limited partnership if a bona fide offer is first made by a third party and accepted by the limited partner.

It is possible that the RFR purchase price will be equal to Debt plus Taxes, and that a third party offer is not required under the legal documentation. However, tax practitioners generally believe that the limited partner must consent to a Debt plus Taxes purchase price in the absence of a third party offer.

The worksheet below will help you to identify the terms of any stated purchase option and/or RFR contained in your legal agreements. These terms may be located in your limited partnership agreement, any purchase option agreement, and/or any RFR agreement. Transfer the terms from each and any of these agreements into the worksheet.

SALE PRICE WORKSHEET

	Terms	Section	Agreement
What is the Purchase Option formula?	_____	_____	_____
What is the estimated price based on the formula? $_____		_____	_____
What is the RFR formula?	_____	_____	_____
What is the estimated price based on the formula? $_____		_____	_____

For each provision noted above, indicate:

What is the Definition of Debt?

_____

_____

What is the Definition of Taxes?

_____

_____

What is the Definition of FMV?

_____

_____

What Approvals are required to exercise the Purchase Option and/or RFR?

_____

_____

_____

What other Conditions must be satisfied to exercise the Purchase Option and/or RFR?

_____

_____

_____

When can the Purchase Option and/or RFR be exercised?

Any notice periods? _____

Date for closing: ___ days after exercise

Are there any Extended Use or Affordability Restrictions or Special Covenants?

_____

_____

Are the Purchase Option and/or RFR assignable to another party? If so, terms?

_____

_____

WHAT IF DOCUMENTS ARE SILENT ON THE SALE PRICE?

If the purchase price formula is ***not*** defined in any of your legal agreements, the limited partner ***may***[3] be willing to accept a purchase price of the greater of FMV or Debt.

Consider two hypothetical scenarios:

If Debt is greater than FMV, the purchase price likely will be equal to Debt. In such a scenario, if the general partner can assume the Debt, it will not have to pay cash to satisfy the sale price.

Example #1: Assume the following project profile:

FMV: $1,000,000
Debt: $2,000,000 (two deferred payment loans from NYC)
($1,600,000 outstanding principal balance)
($400,000 in accrued interest)

Because Debt in this example exceeds the FMV, the limited partner may be willing to accept a sale price of $2,000,000 (constituting the assumption of Debt). In order to assume the Debt, the purchaser would need to obtain lender consents as described below under Chapter 6, p. 12.

If FMV is greater than Debt, the purchase price likely will be equal to FMV, unless some other purchase price is negotiated.

Example #2:

Assume instead that the FMV is $2,000,000 and the Debt is $1,000,000. In this scenario, the purchase price would be $2,000,000.

If the purchaser can assume the Debt, the purchaser would only be required to pay $1,000,000 in cash; otherwise, the purchaser would need $2,000,000 in cash to cover the total purchase price, including the payment of Debt.

[3] This is an assumption for illustrative purposes only, and is not based on any discussions with, or representations by, any limited partner. The FMV rarely exceeds debt on CDC tax credit projects.

6. MORTGAGED DEBT

Objective: To assess the amount, term and assumability of mortgaged debt and whether any long-term affordability restrictions are tied to the mortgaged debt.

Note: "Debt" for the purposes of determining the sale price constitutes both "Mortgaged Debt" discussed in this section and "Other Liabilities" discussed in 6 below.

Documents: This information for *each* loan may be contained in various documents:

- ☐ Note, Mortgage, Deed
- ☐ Loan Agreement (if any)
- ☐ Regulatory Agreement (if any)
- ☐ Land Use Restriction Agreement (if any)
- ☐ Land Distribution Agreement (if any)
- ☐ Funding and Disbursement Agreement (if any)
- ☐ HOME Written Agreement (if any).

"Debt", for the purposes of determining the sale price, refers to total outstanding debt (principal and accrued interest) owed by the limited partnership.

You can satisfy the Debt if it is a component of your purchase price[4] either by:

- ☐ Retiring the Debt in cash through a refinance or other cash infusion,

<u>or:</u>

- ☐ Assuming the Debt (if you seek to acquire the property), <u>or</u>
- ☐ Obtaining lender consents pursuant to any change of control provision (if you seek to acquire the limited partner interest).

Loans may have a balloon payment due, a large deferred interest payment due, or may simply mature, at or shortly after Year 15. If you cannot pay off this debt with a cash infusion, you must either refinance it or negotiate rescheduling or assumptions after the end of Year 15.

If your agreement with any public lender prohibits assignments, or is silent on this point, the lender might allow an assumption if you agree to continue operations as low-income housing.

Some public lenders tie affordability/use restrictions to the original debt, and extend them for several years after the end of Year 15 (see 7 below).

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[4] Because of the different methods under which interest is accrued for federal income tax purposes and how it is accrued based on the terms of the note, there may be a difference between the federal income tax basis and the book value basis of the debt. This can be a complicated analysis, and you should consult your accountant or consultant.

Your project may have multiple sources of public and commercial debt, with cross-acceleration and cross-default provisions (meaning that acceleration or default on one debt obligation triggers acceleration or default on another debt obligation). For example, refinancing Loan A, or effecting a change in control of the limited partnership without the consent of the lender of Loan A, might trigger an acceleration of payment of all outstanding indebtedness of Loan B (as well as Loan A).

For *each* loan, note key provisions contained in the following **Debt Analysis Worksheet**:[5]

Debt Analysis Worksheet

Name of Lender	Current Outstanding Principal Balance & Accrued Interest (per audit)	Projected Year 15 Principal Balance & Accrued Interest (book accounting)	Maturity Date	Interest Rate	Loan Payments (Mo/ Yearly)	Balloon Payment? If so, Terms	Deferred Payment? If so, Terms	Assumption or Change of Control Provisions? (Yes/No)	Long Term Restrictions? (Yes/No)
1)	$	$							
	$	$							
2)	$	$							
	$	$							
3)	$	$							
	$	$							
4)	$	$							
	$	$							

Lender Consents for Assumption of Loan:

Loan 1) _____
Loan 2) _____
Loan 3) _____
Loan 4) _____

Lender Consents for Sale or Disposition of Project Ownership:

Loan 1) _____
Loan 2) _____
Loan 3) _____
Loan 4) _____

Lender Consents for Change of Control of Limited Partnership:

Loan 1) _____
Loan 2) _____
Loan 3) _____
Loan 4) _____

Other Relevant Lender Consents?

_____
_____
_____

Any Pre-Payment Penalties?

_____
_____
_____

Any Restrictions on Refinancing?

_____
_____
_____

[5] Source: NEF.

7. OTHER LIABILITIES

Objective: To determine how much debt owed by the limited partnership (other than the "Mortgaged Debt" discussed in Chapter 6, p. 12) is due and payable at sale or dissolution of the partnership.

Note: "Debt" for the purposes of determining the sale price constitutes both "Other Liabilities" discussed in this section and "Mortgaged Debt" discussed in Chapter 6, p. 12.

THIRD PARTY AND RELATED PARTY DEBT

All creditors[6] of the limited partnership must be paid at sale or dissolution, before any distributions are paid out to the partners in the order of priority listed in your limited partnership agreement.

List any outstanding third party (*eg*, lender, vendor, supplier, etc.) and related party (*eg*, GP, Sponsor, LISC, NEF) debt for your project:

Third Party Debt

Third Party	Current Accrued Balance	Interest Rate	Projected Balance at Year 15	Payout Terms	Assumable?
_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____

Related Party Debt

Related Party	Current Accrued Balance	Projected Balance at Year 15	Assumable?
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

[6] In some of the early deals, general partner loans may not be considered debt for purposes of the distribution rules under the limited partnership agreement. As a result, some limited partnership agreements may provide for a distribution to the limited partner in order to pay capital gains taxes *before* payment of certain loans made by the general partner.

PARTNER FEES

You will need to account for any fees, payments or other amounts payable to the general partner or related parties (*ie*, Sponsor, LISC) due upon sale (as opposed to loans, covered in the section above entitled "Third Party and Related Party Debt"). List all accrued fees payable to the general partner and related parties due upon sale:

Fees Payable to the GP and/or Related Party

	Annual Fee	Current Accrued Balance	Projected Balance at Year 15
Deferred Developer Fee	_____	_____	_____
Partnership Management Fee	_____	_____	_____
Related Party Prop. Mgmt. Fees	_____	_____	_____
Guaranty Advances	_____	_____	_____
Other Fees	_____	_____	_____
Total Fees Payable	_____	_____	_____

8. LONG-TERM RESTRICTIONS

Objective: To determine whether any existing restrictions will continue beyond Year 15.

Documents: All documents listed above under "Mortgaged Debt"

Some public lenders, eg. Home or HoDAG, tie to their debt, affordability and/or use restrictions that continue for years *after* the end of Year 15. These lenders are likely to require additional restrictions as a condition to refinancing, debt assignment or providing necessary consents for a sale (see 5 below). In addition, the Internal Revenue Code requires an extended use agreement for projects receiving tax credit allocations beginning in 1990, and allowed some projects receiving credits prior to that date to enter into such agreements.

Each of these restrictions and any statutory extended use agreement (and the terms of any "opt-out clauses"[7] therein) have a significant impact on the long-term affordability of the rental units, the valuation of the real estate, and your ability to refinance the project.

For *each* regulatory agreement, restricted use agreement and debt instrument, indicate any of the following terms:

Long Term Restrictions

Affordability (Income and/or Rent) Restrictions:

Description: _____
Term: _____

Description: _____
Term: _____

Description: _____
Term: _____

Terms of any Opt-out Clauses:
_____
_____

[7] An "opt-out clause" generally allows the low-income rent and residency restrictions to lapse, but only if the local housing authority is unable to find a buyer who will purchase the project at a minimum price (Debt plus Taxes plus equity contributed by the limited partner) within a certain period of time, and be willing to operate the project subject to the restrictions.

9. EXIT TAXES

Objective: To determine the exit tax liability on sale. (The tax is really a capital gains tax, but in the context of Year 15 transitions, we almost always referr to it as the "exit tax.")

Documents:

- ☐ Most recent partnership tax return, Form 1065, Schedule K-1
- ☐ Last three years' audited financial statements of the partnership
- ☐ Current project budget.

If your purchase price contains a tax component, you will need to calculate the amount of the exit tax liability. Generally, the limited partner will incur an exit tax on the sale if its capital account is negative at the time of sale.

In cases where the sale price *equals* Debt, the exit tax will approximate the negative capital account.[8] To the extent that sale price *exceeds* Debt, the exit tax will approximate the sum of the negative capital account plus the amount of cash the limited partner is to receive as a result of the sale price exceeding Debt. Note that if the limited partner has a positive capital account, it may still have exit tax liability if the sale price exceeds Debt and generates cash.

A negative capital account results if the amount of taxable losses, historic credits and cash distributions taken by the limited partner over the 15-year tax credit compliance period exceed the amount which the limited partner contributed to the partnership. The capital account balance is stated in Box N of the limited partner's Schedule K-1 on the most recent partnership tax return.[9]

If the limited partner's capital account is negative, an exit tax will be due. You calculate this tax by multiplying the limited partner's negative capital account by the investor's combined federal, state and city tax rate. Because this amount will vary in every individual case, we assume a rate of 35% for purposes of this analysis.

In the event that any third party (including the sponsor or general partner) pays the exit tax on behalf of the limited partner, this payment is itself a taxable event, and so a "gross-up" factor must be applied to the amount of taxes paid. This "gross-up" factor is calculated by taking the amount of taxes originally calculated using the negative capital account and dividing it by 1 minus the marginal combined federal, state and city tax rates (*eg*, 1 – 0.35[10]).

A short-cut method to estimate the exit tax is to use the limited partner's Form 1065, Schedule K-1, on the limited partnership tax return for the previous fiscal year.[11]

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[8] Note that this does not account for any "gross up" (this concept is discussed below).

[9] You should discuss this with your accountant to verify how much taxable income the limited partner would have to recognize on sale. There may be a discrepancy between the tax and book accounting method used to calculate the capital account balance on the tax return. Any discrepancy between the book capital account and the tax capital account needs to be reconciled to the tax accounting method.

[10] This formula assumes an infinite gross up, rather than a one-time gross up (which would be the taxes owed multiplied by 1.35 (assuming that the 35% tax rate is first applied)).

[11] Note that this short-cut method is for estimation purposes only. When actually determining the amount

To calculate taxes for your project, start with the limited partner's capital account balance at the end of the last fiscal year, listed in Box N on that Schedule K-1. You can then forecast the capital account balance at the time of sale by deducting losses projected through the time of sale from the capital account balance stated in Box N.[12]A short-cut method to estimate future losses is to use the number located in Box N of the limited partner's Form 1065, Schedule K-1.[13]

Here is an example of this short cut method for calculating the exit tax ("LP" = Limited Partner):

Short-Cut Method – Exit Tax Analysis[14]

Operation	Information Needed	Calculation from Operation Column
(a)	Year of Most Recent Completed Tax Return	2002
(b)	LP's Capital Account Balance – Box J(e)	$(1,830,264)
(c)	Taxable losses for Year – Box J(c)	$(120,000)
(d)	Number of years until sale	1 (Year 15 = 2003)
(e) = (c) * (d)	Total additional projected losses	$(120,000)
(f) = (b) + (e)	Projected LP Capital Account at sale If number is positive, do not complete (g)	$(1,950,264)
(g) = (f) x 0.35	Tax on Sale (if LP pays taxes)	$(682,592)
(h) = (g) x 1.35	Tax on Sale (grossed up, if purchaser pays)	$(921,500)

of taxes due, your accountant will need to conduct a more thorough analysis, taking into account any booktax differences from previous years.

[12] See footnote 10.

[13] An alternative methodology is to trend losses based on past losses (derived from the tax returns) and knowledge of the project's expected losses. In addition, there are circumstances in which future losses will not be allocated to the limited partner, and therefore the limited partner's capital account may not go as far below 0 as was projected.

[14] Source: NEF.

Calculate the exit tax for your project using the **Exit Tax (Capital Gains) Analysis Worksheet**[15] below ("LP" = Limited Partner"):

Capital Gains Tax Analysis Worksheet

Operation	Information Needed	Your Calculation
(a)	Year of Most Recent Completed Tax Return	_____
(b)	LP's Capital Account Balance – Box J(e)[17]	$ _____
(c)	Taxable losses for Year – Box J(c)	$ _____
(d)	Number of years until sale	_____
(e) = (c) * (d)	Total additional projected losses	$ _____
(f) = (b) + (e)	Projected LP Capital Account at sale If number is positive, do not complete (g)	$ _____
(g) = (f) x 0.35	Tax on Sale (if LP pays taxes)	$ _____
(h) = (g) x 1.35	Tax on Sale (grossed up if purchaser pays)	$ _____

[15] Source: NEF.
[16] See footnote 10

10. FAIR MARKET VALUE

Objective: To determine the FMV of your project in order to assess the purchase price.

Methodology: Calculate the FMV by applying a capitalization rate[17] to net operating income (at maximum levels permitted under long-term rent restrictions and market rates).

Your limited partnership agreement might require you to obtain an independent appraisal or may require that specific factors be included in the valuation of your project. Three basic appraisal methodologies are: sale comparisons, cost approach, and income potential. For rental properties, the income approach is the most common.

If your limited partnership agreement does not specify the valuation method, the limited partner may accept an income-approach analysis of value. However, in any particular case, the limited partner may require a professional appraisal. The limited partner probably request that your income-based analysis address the following questions:[18]

1) What is the current net operating income (NOI) of the project?
2) How long are rent limits in effect under your regulatory or loan agreements?
3) To what level would the market allow rent increases, within any regulatory ceiling? One way to answer this question would be to consult a rent survey of comparable properties or review local press advertisements for comparable rental properties.
4) What capital improvements would yield market rents higher than current market rents and at what anticipated cost (where regulated rents are above market rents)?
5) Are there any foreseeable changes to the current operating budget?

Using this information, you can assess the FMV based on NOI, at maximum levels permitted under long-term rent restrictions that take into account market conditions and any necessary capital improvements. You can use a 10% capitalization rate to derive FMV from that restricted NOI, though you may wish to consider a higher or lower capitalization rate appropriate to the local market and interest rate environment. Below is an example of a FMV calculation based on an income approach to value:

Example of FMV Calculation (Income Approach)

Restricted Income	$500,000
minus Vacancy at 5%	$25,000
equals Effective Gross Income	$475,000
minus Operating Expenses	$300,000
equals Net Operating Income	$175,000
divided by 10% cap rate	10%
equals FMV	$1,750,000

[17] Definition: The rate of interest used in calculating the present value of future periodic payments.
[18] Source: NEF.

11. RESERVE ANALYSIS

Objective: To determine the most appropriate use for any remaining project reserves, considering any restrictions on the use of those reserves.

Documents:

- ☐ All documents listed under Chapter 6, p. 12
- ☐ Limited Partnership Agreement.

Depending on the provisions of your legal agreements, any lender and/or regulatory requirements, and the outcome of your purchase negotiations, reserves might be required to recapitalize project reserves to protect the project's viability and/or be used to pay:

- ☐ Capital needs
- ☐ Debt
- ☐ Accrued fees
- ☐ Legal and closing costs
- ☐ Transfer taxes
- ☐ Exit tax.

Project reserves, typically replacement and operating deficit reserves, are assets of the limited partnership. Therefore, any reserves remaining after the sale of the project, along with any cash proceeds of the sale, are to be distributed according to partnership allocation rules and the limited partnership agreement.

Although reserves, in accordance with the partnership agreement, may be intended to flow to the partners according to the distribution provisions relating to other assets of the limited partnership, some lenders and/or regulators may require a different order of priority for distribution of reserves. For example, some local governments include a provision for the city, at its discretion, to require operating and replacement reserves be used to pay down city debt. Often, a second priority under such provisions is that remaining reserves be used to recapitalize the project in order to protect the future viability of the project.

Even if there is no such provision, lenders may require that a certain level of reserves be in the project to protect its future viability as a condition of consenting to the sale debt restructuring. Also, any new lender typically will require a minimum level of reserves in the project.

In addition, loan documents may contain limitations on the replacement reserve account in the event a subsequent buyer assumes the loan assumed form the partnership. Sponsors are asked to detail the amount of remaining reserves and any lender controls on reserves as part of a purchase proposal.

The **Reserve Analysis Worksheet** below will help you analyze how your legal documents provide for the treatment of reserves at sale or dissolution.

Reserve Analysis Worksheet

	Actual	Projected at End of Year 15
Operating Reserve Balance	_____	_____
Replacement Reserve Balance	_____	_____

Treatment of Partnership Assets (*eg,* reserves) at Sale or Disposition:

Priorities

1st _____

2nd _____

3rd _____

4th _____

Lender Consents Required for Use of Reserves at Sale or Disposition?

_____

_____

Limited Partner Consents Required for Use of Reserves at Sale or Disposition?

_____

_____

12. CAPITAL NEEDS ASSESSMENT

Objective: To identify and provide cost estimates for immediate and long-term capital improvement needs of the property. You will then be able to compare these needs to available reserves, and also assess whether the capital needs are substantial enough to seek to recapitalize the project through new low income housing tax credits, if available (see 16 below).

Methodology: Conduct an internal Capital Needs Assessment (CNA) and/or have a CNA conducted by a professional engineer.

Capital Needs Assessment

What is the anticipated cost of repair/replacement needs over the next 2, 5, 10 years?

2 Years:
In-house Assessment: _____
Third Party Assessment: _____

5 Years:
In-house Assessment: _____
Third Party Assessment: _____

10 Years:
In-house Assessment: _____
Third Party Assessment: _____

The CNA will enable you to determine whether project reserves will be needed for repairs and replacement items over the next several years. You must then assess whether the project has sufficient reserves to cover those items.

Capital Needs Compared to Remaining Level of Reserves

Projected amount of replacement reserves at end of Year 15 (see Tab 11): $_____

Permitted uses of replacement reserves at sale/dissolution (see Tab 11)?:

Priorities
1st _____
2nd _____
3rd _____
4th _____

13. CASH FLOW ANALYSIS

Objective: To determine the long-term economic viability of the project, the amount of debt it can service, and whether you need to recapitalize the project.

Methodology: Prepare 15-year cash flow projections.

Cash flow projections will help you decide:

- whether you want to acquire the project
- whether you can afford to acquire the project
- the amount of debt the project can service from cash flow, and
- whether you need to recapitalize the project.

The cash flow analysis should answer the following questions:

1) Is cash flow sufficient to support operations?
2) Is cash flow sufficient to support capital needs?
3) Is the net operating income sufficient to service current debt?
4) What, if any, additional debt can the project carry?
5) Have operating expenses been trending significantly above income?

14. PURCHASE PROPERTY or LIMITED PARTNER INTEREST?

You may wish to seek to purchase the partnership interests held by the limited partner rather than the project itself. The purchase price and other analyses will be similar to what has been discussed above.

If you purchase the limited partner interest rather than the real estate project, however, there are other differences which may or may not be advantageous for your CDC. You will gain control of 100% of the limited partnership, and therefore the limited partnership will not need to be terminated in the same way. Here are a few other key issues to consider:

1) Change of control provisions: You may need to ask your lenders for written approval for a change of control of the limited partnership because you will be purchasing 99% (or 99.99% in later deals) of the limited partnership interests.

2) Treatment of reserves: Reserves (like other cash) are partnership assets and will generally stay with the limited partnership upon sale of the limited partner interest (your lender may negotiate different uses for reserves).

3) Real estate transactions costs: In general, you do not avoid these costs, such as title and recording fees, but in some localities, qualified not-for-profit corporations may be exempt from paying transfer taxes, for example. Check with your attorney for local requirements.

4) Deficit restoration requirement: If you, as the general partner, have a deficit restoration requirement (see Chapter 16, p. 27), it is not triggered by a sale of the limited partner interest. The requirement is only triggered by purchase of the property and liquidation of the partnership or your interest therein.

This list is not comprehensive, and each case has unique factors, so you should consult your legal counsel in deciding whether it is better for you to purchase the limited partner interest or the project property.

15. DASHBOARD OF RESULTS

Now you can summarize your findings to help build your purchase plan:

Purchase Price:	? FMV ? Debt ? Debt + Taxes ? Other? _____
Purchase Option:	_____
RFR:	_____
Exercise Periods, if any:	Option: _____ RFR: _____
Total Outstanding Mortgaged Debt:	$ _____
Total Related Party Debt:	$ _____
Total Third Party Debt:	$ _____
Total General Partner Fees:	$ _____
Capital Gains Tax Liability:	$ _____
Fair Market Value:	$ _____
Long-Term Use Restrictions:	_____
Total Closing Costs:	$ _____ GP%: _____
Replacement Reserves	
Balance:	$ _____
Permitted Uses:	_____
Operating Reserves	
Balance:	$ _____
Permitted Uses:	_____
Capital Needs:	$ _____ over 2 years $ _____ over 5 years $ _____ over 10 years
Required Lender Consents:	_____ _____ _____
Purchase of Limited Partner Interest or Property	? LP Interest ? Property

16. DISTRIBUTION OF PROCEEDS TO PARTNERS

If any cash proceeds[19] result from a sale of the project (plus other assets of the limited partnership), your limited partnership agreement will indicate the order of priority in which these amounts are to be distributed among the partners.

DEFICIT RESTORATION REQUIREMENT

In the VERY unlikely event that the general partner has a negative capital account (deficit balance) after the gain from sale is allocated, it may have an obligation under the limited partnership agreement to put cash into the partnership to restore its capital account to zero.

As you plan your Year 15 strategy, it won't hurt to discuss with your accountant how to anticipate whether or not you will have a deficit balance that could trigger a deficit restoration requirement.

Note: This requirement is triggered only upon liquidation of the partnership, NOT upon sale of the limited partner interest.

[19] After payment of closing costs, transfer taxes, and set-aside of reserves for winding up of the limited partnership (in the event of a sale of the property).

17. REFINANCING STRATEGIES

If you can purchase the property by assuming the Debt and you incur no out-of-pocket expenses, you will not need to raise additional capital to pay the purchase price. However, it may be necessary to raise capital (1) to meet capital needs that cannot be funded from the reserve account or paid by project cash flow over time, or (2) to pay closing costs or fees related to the closing (including transfer taxes).

But if you do owe cash (for example, to cover any tax portion of the purchase price, or the margin by which FMV exceeds Debt), what are your financing options?

- Can you seek additional soft debt from public lenders?
- Can you obtain a federal grant?
- Can you obtain 4% or 9% credits, if your project has capital needs?
- Can you obtain a new or additional loan from private debt markets, possibly a refinancing using 501(c)(3) bonds?
- Do you have any other financing options?

18. ACQUISITION PROCESS

After you have analyzed the elements of your purchase proposal and discussed these with your consultant, accountant and legal counsel, you will be ready to prepare a purchase offer to submit to your limited partner.

You might expect the acquisition process to unfold as follows:[20]

1) CDC contacts NEF or NEF contacts general partner to determine disposition strategy, during year 14 of year 15 of the project compliance period.

2) Sponsoring CDC submits its purchase proposal, or plan for sale to a third party, before the end of year 15 of the project compliance period.

3) NEF Board Disposition Committee reviews proposal for approval, during year 15 or year 16 of the project compliance period.

4) Real estate or limited partnership interest is transferred, as early as possible after the end of year 15 of the project compliance period.

[20] Source: NEF.

19. OTHER RESOURCES

Relevant articles and webcasts:

LISC Webcast "Countdown to Year 15: Are You Ready?"
www.lisc.org/content/publications/detail/2125

National Equity Fund Disposition Philosophy
www.nefinc.org/HomePage/Highlights/DispositionPhilosophy.pdf

National Equity Fund Plan Outline
www.nefinc.org – click on Asset/Property Managers and scroll down

Enterprise Overview of Disposition Process
www.enterprisecommunity.com/industryTaxCredit/assetMgmt_subs/year15.html

Enterprise Relevant Definitions
www.enterprisecommunity.com/industryTaxCredit/assetMgmt_subs/year15/resources.html

Overview of the issues:

Joint Center for Housing Studies of Harvard University, Expiring Affordability of Low-Income Housing Tax Credit Properties: The Next Era in Preservation, October 1999
www.jchs.harvard.edu/publications/finance/collignon_w99-10.pdf

Preparing a Capital Needs Assessment:

HUD's *Residential Rehabilitation Inspection Guide*:
www.huduser.org/publications/destech/inspection.html

Training:

NeighborWorks® Training Institute
www.nw.org/network/training/training.asp

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