Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits

May 2011, Volume II, Issue V

Published by Novogradac & Company LLP

Managing the Exit Tax Burden of the QALICB

Part Two of Two

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Part One of this article explained that when a new markets tax credit (NMTC) investor exercises a put option (the exit transaction) in a leveraged transaction at the end of the seven-year compliance period, it is possible that the qualified active low-income community business (QALICB) will not recognize any cancellation of indebtedness (COD) income. Part One also explained that if COD income is recognized, the amount of income should be the difference between the issue price of the "B loan" and the fair market value of the B loan when the put is exercised.

The following example was used to illustrate these points:

An investor contributes $3 million to Investment Fund LLC in exchange for 100 percent of the membership interests in the fund. The fund borrows an additional $7 million (the leverage loan) and uses its combined $10 million of capital to make a qualified equity investment (QEI) in a community development entity (CDE) in exchange for a 99.99 percent membership interest. The leverage loan has a seven-year term. Only interest is paid until the end of the term. The CDE makes two qualified low-income community investment (QLICI) loans to the QALICB. The A loan has a seven-year term, and the B loan has a 30-year term. Both loans call for interest payments only during the first seven years, generating sufficient interest for the CDE to make the required interest payments on the leverage loan. At the end of seven years, the QALICB refinances its property, repaying the A loan. The CDE distributes the proceeds to the fund, which repays the leverage loan. Shortly thereafter, the investor exercises its put option, selling its 100 percent interest in the fund to an affiliate for $1,000.

Planning to Reduce COD Income

In Part Two of this article, it is assumed that COD income is recognized in the exit transaction. QALICBs have a number of options for planning to reduce the amount of COD income and thus defer the tax burden on the economic benefit from the exit transaction that accrues to the family of entities that includes the QALICB and affiliate (the entity family).

Because the amount of COD income that results from the exit transaction under Treas. Reg. §1.108-2(f)(2) is based on the fair market value of the B loan at the time of the transaction, one approach is to take steps to maximize that value. If the QALICB's activities can support a high interest rate and a QALICB affiliate is the leverage lender, market interest rates on the A and B loans from the time the NMTC financing is closed may be advantageous. If a high interest rate from the outset would jeopardize the "true debt" status of the QLICI loans, another approach is for the QALICB and CDE to agree, after the end of the compliance period, to increase interest on the B loan to a market rate. Of course, the QALICB should be mindful of the business risk that the investor will not exercise its put option.

Another option is to convert the B loan to an equity interest in the QALICB before the investor exercises the put option. Under Internal Revenue Code (IRC) §108(e)(8), if a debtor corporation issues stock, or a debtor partnership issues a capital or profits interest, to a creditor in satisfaction of indebtedness, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the equity interest. Therefore, if the QALICB is a corporation or a partnership, it may be able to minimize

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COD income by issuing to the CDE an equity interest with a fair market value as close as possible to the adjusted issue price of the B loan before the exit transaction occurs. If the B loan is converted to equity before the exit transaction occurs, COD income will be recognized only to the extent it is triggered by the equity conversion itself; since there will be no debt after the conversion, COD income cannot be triggered by the exit transaction itself.

The equity interest issued to CDE should be structured carefully, with a view to its value upon issuance. For example, the CDE may be given a capital account credit equal to the balance of the B loan, a preferred return, and a to-be-determined residual profits interest that fairly reflects the value of the QALICB's property at the time of the conversion. Of course, the QALICB should be mindful of the business risk that the investor will not exercise its put option.

Note that if the QALICB is a single member LLC and is a disregarded entity for tax purposes, its issuance of an equity interest to the CDE may be treated as the transfer of an undivided interest in the QALICB's assets to the CDE in satisfaction of the B loan followed by the formation of a new partnership by the CDE and the QALICB's single member. (See Rev. Rul. 99-5, 1999-1 C.B. 434, Situation 1.) This should avoid COD income to the same extent as under IRC §108(e)(8), but the QALICB will have taxable gain if the basis in the assets deemed to be transferred to the CDE is less than their fair market value. To avoid that result, if it is contemplated that a QALICB that is an LLC will issue an equity interest to the CDE in satisfaction of the B loan, the QALICB should have at least two members well before the exit transaction occurs.

The QALICB and CDE may agree at any time prior to the exit transaction that the QALICB will issue a membership interest to the CDE in satisfaction of the B loan. However, it may be advantageous for the parties to enter into an equity conversion option agreement when the QLICI loans close. Having an option mechanism in place will remind the parties that converting the debt to equity should be considered as the end of the tax credit period approaches. Furthermore, an option mechanism will allow the conversion to take place upon delivery of an exercise notice and will eliminate the need for the parties to establish the terms of the CDE's equity interest in the QALICB in year seven.

It is important to note that any option to convert the B loan into equity of the CDE must be held by the CDE, and not the QALICB. If the QALICB has the option to convert B loan into equity, there is a risk that the B loan will not be treated as true debt for tax purposes. If COD income cannot be avoided because of a decline in the value of the QALICB's property, consideration should be given to provisions in IRC §108 under which COD income may be excluded from taxable income.

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ISSN 2152-646X

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If the QALICB is a corporation, and its liabilities exceed the value of its property, COD income resulting from cancellation or reduction of the B loan may be excluded under the insolvency exclusion in IRC §§108(a)(1)(B) and (a)(3). The exclusion under these rules is limited to the amount by which the QALICB is insolvent immediately before the debt reduction.

If the B loan was used to acquire or construct real property, and the QALICB is a partnership with one or more partners that are not C corporations, the QALICB may elect to exclude its COD income under the rules in IRC §§108(a)(1)(D) and 108(c) for qualified real property business indebtedness (QRPBI). The exclusion under these rules is limited to the amount by which the outstanding principal amount of the canceled debt exceeds the fair market value of the real property securing the debt minus the outstanding principal amount of any other QRPBI secured by the property. Only non-corporate partners in the QALICB can benefit from the QRPBI exclusion.

Exclusion of COD income under the insolvency rules or the QRPBI rules will cause a reduction in the basis of the QALICB's property (or, in the case of the insolvency exclusion, other tax attributes) by the amount of the excluded income. This generally will be a small price to pay for avoiding current tax on COD income.

The exclusion rules in IRC §108(a)(1) operate in tandem with the rules that determine the amount of recognized COD income. For example, suppose that the QALICB is a corporation, has property with a value of $8 million, and has refinanced its $7 million A loan with another $7 million loan. Before the exit transaction occurs, the QALICB issues stock with a $3 million liquidation preference and a 10 percent residual equity participation in full satisfaction of the $3 million B loan. If it is determined that the stock has a fair market value of $1 million (the value of the QALICB's property net of the $7 million loan), the QALICB will recognize $2 million of COD income under IRC §108(e)(8). However, because the QALICB is insolvent by $2 million, the QALICB may exclude all of its COD income under IRC §108(a)(1)(B).

Income Other Than COD Income

Taxable QALICBs and their affiliates should be mindful that the IRS could take the position that the exit transaction produces current taxable income that is not COD income. Whether such income arises depends on the application of nonstatutory tax doctrines and is beyond the scope of this article.

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This article first appeared in the May 2011 issue of the Novogradac Journal of Tax Credits.