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ACQUISITION AND REHABILITATION OPPORTUNITIES:

Projects with an Expiring Nine Percent Tax Credit Compliance Period

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Residential rental projects financed with "9%" low income housing tax credits in the late 1990's or early 2000's offer, or will soon offer, special opportunities for acquisition/rehabilitation financing with tax-exempt bonds and new "4%" low income housing tax credits. Many of these properties must remain affordable even though the tax credit compliance period has run, and, after being in service for over a decade, will generally benefit from new capital expenditure, either because significant work needs to be done to restore the property to its original condition or valuable additions, such as solar or other green energy improvements, can be made.

The current owner of a project, either the original tax-credit partnership or the general partner following exercise of its purchase option, may have a strong interest in selling. The owner/seller can realize gain from the receipt of the purchase price, either as cash remaining after retiring any debt not assumed by the purchaser or in the form of a seller take-back note. If the value of the property has increased, this gain can be substantial. The owner/seller may also be able to cash out any renewal and replacement or other reserves maintained for the project. Further, if the property needs substantial repairs, the seller/owner can be relieved of the burden of trying to obtain funding for the repair work.

Upon satisfaction of the applicable tax rules, the purchaser can finance the acquisition and rehabilitation of or improvements to the project with tax-exempt bonds and new 4% tax credits. In order for the transaction to qualify as an "acquisition", the purchaser must be unrelated to the seller for tax purposes. Subject to the restrictions discussed below, however, a limited partnership purchaser with a general partner that is the current owner of the project or the general partner of the current limited partnership owner of the project may be "unrelated" to the seller/owner. That is, the current owner may be able to sell the property to a tax-credit limited partnership in which the current owner's general partner (or the current owner, if the general partner of the original tax-credit limited partnership has exercised its purchase option) is the general partner.

TRANSACTION STRUCTURE

The basic transaction structure is as follows: A new partnership purchases the project from the existing owner for cash and, if necessary, a subordinate note payable by the seller, and the purchaser then proceeds to rehabilitate the property. The purchaser obtains the funds for the cash portion of the purchase price and for rehabilitation costs through the sale of tax-exempt bonds and new 4% tax credits. Any existing debt on the project must be paid-off, assumed or replaced. Depending upon the amount of rehabilitation that needs to be done, new soft money sources may need to be found.

The bonds must be either credit enhanced or privately placed with a lender. If the tax-credit equity is provided at the closing, the bond loan may be simply a new permanent loan, but if tax-credit equity comes in only upon the completion of rehabilitation, the bonds may require a separate construction loan as well as a permanent period loan. As with any acquisition/rehabilitation financing, the appraisal, the physical needs assessment, occupancy levels and income and rent limits will all impact the credit analysis and the transaction terms.

TAX ISSUES

Bond Tax Issues. For tax-exempt bond purposes, the bonds issued to finance the acquisition and rehabilitation of the project is a "new money" issue. The tax requirements, including requirements respecting the amount of rehabilitation expenditure required, are for the most part the same as for tax-exempt acquisition/rehabilitation financings generally. The requirement that the seller and the purchaser be "unrelated parties" for federal income tax purposes (discussed below) is, however, a threshold issue.

Low Income Housing Tax Credit Issues. On the tax-credit side, existing regulatory agreements will need to be assigned to and assumed by the purchaser and may need to be amended or supplemented, and deal terms relating to the new credits will need to be determined by the partners of the partnership purchasing the property. The requirement that the seller and the purchaser be "unrelated parties" for federal income tax purposes is an issue for low income housing tax credit purposes as well.

Unrelated Party Issue. To have an "acquisition" for tax purposes, the seller and the purchaser must not be related parties for tax purposes. The seller can be a "related party" to the purchaser if the seller or a partner of the seller is a partner in the purchaser partnership (e.g., the seller or seller general partner is the general partner of the purchaser partnership). In that case, the rights and obligations under the partnership agreements must be evaluated to determine that a transfer of at least a 50% economic interest in the project has occurred (i.e., that neither the general partner's capital interest nor its profits interest in the purchaser partnership is greater than 50%). The seller can also be a "related party" to the purchaser if the terms of a seller take-back note in the context of the overall economics of the transaction are such that what is in form debt is susceptible to being characterized as an equity interest in the project or the purchaser partnership. The resolution of unrelated party issues involves complex evaluations of law and fact, but is generally not an impediment to the successful completion of a financing if identified early and carefully addressed in structuring the transaction.

THE PROCESS

The financing process generally follows the path for completion of an acquisition/rehabilitation tax-exempt bond financing with 4% tax-credits. The project sponsor, which will generally be the general partner of the partnership formed to purchase the property, works with its financial consultant and bond counsel to select an issuer, a lender and a tax-credit investor, applications for allocations of private activity bond volume cap and low income housing tax-credits are submitted and the financing ream works to negotiate and assemble the transaction documents. One important point to note, however, is that given the potential complexity of the tax analysis, it is especially important for the project sponsor to begin working with its financial consultant and bond counsel to structure the transaction early in the process. For more information, see Orrick's booklet Multifamily Rental Housing: Financing with Tax-Exempt Bonds, available upon request or at:
www.orrick.com/fileupload/2709.pdf