Negotiating LIHTC Operating Agreements with an Eye on Y15

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STRENGTH MATTERS®

Financial Management Conference

This session will help CFOs and finance staff to:

- **Identify Operating Agreement provisions that impact your LIHTC portfolio and organization at Y15**
- **Learn how to analyze LIHTC capital accounts and estimate value at Y15**
- **Understand the legal agreements of the OA and ways to negotiate and mitigate impacts of unfavorable and/or unclear language and provisions..**

POLL QUESTION 1

Y15 Overview

- IRS Section 42 refers to the IRS code that regulates the use of the LIHTC tax credit.
- Each project has a 15-year compliance period and a 15-year extended use period. Tax credits are claimed by the investor on an accelerated timeline over 10 years.
- By year 15 all of the investor tax benefits have been claimed and generally, the investor seeks to exit the partnership.
- At this juncture you may seek to wholly own the partnership and it's your job to determine:
  - when your project reaches the end of the compliance period (Y15).
  - Consider your repositioning goals and the investor interest.
  - Assign staff to work on purchase plan – project manager, legal, accountant.
  - Gather and review legal and financial documents.
    - Identify the LPA purchase price, timing – purchase option or right of first refusal (ROFR), value calculation, waterfall, backend split
  - Determine Capital needs
  - Assess value – BOV and/or appraisal
  - Formulate a purchase plan for ongoing use of the property
  - Negotiate exit with the limited partner
  - Investor exit and repositioning

Assembling Documents for a Purchase Plan

Partnership Agreement

- Purchase Option and ROFR – terms and timing of acquisition/sale
- Valuation of property
- Disposition of reserves – operating and replacement
- Capital account deficit restoration requirements

Debt Agreements

- Outstanding balances
- Terms related to sale
- Mortgage repayment terms
- Consents required to transfer ownership
- Reserves regulations
- Restrictive covenants of funding that could impact valuation – LDA, land lease, extended use agreements

Audits

Other Agreements

- Land Use Regulatory Agreement (LURA) - continued monitoring by HFA/ allocating agency
- Other reporting requirements

- HFA
  - Land Use Regulatory Agreement (LURA) – extended affordability, physical condition, tax benefits, control of reserves

When is Y15?

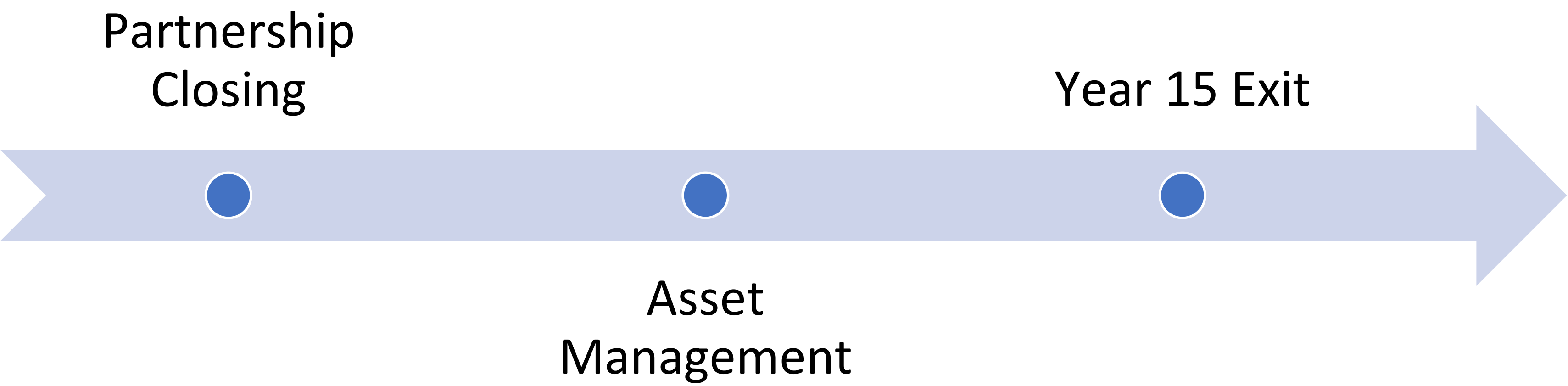
- The end of Year 15 is the last day of the tax year of the 15th year beginning with the first year in which any tax credits were claimed (1st credit year +14 = exit year). Tax credits are claimed in either the year the qualified building was placed in service or the next year. The Form 8609 filed with the IRS indicates when the credits were elected to be claimed.

Part II **First-Year Certification**—Completed by Building Owners with respect to the First Year of the Credit Period

7	Eligible basis of building (see instructions)	7	
8a	Original qualified basis of the building at close of first year of credit period	8a	
b	Are you treating this building as part of a multiple building project for purposes of section 42 (see instructions)?	☐ Yes	☐ No
9a	If box 6a or box 6d is checked, do you elect to reduce eligible basis under section 42(i)(2)(B)?	☐ Yes	☐ No
b	For market-rate units above the average quality standards of low-income units in the building, do you elect to reduce eligible basis by disproportionate costs of non-low income units under section 42(d)(3)(B)? ▶	☐ Yes	☐ No
10	Check the appropriate box for each election: **Caution:** *Once made, the following elections are irrevocable.*		
a	Elect to begin credit period the first year after the building is placed in service (section 42(f)(1)) ▶	☐ Yes	☐ No
b	Elect **not** to treat large partnership as taxpayer (section 42(j)(5)) ▶	☐ Yes	
c	Elect minimum set-aside requirement (section 42(g)) (see instructions) ☐ 20-50 ☐ 40-60	☐ 25-60 (N.Y.C. only)	
d	Elect deep rent skewed project (section 142(d)(4)(B)) (see instructions)	☐ 15-40	

Disposition timeline

- A LIHTC developer should be thinking about the disposition process from the very beginning - even before a deal closes. The extra penny per credit your equity partner might pay to win a deal could pale in comparison to the cost to exit at Y15.



Roadmap

- <u>Part 1: Background</u>
  - Why is Year 15 Significant
  - Negotiation Timeline
  - Transactional Cost

- <u>Part 2: Strategies</u>
  - Fair Market Value Purchase Option
  - Year 11 Early Buy-Out
  - Not-for Profits Right of First Refusal (Governmental Agencies Too)
  - Qualified Contract

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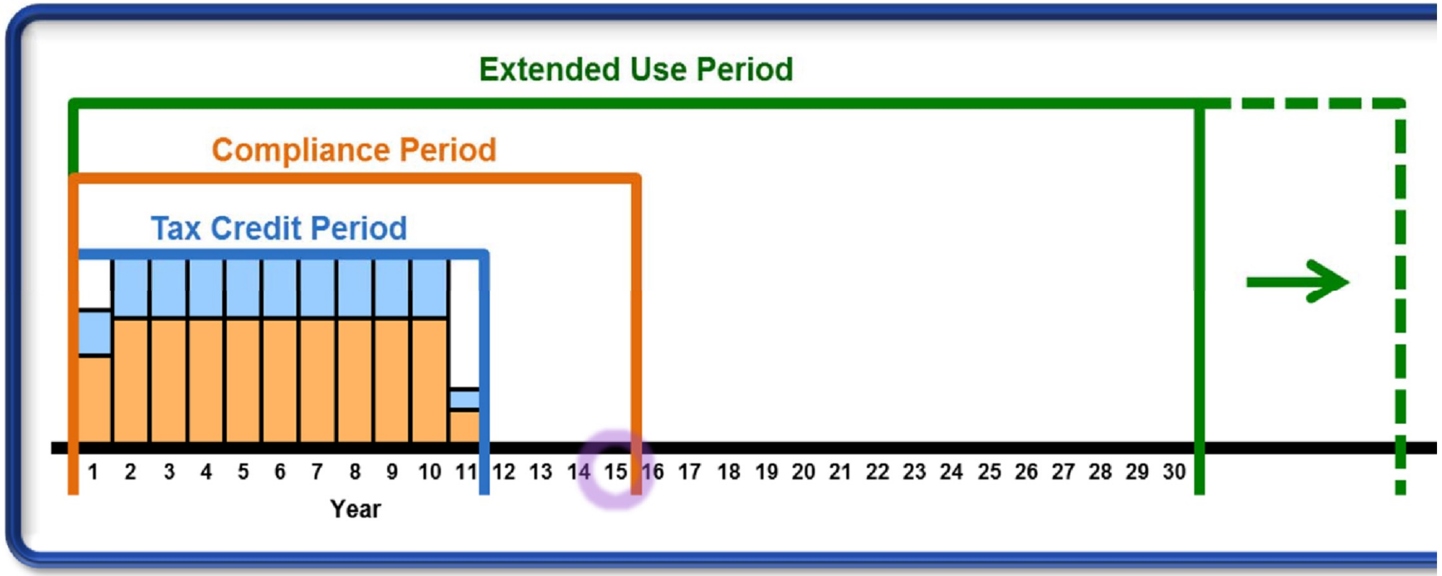
Measuring a Tax Credit Project Lifecycle



**Slide graphics are courtesy of Novogradac & Co.*

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Form **8609**
(Rev. December 2006)
Department of the Treasury
Internal Revenue Service

Low-Income Housing Credit Allocation and Certification

OMB No. 1545-0988

Part I **Allocation of Credit.**

Check if: ☐ Addition to Qualified Basis ☐ Amended Form

A Address of building (do not use P.O. box) (see instructions) [redacted] Brooklyn, New York 11206	B Name and address of housing credit agency NYS Division of Housing and Community Renewal 38-40 State Street Albany, NY 12207
C Name, address, and TIN of building owner receiving allocation [redacted] L.P. [redacted] Brooklyn, New York 11237 TIN ▶ 52[redacted]	D Employer identification number of agency 14-6002615 E Building identification number (BIN) NY-03-[redacted]

1a	Date of allocation ▶ 06 / 04 / 2003 **b** Maximum housing credit dollar amount allowable	1b	$840,564
2	Maximum applicable credit percentage allowable	2	7.87 %
3a	Maximum qualified basis	3a	$10,680,610
b	If the eligible basis used in the computation of line 3a was increased, check the applicable box and enter the percentage to which the eligible basis was increased (see instructions) ☐ Building located in the Gulf Opportunity (GO) Zone, Rita GO Zone, or Wilma GO Zone ☑ Section 42(d)(5)(C) high cost area provisions	3b	130 %
4	Percentage of the aggregate basis financed by tax-exempt bonds. (If zero, enter -0-.)	4	%
5	Date building placed in service ▶ 04 / 18 / 2005		

6 Check the boxes that describe the allocation for the building (check those that apply):
a ☐ Newly constructed and federally subsidized b ☑ Newly constructed and **not** federally subsidized c ☐ Existing building
d ☐ Sec. 42(e) rehabilitation expenditures federally subsidized e ☐ Sec. 42(e) rehabilitation expenditures **not** federally subsidized
f ☐ Not federally subsidized by reason of 40-50 rule under sec. 42(i)(2)(E) g ☐ Allocation subject to nonprofit set-aside under sec. 42(h)(5)

Signature of Authorized Housing Credit Agency Official—Completed by Housing Credit Agency Only

Under penalties of perjury, I declare that the allocation made is in compliance with the requirements of section 42 of the Internal Revenue Code, and that I have examined this form and to the best of my knowledge and belief, the information is true, correct, and complete.

▶ Robert M. Shields (signature) ▶ Robert M. Shields ▶ 10/3/08
Signature of authorized official — Name (please type or print) — Date

Part II **First-Year Certification**—Completed by Building Owners with respect to the First Year of the Credit Period

7	Eligible basis of building (see instructions)	7	10,680,610
8a	Original qualified basis of the building at close of first year of credit period	8a	10,680,610
b	Are you treating this building as part of a multiple building project for purposes of section 42 (see instructions)?		☐ Yes ☒ No
9a	If box 6a or box 6d is checked, do you elect to reduce eligible basis under section 42(i)(2)(B)?		☐ Yes ☐ No
b	For market-rate units above the average quality standards of low-income units in the building, do you elect to reduce eligible basis by disproportionate costs of non-low income units under section 42(d)(3)(B)? ▶		☐ Yes ☐ No
10	Check the appropriate box for each election: **Caution:** *Once made, the following elections are irrevocable.*		
a	Elect to begin credit period the first year after the building is placed in service (section 42(f)(1)) ▶		☐ Yes ☒ No
b	Elect **not** to treat large partnership as taxpayer (section 42(j)(5)) ▶		☐ Yes
c	Elect minimum set-aside requirement (section 42(g)) (see instructions) ☐ 20-50 ☐ 40-60		☒ 25-60 (N.Y.C. only)
d	Elect deep rent skewed project (section 142(d)(4)(B)) (see instructions)		☐ 15-40

Under penalties of perjury, I declare that the above building continues to qualify as a part of a qualified low-income housing project and meets the requirements of Internal Revenue Code section 42. I have examined this form and attachments, and to the best of my knowledge and belief, they are true, correct, and complete.

▶ [redacted] ▶ ▶ 10/6/08
Signature — Taxpayer identification number — Date

▶ ▶
Name (please type or print) — Tax year

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 63981U Form **8609** (Rev. 12-2006)

2001C7ES. 1

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Project's Entering Year 15
2021-2022

(Nationally)

Year 15	2021	2022
Number of Projects	1742	1523
Number of Units	141219	115828

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Key Concept:
Exit Taxes Vs. Transfer Taxes

	EXIT Taxes = Federal Tax
	Capital Account
1	$12,000,000
2	-1000000
3	-1000000
4	-1000000
5	-1000000
6	-1000000
7	-1000000
8	-1000000
9	-1000000
10	-1000000
11	-1000000
12	-1000000
13	-1000000
14	-1000000
15	-1000000
Ending Capital Account	($2,000,000)
Investor Tax Rate	0.21
Exit Tax	($420,000)

	TRANSFER Taxes = State & City Tax on Value/ Consideration	
Value	$	5,000,000.00
NY State Tax	$	20,000.00


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Capital Accounts

(Negative and Positive Examples)

	Capital Account	
1	$	10,000,000
2	$	(1,500,000)
3	$	(1,500,000)
4	$	(1,500,000)
5	$	(1,500,000)
6	$	(1,500,000)
7	$	(1,500,000)
8	$	(1,500,000)
9	$	(1,500,000)
10	$	(1,500,000)
11	$	(1,500,000)
12	$	(1,500,000)
13	$	(1,500,000)
14	$	(1,500,000)
15	$	(1,500,000)
Ending Capital Account	$	(11,000,000)
21% Tax Rate	*$*	*(2,310,000.00)*
25% Tax Rate	*$*	*(2,750,000.00)*
35% Tax Rate	*$*	*(3,850,000.00)*

	Capital Account
1	$10,000,000
2	-400000
3	-400000
4	-400000
5	-400000
6	-400000
7	-400000
8	-400000
9	-400000
10	-400000
11	-400000
12	-400000
13	-400000
14	-400000
15	-400000
Ending Capital Account	$4,400,000

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Forced Sale Provision

•**<u>Sample#1</u>**

•At any time after the expiration of the Compliance Period (Year 15): (i) the General Partners shall offer the Property for sale if requested to do so by the Investor Limited Partner, and (ii) the ***<u>Investor Limited Partner</u>*** shall be permitted to commence marketing the Property and obtain offers to purchase the Property.

•**<u>Sample #2</u>**

•Notwithstanding the foregoing, at any time after the sixteenth (16th) anniversary of the first day of the first taxable year of the applicable Compliance Period, the ***<u>Investor Member</u>*** may request that the Company sell the Apartment Complex subject to the Extended Use Agreement (a "<u>Continued Compliance Sale</u>).

•*Note: The LOI should prohibit forced sales*

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CAPITAL ACCOUNT FORECASTING

YEAR 15 - PROJECTION of LIMITED PARTNERS CAPITAL ACCOUNT		
Computation for the Tax	Date of Last Bin Placed In Service (source is original 8609's)	2015
A	Year of the Most Recent Completed Tax Return	2022
B	Limited Partner's Capital Account Balance Shown in the Most Recent Tax return - From 1065 L Ending Capital Account Balance	$ 300,000
C	Taxes losses for Year - Box L current year increase or decrease (Show as a negative number)	$ (40,000.00)
D	Number of Years Until the Sale	8
E = C * D	Total Additonal Projected Losses (show as a negative number)	$ (320,000)
F = B + E	Projected Limited Partner Capital Account at Sale (if this box is a positive number there will be no exit taxes	$ (20,000)
G = F 8 .30 *1.30-1	Tax on Sale - Only if (f) is a Negative Number; Tax is expressed as a positive number	$ (9,451)

Negotiation Timeline

2003

Letter of Intent
Critical to negotiate exit strategy at LOI

2005

Closing Partnership Agreement
Protect the concepts negotiated in the LOI

2007-2021

Project Operations

2017

Revisit Exit Strategy
Analyze exit price, opportunities for early investor exit, estimate timelines needed for governmental approvals

2021-2022

Execute Exit
Assuming there was not an early exit, approvals should be submitted no later than 2020

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Transactional Costs

Time and Money

- Time!
- Appraisals (how well does the appraiser know Year 15 economics?)
- Title
- Transfer Taxes
- Catch-up payments for reserves or loan payments
- Accounting/ Legal
- Specialist Coordination

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Year 15 Timing Considerations

- Timing Deadlines under the LPA/ Operating Agreement
- HUD Programs
- Lender/ Agency Consents

Strategies to Exit Investor

- Fair Market Value Purchase Option
- Year 11 Early Buy-Out
- Not-for Profits Right of First Refusal (Governmental Agencies Too)
- Resyndication/ Refi
- Qualified Contract

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Fair Market Value Purchase Option

- Typical Terms:

- **Fair Market Value**

- Or

- **Greater of (i) Fair Market Value and (ii) Debt plus Taxes**

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Fair Market Value

debt should be included in the calculation

- NOI (Revenues minus expenses): $150,000
- Cap Rate: 6.5%
- Value: $2,307,692

- Debt: $5,000,000

- Fair Market Value: $1.00 ($2,307,692 - $5,000,000 is negative ($2,692,308))

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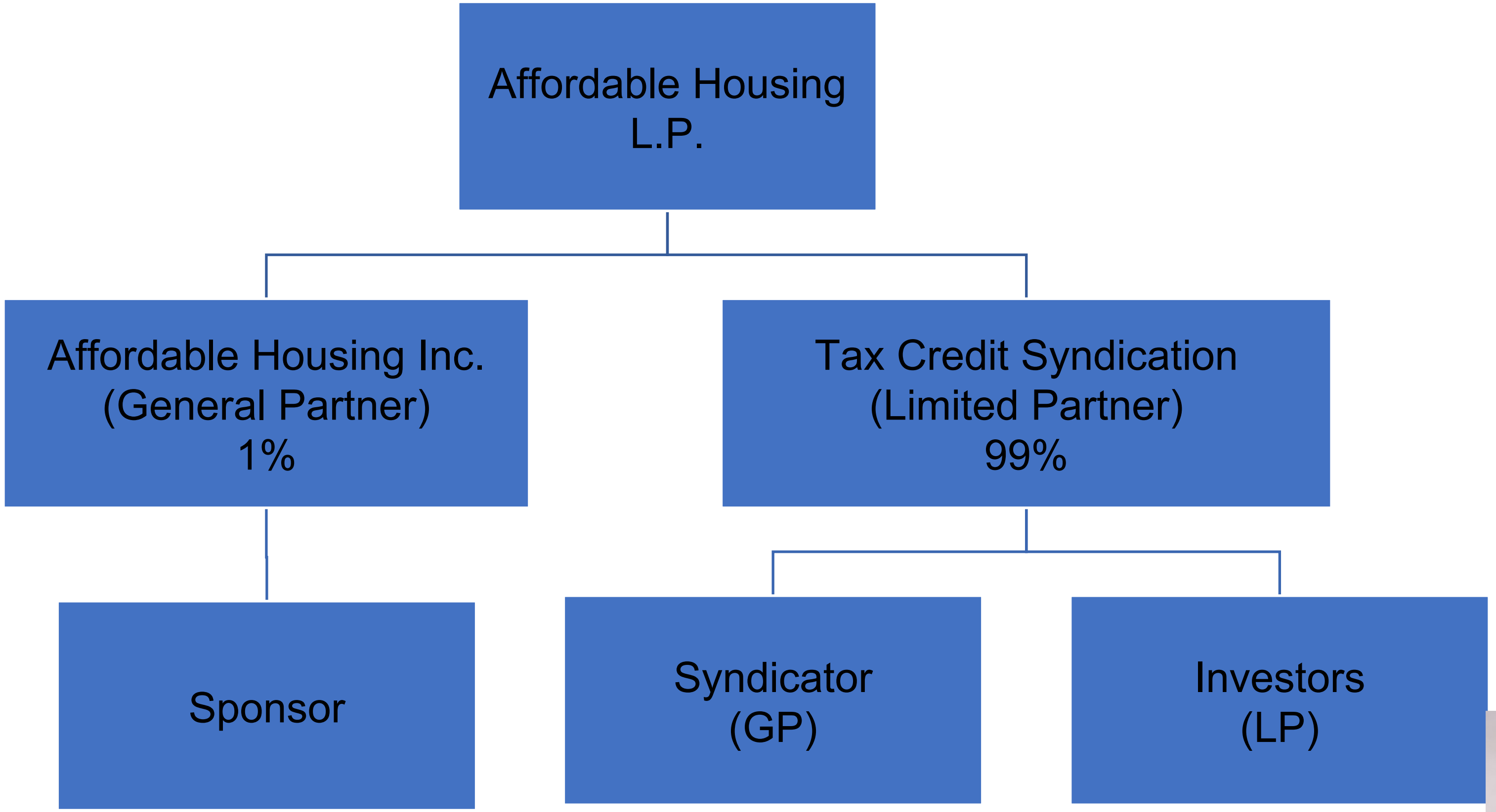
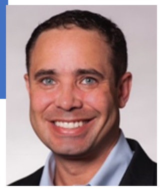
ORGANIZATIONAL CHART

Pre-Year 15 Organizational Chart

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Purchase Option

- Sample Purchase Option Provision:
- During the period commencing upon the expiration of the Compliance Period and ending one hundred eighty (180) days thereafter, the Managing Member shall have an option to purchase the Apartment Complex from the Company at a price (the "Purchase Price") equal to the greater of (i) fair market value of the Apartment Complex or (ii) Exit Taxes.

- Suggested Revision:
- During the period commencing upon the expiration of the Compliance Period and ending ~~one hundred eighty (180) days~~ three (3) years thereafter (which will be tolled during any period in which the Managing Member is under considerations for Agency or Lender approvals), the Managing Member shall have an option to purchase the Apartment Complex from the Company at a price (the "Purchase Price") equal to the ~~greater of (i)~~ fair market value of the Apartment Complex ~~or (ii) Exit Taxes~~.

- Notes: (1) *cap the exit tax amount if it must stay*, and (2) *Capital Account analysis might require additional revisions*

Purchase Option

(Going Concern Language – Interest Option)

- Upon the expiration of the Compliance Period, the Managing Member shall have an option (which may not be assigned) to purchase the Investor Members' Interests (the "Interest Option") from the Investor Members at a price (the "Interest Purchase Price") equal to the fair market value of the Investor Members' Interests, based on an appraisal…..

- Upon the expiration of the Compliance Period [Credit Period?], the Managing Member or its affiliate shall have an option (which may not be assigned to a third party who is not an affiliate of the Managing Member or is not acting as the managing member) to purchase the Investor Members' Interests (the "Interest Option") from the Investor Members at a price (the "Interest Purchase Price") equal to the fair market value of the Investor Members' Interests, assuming the continuation of the Partnership as a going concern, based on an appraisal paid for by the Company …….

Strategies to Exit Investor

- Fair Market Value Purchase Option
- Year 11 Early Buy-Out
- Not-for Profits Right of First Refusal (Governmental Agencies Too)
- Qualified Contract

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YEAR 11 Early Buy Outs

- Benefits to Developer
  - Audit/Tax Reporting Costs
  - Exit Taxes may still be growing in Years 11-15
  - Control your own destiny

- Benefits to Investor:
  - Improve relations with developer
  - Low appetite for losses
  - Not enough value for a Year 15 payout
  - Accelerate some losses

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Strategies to Exit Investor

- Fair Market Value Purchase Option
- Year 11 Early Buy-Out
- Not-for Profits Right of First Refusal (Governmental Agencies Too)
- Qualified Contract

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Below Market Right of First Refusal

Section 42(i)(7)

- (7) IMPACT OF TENANT'S RIGHT OF 1ST REFUSAL TO ACQUIRE PROPERTY

- **(A) In general** No Federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of 1st refusal held by the **tenants** (in cooperative form or otherwise) or **resident management corporation** of such building or by a **qualified nonprofit organization** (as defined in subsection (h)(5)(C)) **or government agency** to purchase the property after the close of the compliance period for a price which is not less than the minimum purchase price determined under subparagraph (B).
- **(B) Minimum purchase price** For purposes of subparagraph (A), the minimum purchase price under this subparagraph is an amount equal to the sum of—

- **(i)** the principal amount of outstanding **indebtedness** secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants), and
- **(ii)** all **Federal, State, and local taxes** attributable to such sale.
- Except in the case of Federal income taxes, there shall not be taken into account under clause (ii) any additional tax attributable to the application of clause (ii).

- **Red = WHO [Eligible Purchasers]**
- Yellow Highlight: WHAT [purchase property, not investor interest]
- **Purple: PRICE [Debt plus taxes purchase price]**
- ***NOTE: THERE IS NO REFERENCE TO (1) INVESTOR CONSENT OR (2) BONA FIDE OFFER***

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RIGHT OF FIRST REFUSAL v. PURCHASE OPTION UNDER IRC SECTION 42

- Options generally entitle the option holder to purchase the property from the owner at a specific price; the holder can exercise it unilaterally, thereby compelling even an unwilling owner to sell.

- Common law rights of first refusal ("ROFR") often require a potential bona fide purchaser for value. The ROFR is a preemptive right, prohibiting an owner from selling to a third party without first offering the property to the holder of the Right of First Refusal.

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Investor Consent to Exercise Rights?

- **Without the consent of the Investor Member, the Managing Member shall not have any authority to**:

- Except with to transfers under the Purchase Option and Right of First Refusal Agreement, sell or otherwise dispose of, at any time, all or substantially all of the assets of the Company or any portion of the Land, upon which the Apartment Complex is built

Sample ROFR Language

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Right of First Refusal Considerations

•Option vs Common Law Right of First Refusal

•Bona Fide Offer
- Is a triggering offer needed?
- Is a third party offer needed or is a related party offer sufficient?
- Can you solicit the offer?
- Would anyone waste time doing diligence on an offer, knowing that a nonprofit will beat them?
- Is the property regularly receiving offers already?

•Investor Consent
- Is the investor consent necessary to (1) market the property, (2) accept an offer to purchase the property and/or (3) to actually transfer the property.

•

•Price
- Debt plus taxes is the minimum purchase price
- Investors usually add other items such as unpaid guarantees. Need to limit the other things which are added.

•

•Timing
- Transfer often needs to occur in a set number of days. 90, 120 or 180. What if government approvals are needed? Transfer should be based upon a reasonable time after approvals are obtained.

•

•Reserves
- Investors argue that the reserves are personal property owned by the ownership entity. Therefore, they should be distributed. They are not a part of the real property which is subject to the ROFR.
- Many state agencies prohibit the distribution of reserves to the investor.
- Is the operating reserve funded with developer fee?


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Exercise of ROFR

Example: Pro Tax Counsel

- For a period of 6 months from the expiration of the Compliance Period, Sponsor, so long as it is a qualified non-profit organization within the meaning of Section 42(h)(5)(C) of the Code, has a right of first refusal to purchase the Project for a price equal to the sum of (i) the principal amount of outstanding indebtedness secured by the Project, (ii) an amount sufficient to pay all Federal, State and local taxes attributable to the sale and payable by the Company or its Members; (iii) all expenses of sale; and (iv) any amounts due to the Investor Member under the Agreement for guarantees or adjusters. Such right of first refusal will be exercisable by Sponsor only (i) after the receipt by the Company of a legally binding, bona fide offer to purchase the Project from a Person not affiliated with the Sponsor at a price greater than the price at which Sponsor may exercise its right of first refusal. The rights of first refusal to be granted hereunder are intended to satisfy the requirements of Section 42(i)(7) of the Code and will be interpreted consistently therewith. Closing must occur within 90 days from exercise or the Right of First Refusal shall lapse.


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Exercise of ROFR

Suggested Revisions

- ~~For a period of 6 months from~~ Subsequent to the expiration of the Compliance Period, Sponsor, so long as it is a qualified non-profit organization within the meaning of Section 42(h)(5)(C) of the Code, has a right of first refusal to purchase the Project for a price equal to the sum of (i) the principal amount of outstanding indebtedness secured by the Project, (ii) an amount sufficient to pay all Federal, State and local taxes attributable to the sale and payable by the Company or its Members; ~~(iii) all expenses of sale;~~ and ~~(iv)~~ (iii) any amounts due to the Investor Member under the Agreement for guarantees or adjusters. ~~Such right of first refusal will be exercisable by Sponsor only (i) after the receipt by the Company of a legally binding, bona fide offer to purchase the Project from a Person not affiliated with the Sponsor at a price greater than the price at which Sponsor may exercise its right of first refusal. The rights of first refusal to be granted hereunder are intended to satisfy the requirements of Section 42(i)(7) of the Code and will be interpreted consistently therewith. Closing must occur within 90 days from exercise or the Right of First Refusal shall lapse.~~

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A Word on Casualty

- Reserves
- CDBG, FEMA and other funding
- Bridge Loans

State Level Policy: Section 42 Right of First Refusal

- Links to State Initiatives:

New York City Housing Preservation and Development https://www1.nyc.gov/assets/hpd/downloads/pdfs/services/2021-draft-qualified-allocation-plan.pdf

Virginia Housing and Development Authority https://www.vhda.com/BusinessPartners/MFDevelopers/LIHTCProgram/LowIncome%20Housing%20Tax%20Cr edit%20Program/2022-QAP-Proposed-Changes.pdf

Washington State Housing Finance Commission https://www.wshfc.org/mhcf/9percent/2021application/c.policies.pdf

Massachusetts Department of Housing and Community Development https://www.mass.gov/doc/nofa-rental-housing-rapid-production-initiative/download?_ga=2.118435722.220054217.1625346619-1034737688.1625346619

District of Columbia Department of Housing and Community Development https://dhcd.dc.gov/publication/2021-dhcd-low-income-housing-tax-credit-qualified-allocation-plan-draft

Pennsylvania Housing Finance Agency https://www.phfa.org/forms/multifamily_news/news/2020/2021-lihtc-allocation-plan.pdf

Federal Policy
Proposed Section 42(i)(7) Revisions

(7) Impact of tenant's option or right of 1st refusal to acquire property

(A) In general

No Federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of ~~a~~an option or right of 1st refusal held by the tenants (in cooperative form or otherwise) or resident management corporation of such building or by a qualified nonprofit organization (as defined in subsection (h)(5)(C)) or government agency to purchase the property or all of the partnership interests (other than interests of the person exercising such option or a related party thereto (within the meaning of section 267(b) or 707(b)(1) relating to the property, after the close of the compliance period for a price which is not less than the minimum purchase price determined under subparagraph (B). For purposes of determining whether an option, including a right of 1st refusal, to purchase property is described in the preceding sentence

(i) such option or right of 1st refusal shall be exercisable without the approval of the owner(s) of the project (including partners, members, and their affiliated organizations), and

(ii) a right of 1st refusal shall be exercisable in response to any offer to purchase the property, including an offer by a related party.

(B) Minimum purchase price

For purposes of subparagraph (A), the minimum purchase price under this subparagraph is an amount equal to the ~~sum of~~

~~(i) the~~ principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants~~), and~~ or other purchaser identified in subparagraph (A)). In the case of a purchase of a partnership interest, the minimum purchase price is an amount not less than such interest's ratable share of the amount determined under the first sentence of this subparagraph.

~~(ii) all Federal, State, and local taxes attributable to such sale. Except in the case of Federal income taxes, there shall not be taken into account under clause (ii) any additional tax attributable to the application of clause (ii).~~

(C) Property

For purposes of subparagraph (A), the term 'property' includes all or any of the assets held for the development, operation, or maintenance of a building.

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Strategies to Exit Investor

- Fair Market Value Purchase Option
- Year 11 Early Buy-Out
- Not-for Profits Right of First Refusal (Governmental Agencies Too)
- Qualified Contract

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Qualified Contract

- **BACKGROUND**
  - LIHTC buildings by statute must have a 15 year compliance period plus an additional 15 year extended use period for a minimum 30 year term
  - Qualified contract allows building to transition to market rents after the initial 15 year compliance period

- **CAVEATS**
  - Many states now require developers to waive the QC as condition to an award of tax credits
  - Complicated calculation
  - Only eliminates extended use agreement; does not eliminate other restrictions from soft debt or any deed restrictions.

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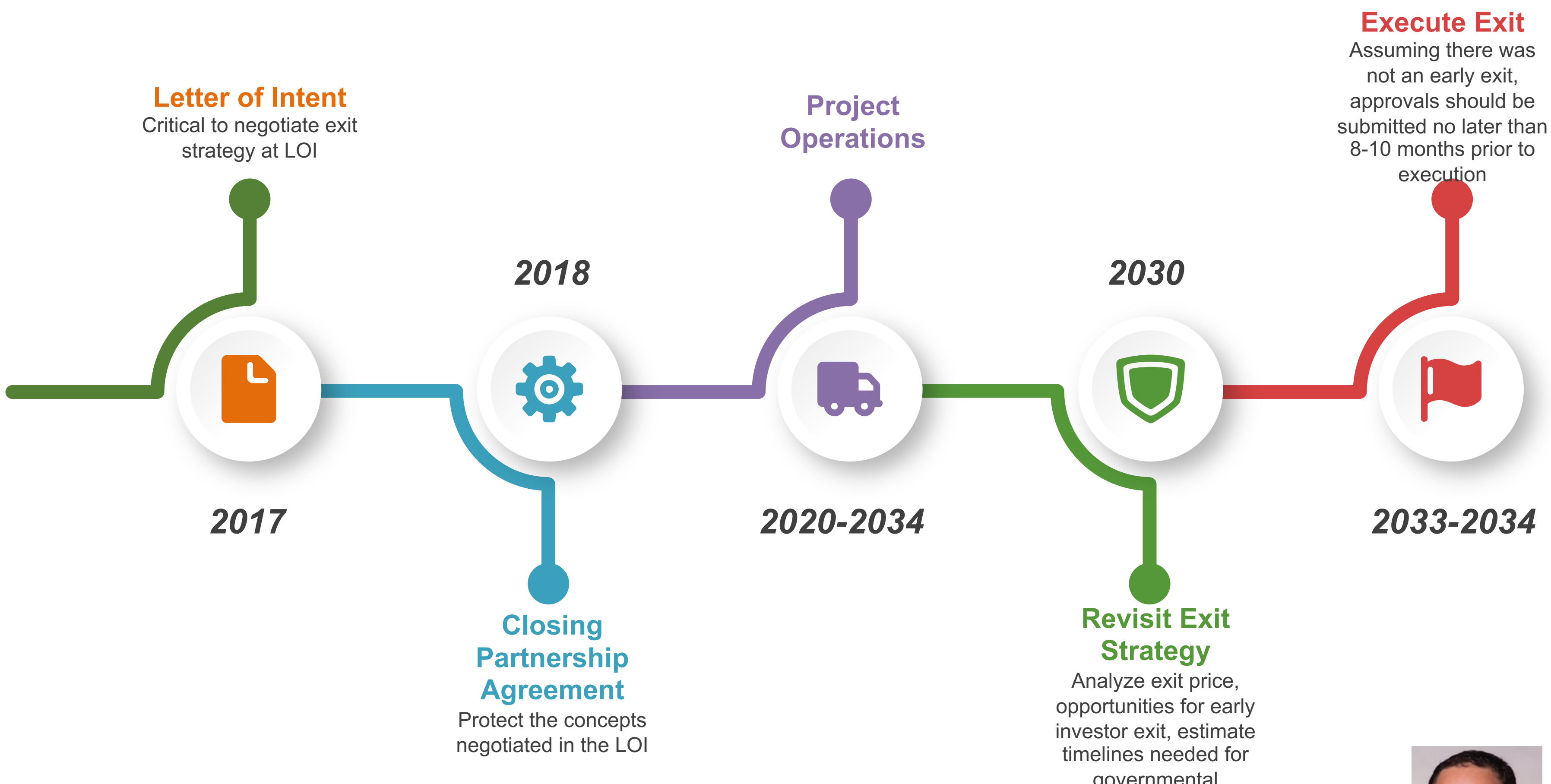
Negotiation Timeline



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BEST PRACTICES

The operating agreement for your LLC or partnership agreement for your LP is the most important agreement that will govern your business for the life of the business. These terms may be difficult to negotiate but if a dispute arises, they will be even more difficult to resolve without the guidance from your operating agreement.

BEST PRACTICES

DURING THE DEVELOPMENT PROCESS

- Development should not be left to negotiate the agreement without the participation of other internal team members namely finance and asset management.
- Beyond the value of "multiple reviewers" of any document, this allows the team to focus on review of the agreement that will take advantage of each member's respective skills.
- Ensuring that the underwriting run lines up with the language in the agreement is also a key quality control issue in the process. The underwriting run can be used to demonstrate "intent". This is particularly important when exiting a partnership.
- Ensure that a transfer of the partnership interest is one of the key provisions.

BEST PRACTICES

DURING THE AUDIT PROCESS

- During Years 1 – 3 the asset manager and the development project manager should review both the audit and the calculation of the waterfall.
- The asset manager should prepare the first draft of the waterfall for review by the internal team prior to sending it to your auditor.
- Update the calculation of the waterfall from the prior year's budget or quarterly forecast.
- Consider having a kick-off meeting that includes the auditor, asset and property management team and the project manager.
- The team should review both the draft audit and the tax return prior to sending it to the auditor.

BEST PRACTICES

DISTRIBUTIONS AND PREFERRED RETURNS

- While distributions govern the division of available cash among the partners, allocations divide net profits and losses (and individual items of income, gain, loss, deduction and credits) among the partners. Allocations are reflected in the capital account that is maintained for each partner. It is recommended that allocations generally correspond to the economics of the partnership in order to avoid a challenge by the IRS.
- Allocation provisions will be more complicated where there is a preferred return or a “promote” structure, or where cash proceeds from operations are distributed contributions can be made in accordance with positive capital account balances.

KNOW WHAT TYPE OF RETURN CALCULATION IS NEEDED

BEST PRACTICES

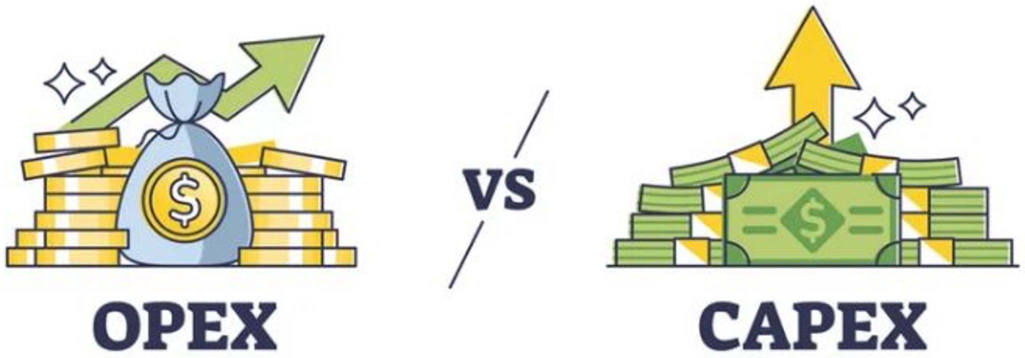
AUDIT RELATED

- A clear indication that you have an outdated operating agreement is the absence of the term “partnership representative.”
- In the past, most agreements provided for a “tax matters partner,” a role that has now essentially been replaced by the “partnership representative” as part of the Bipartisan Budget Act of 2015 (the “BBA”). The BBA created a new centralized partnership audit regime, generally effective for tax years beginning after December 31, 2017.
- While distributions govern the division of available cash among the partners, allocations divide net profits and losses (and individual items of income, gain, loss, deduction and credits) among the partners. Allocations are reflected in the capital account that is maintained for each partner. It is recommended that allocations generally correspond to the economics of the partnership in order to avoid a challenge by the IRS in the event of an audit.

BEST PRACTICES

DURING THE BUDGET PROCESS

- The budget for the property should not be approved until the asset manager has calculated the waterfall.
- Prepare the waterfall in the same format as the auditor is using for the workpapers so that you have continuity from year-to-year and balances are carried forward.
- Discuss the categorization of costs with the property management company preparing the budget so that it lines up with the practices of your auditors and partners.



BEST PRACTICES

DURING THE LIFE OF THE AGREEMENT

- Keep your agreement current as change is inevitable. People leave both the larger team and the organization.
- Agree to changes with your partners and put them in writing or at the very least discuss them with your attorney and auditor to decide if the agreement may need to be changed.
- Reviewing your management & operating agreement with an attorney periodically and making adjustments as you go can ensure everyone’s rights and interests are protected.

POLL QUESTION 2

STRENGTH MATTERS® Financial Management Conference

WHOSE MONEY IS IT, ANYWAY?

Understanding How Operating And Replacement Reserves Are Valued At Year-15

Shaun Rai, VP Asset Management, Community Housing Partners

September 8th, 2022

Discussion Topics

- Case Study
- Managing Expectations and Preparing for Year-15
- Negotiating Options and Mitigating Factors
- Informing the Deal on the Front End
- Questions

CASE STUDY - RIVERMEADE I

- 48 Unit Family Property
- Tax Credit; USDA RD; HOME
- Purchase Option and Non-Profit ROFR (Debt plus Taxes; positive capital accounts)
- Reserve Balances: Replacement Reserves - $422,209; Operating Reserve - $113,276; Rental Assistance Reserve - $104,231

CASE STUDY - RIVERMEADE I

Valuation of Purchase Option:

FMV	$1,826,205(NOI $117K; 6.45% Cap)
Reserves	$ 639,716
Cash	$ 74,922
	$2,540,843
Total Debt	$1,708,936
AP	$ 1,890
Net Value	**$ 830,017**

CASE STUDY - RIVERMEADE I

Valuation of ROFR:

Cash & Escrows	$ 74,922
Reserves	$639,716
less: AP	$ 1,890
Net Value	**$712,748**

CASE STUDY - RIVERMEADE I

Negotiating and Mitigating Factors:

- CNA showing **$458,000** in estimated repairs (HVAC, Appliances)
- Agency Requirements - USDA RD requires an annual cash holdback of 20% of budgeted operating expenses for the following year - Calculated to be $276,379 X 20% = **$55,276**
- COVID uncertainty - the exit year was 2020 - the property did not have full rental assistance but had a Rental Assistance Reserve of **$104,198**

TOTAL ADJUSTMENTS - $617,474

CASE STUDY - RIVERMEADE I

Final Negotiated Value of ROFR: *(adjusted for 2020 Audit)*

Valuation of ROFR:

Cash & Escrows	$ 92,853
Reserves & Deposits	$671,269
less: AP, Prepaids, Other	$ 22,407
less: Negotiated Adjustments	$617,474
Net Value	**$124,241**

Managing Expectations & Best Practises

- Know your partnership agreement
- Most are silent on how Reserves are treated at exit
- Valuation of Reserves and other cash deposits is common
- Plan in advance - work with your syndicator to draw down reserves well in advance of the exit
- Identify capital needs
- Pay deferred developer fees
- Understand Lender and Agency Requirements

Informing the Deal on the Front End

- Should you include the treatment of the Reserves? - not a one size fits all solution
- Important to understand the impact of each option
- Should be part of the negotiation on credit price
- Should inform how you asset manage the property and prepare for the exit year

Questions

- What do your Partnership Agreements say about the Reserves?
- How do you/your AM Team handle these at exit?
- How does this impact they way they manage the property and prepare for Year 15?

POLL QUESTION 3

Resources

- Consortium for Housing and Asset Management (CHAM) webinars

  New Initiatives to Deter Year 15 Right of First Refusal Disputes May 12, 2021

  Year 15 Dispositions: Navigating the Challenges with Purchase Options and Rights of First Refusal September 23, 2020

- National Equity Fund

- https://www.nationalequityfund.org/partnerportal/developers/developing-a-15-year-transition-plan/

- LISC, Refinanced and Reborn: Planning for the Year 15 Transition of Your Tax Credit Projects

More Resources

- Right of First Refusal in the Housing Credit Program – NHT
- Investors Mine For Profits In Affordable Housing, Leaving Thousands Of Tenants At Risk – WBUR
- Local Officials And Congressional Leaders Decry Investors Who Put Affordable Housing At Risk - WBUR
- 10 Red Flags in LIHTC Deals -- David Davenport

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