BUSINESS BRIEFING

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Like-Kind Exchange as an Exit Strategy for Investors in Affordable Housing

One important challenge facing the affordable housing industry is meeting the needs of individuals who invested more than 15 years ago in affordable-housing projects that involved tax credits. Finding a good exit strategy for these individual investors is a thorny problem that confronts syndicated limited partnerships owning such older affordable-housing properties. The exit-strategy issue affects not only individuals who originally invested in the limited partnerships; it also has an impact on the partnerships' general partners, on potential buyers and developers of the properties, and, indirectly, on tenants and others who do work related to the affordable housing in question.

At a recent seminar in Boston on "Current Developments in Affordable Housing," Jeffrey W. Sacks, a partner at the law firm Brown Rudnick Berlack Israels LLP, described an innovative approach the firm's Real Estate Group has implemented to solve this exit-strategy dilemma.

The Haunting Effects of Phantom Income

Originally, individual investors in these limited partnerships received tax benefits from their affordable-housing investments through depreciation deductions. But by now – some 15 years later – those tax benefits have been exhausted, and the individual investors are often left with the resulting "phantom income." Projects generate phantom income when they are creating taxable income without yielding comparable cash flow, typically because all or part of the operating income is used to pay down debt principal payments, which, unlike most interest payments, are not tax-deductible.

The issue of the phantom income is causing investors to seek a solution that will alleviate their tax burden. However, it is difficult to find a solution that will satisfy all stakeholders. Limited partners with negative capital accounts look to defer this huge tax problem without current tax liability. At the

same time, other investors do not face this tax burden, because they have carried forward passive losses or have inherited their partnership interest (along with stepped-up basis), and therefore, are willing to be bought out and bring their investment to an end. Both scenarios have inherent problems: Holding onto affordable-housing projects that generate phantom income may yield tax costs for the individual investors who make up the limited partnership. But, in many cases, direct sales of the projects can generate capital gains tax liabilities for those individual investors.

Brown Rudnick has implemented an alternative solution to this problem. Sacks explained how he and his partners, Forrest Milder, who specializes in the taxation of real estate development and finance, and Jonathan Black, an expert in like-kind exchanges, collaborated with a leading real estate investment and advisory firm, Net Lease Capital Advisors, which specializes in solutions to complex real estate and tax problems, to implement the solution.

This solution combines a careful restructuring of the limited partnership with a tax-free "like-kind exchange," using leveraged properties leased to investment grade tenants. This enables partners who formerly had phantom income to remain in the partnership; but they now hold an interest in an investment grade net-leased property with restructured debt, allowing them to benefit from a significant deferral of taxable income. At the same time, the program can allow the other partners, who have stepped up basis, to be bought out from their investment, satisfying the needs of all constituents. Finding out which strategy – holding, selling, or using a like-kind exchange – is right for a given set of limited partnership investors requires a "Goldilocks-style" approach, Sacks noted, in which various options are examined to find out which is most appropriate for a given project and set of limited partners.

The Credit-Tenant Solution – Just Right

The concept of tax-deferred, like-kind exchanges under Section 1031 of the Internal Revenue Code is, of course, not new. But, Sacks explained, it has always been difficult to find the right kind of properties to match the needs of investors in tax-credit properties and to make a like-kind exchange feasible.

However, he said, there is now an emerging trend that involves the trading of investment grade credit-tenant commercial properties. These credit-tenant properties have 20-year to 30-year triple net leases with established, investment-grade tenant companies – such as large retailers or Fortune 500 corporations – that have sold and leased back their headquarters buildings. In a triple net lease, the building tenant bears the responsibilities for operational costs, such as upkeep, maintenance and taxes, for the duration of the lease. Brown Rudnick, Sacks explained, works in conjunction with Net Lease Capital Advisors, since the company specializes in developing tax strategies and real estate acquisition as part of those strategies.

When a like-kind exchange is made between an affordable-housing project and a credit-tenant commercial property, the debt on the credit-tenant property is structured to limit or eliminate the phantom income problem the individual investors in the partnership had previously faced, and to defer their tax liabilities for up to 20 years. Because many of the

individual investors involved in these older affordable-housing limited partnerships are by now themselves older individuals, a 20-year deferral of tax liabilities may mean that, by the time any tax is due, their interests in the partnership will have been transferred to heirs, with the step-up in basis that such a transfer entails. For the individual investors, such a like-kind exchange should be viewed as deferring virtually all tax liability for 20 years or more, but also adding a modest risk of immediate tax liability, with no cash available, if the credit tenant files for bankruptcy during the duration of the lease.

An Exchange that Works for Everyone

Sacks explained how such a like-kind exchange works in practice. Typically, a like-kind exchange does ***not*** literally involve a swap of one property for another. Instead, under the IRS regulations, a holder of property can get tax-free treatment when it sells that property, has the sales proceeds delivered to a "qualified intermediary" or "QI", and then instructs the QI to use the proceeds to buy a different or "replacement" property which is deeded directly back to the holder. For example, where the original property is an affordable-housing project, it could be transferred to a housing developer who wishes to renovate it, and who may, as the new owner, receive tax-credit benefits for doing so. That developer will pay the cash portion of the purchase price to the QI, who will hold the cash until the new credit-tenant commercial property has been identified for acquisition by the limited partnership, and then use the proceeds from the sale of the housing project to purchase a credit-tenant property, which is transferred to the partnership that previously owned the housing project. The result: individual investors in that partnership, which now own the credit-tenant property, are put in a more favorable tax position; the affordable-housing project is recapitalized with new debt and is renovated by its new owners; and those new owners, in turn, get both low-income housing tax credits and depreciation benefits. (Note that many technical rules apply to limit the availability of the tax credit to the new owner of the project. For example, under Section 42 of the Internal Revenue Code, the new developer can qualify for tax credits only if no more than 10% of the partnership interests in the new partnership are related to the partnership that previously owned the project.)

According to Sacks, this type of like-kind exchange is optimal for housing projects that have large negative capital accounts, low basis (i.e., their original cost, reduced by the depreciation deductions taken) and low net value. Careful review of regulatory restrictions, project financing restrictions, and the limited partnership agreement are necessary to determine if a like-kind exchange makes sense for a given affordable-housing property.

As presented at "Current Developments in Affordable Housing," a seminar sponsored by the National Affordable Housing Practice of American Express Tax and Business Services. The author, Jeffrey W. Sacks, is a partner at the law firm Brown Rudnick Berlack Israels LLP.

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