Housing Finance Corporation

Partnership Opportunities and Challenges

Prepared

By

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HFC
Partnership Opportunities/Challenges

I. Policy Considerations

- Should the HFC expand into this role?
- Financial reasons
- Control of the project- protecting against potential tax events
- But for analysis- deal won't work without exemption
- PILOT
- Do you participate only in bond deals or also in 9% deals

II. Legal structure

- D & O Insurance
- Establish subsidiary entities to minimize risk and liability
- Organizational chart of subsidiaries and relationship
- LLC as landowner – will the CAD accept this structure
- 115 versus disregarded entity questions on LLCs
- 501(c)3 as general contractor – sales tax savings
- GP LLC must be for-profit (168H filing)
- 35 day filing on bond deals – partnership must be set

III. Business Deal Structure

- MOU – sets out standard deal as beginning point for discussion- get signed early as this establishes responsibility for payment of fees
- What is customary fee and cash flow split – cash fee vs deferred fee
- Plan A- not the issuer
  9% deals
- Plan B- When also the issuer - potential IRS 752 (related partner) issue

- Other sources of revenue from the deal – ground lease payments, GC fees
- GP partnership management fee – waterfall placement
- Threshold standards – what if there is no cash flow
- Year 15 – 42(i)(7)(b) and developer continuing participation

IV. Living with the Deal/Staffing

- Review and approval of engineering and architectural plans
- Approval of social services and provider
- Approval of property manager
- Construction – use of a third party inspector
- You have to live with the product for at least 15 years
- Added named insured (GC entity)
- Plan on no cash flow
- Internal staff versus outsourcing
- Accounting, reporting, compliance (GP responsibilities)
- Life Cycle cost analysis

V. Inherent Tensions in the Deal

- Guarantees – developer – construction completion, lease up, operating deficit
- Developer participation after year 15
- Non-Profit cannot guarantee more than its share of the fees and maintain non-profit status
- Developer will want control of PM, etc during guarantee period – joint approval

Policy Considerations

What is the reason for undertaking the General Partner role?

Generation of additional revenue for the HFC to fund additional activities- developer fees and potential cash flow will provide additional resources to further public purpose capabilities

Control of the non-profit role in the transaction to ensure long-term viability – bond transactions involving a non-profit not controlled by the HFC have the potential for actions by the non-profit causing the HFCs bonds to be declared taxable.

But/For Analysis – the HFC may require the developer to show that the project will not underwrite without the tax exemption

PILOT – the HFC may adopt a policy requiring a PILOT program on all tax exempt transactions with a minimum threshold amount and/or service requirements

Does the HFC also want to entertain the GP role on 9% tax credit deals

Should the HFC focus on a specific type of project – e.g. seniors

Start slowly – do one transaction – make sure systems and controls are in place

Is the HFC willing to put up its share of the developer fee as a guarantee ?

What is the goal of the HFC in terms of long term ownership? Do you plan to own/operate the property for the entire 30 year LURA period or look at other options at year 15?

Legal Structure

Does the HFC have D& O insurance?

Establish subsidiary entities to minimize risk and liability – by creating single asset entities, ownership resides at that level and protects the parent corporation. The LLCs must be created with the HFC as the sole member and the provision that all assets of the LLC revert to the member upon dissolution of the LLC. This is necessary to ensure that the tax exemption provided under LGC 394.905 flows down to the wholly owned subsidiary LLC

Must confirm with CAD that they will accept the structure of a subsidiary LLC being the landowner instead of the HFC being the landowner. May vary from CAD to CAD.

Must treat the subsidiary LLCs as115 entities or disregarded entities for IRS purposes. CAHFC selected the 115 option as opposed to considering the LLCs as disregarded entities as the parent HFC is a 115 entity.

The LLCs may be subject to franchise tax initially but this can be addressed with the Comptroller if revenue is anticipated to exceed threshold levels.

The General Partner entity will be required by the investor limited partner to elect to be taxed as a taxable entity (C Corporation) in order for the investor partner to receive the benefit of the accelerated depreciation schedule under IRS guidelines. The entity must file form 8832 with the IRS and elect to NOT be treated as a tax exempt entity under IRC Section 168(h)(6)(9F)(ii). This election can be made at the time the EIN is secured from IRS or with the filing of the first tax return (form 1120). This is the General Partner tax return and should not be confused with the Limited Partnership tax return. It is desirable that this election take place before the placed in service date of the property.

Business Deal Structure

Memorandum of Understanding – the purpose of this document is to provide a consistent framework for the initial discussion and negotiation of the partnership parameters. The basics of the partnership memorialized in the MOU will be carried into the Partnership Agreement.

This document should be negotiated and signed early - the business deal should be agreed to before the 35 day filing on a bond transaction as the partnership cannot be changed after that date.

The MOU also outlines responsibility for payment of all fees related to the transaction.

For bond transactions the HFC may need two business plans relating to the cash flow splits. It may be held by some investor tax counsel that the fact the HFC is the issuer of the bonds and the general partner in the partnership creates a "related party" situation under section 752 of the Internal Revenue Code. This situation will limit the HFC to 10% of the project cash flow. This decrease in allowable cash flow can be offset by increasing the developer fee percentage, increasing the annual administrative fee to the issuer, or by inserting a higher ground lease payment which would start at the time the deferred developer fee is paid off.

The HFC should insist on a general partner "Partnership Management Fee" which will be paid higher in the "waterfall" to ensure its availability. The amount of this fee is normally approximately $10,000 per year.

Year 15 – 42(i)(7)(b) – This section of the code provides for a specific methodology to allow the non-profit general partner to acquire the property for the outstanding debt plus exit taxes.

Living with the Deal

Staff requirements- CAHFC currently has two full time employees. We have an outside CPA firm to assist us with accounting matters on an as needed basis.

Review and approval of all engineering and architectural plans – make sure you will be happy with the product long term – you must live with it for at least 15 years and maybe 30 years. We try to apply the principles of life cycle cost analysis to our partnership transactions to strike an appropriate balance in the quality of FFE (furniture, fixtures, equipment)

The property will usually have a 30 year LURA (required by TDHCA)

Due diligence of the budget and pro forma – it is advised that particular attention be paid to maintenance reserves to ensure adequacy for future repairs.

Plan on little or no cash flow – after the deferred developer fee is paid in full, cash flow will begin. Will there be enough to allow the HFC to fulfill its fiduciary responsibilities to the partnership? This is why you want the General Partner Partnership Management Fee – this will provide cash flow to the GP to cover expenses. The Investor Limited Partner will take a similar fee, usually referred to as "Asset Management Fee."

The HFC will need to create bank accounts, charts of accounts and budgets for each entity created for the transaction. Each LLC will need to be adequately capitalized to begin operations. While there is no bright line test for "adequate", we believe initial capitalization of $10,000 per LLC should be sufficient.

Setting up the charts of accounts and "tagging" income from various sources to accommodate the "150 Test" is crucial if you are the bond issuer on a partnership transaction. This tax analysis should be discussed early with tax counsel.

Inherent Tensions in the Deal

What are the inherent tension points in a deal?

There are three parties in the partnership – the developer as the Special Limited Partner, the investor as the Investor Limited Partner, and the HFC subsidiary as the Managing General Partner. These parties will probably have different goals – the GP will want developer fee and continuing cash flow and will want to underwrite to achieve those goals – the investor will not be as interested in cash flow as coverage. The developer will be interested in developer fee, guarantee release, and long term residual income while minimizing up front costs.

Guarantees – the developer is required to provide guarantees for construction completion, lease up, operating deficit, and possibly others.

Developer participation after year 15 – does the developer want to continue in the deal? If so, they may want a side agreement to memorialize the terms of this participation. This will need to be addressed in the context of the HFC policy regarding IRC 42(i)7(b).

The developer will want control of the property manager as long as the guarantees are in place. The GP should have consent rights related to the PM but both parties must agree on the PM and the removal rights to ensure quality management of the property.

Know the value of the tax exemption granted under LGC 394.905 and know your potential partner.

Due Diligence

In addition to the items listed on the Due Diligence Checklist of the MOU the HFC should consider the following:

Check out the developer's infrastructure – visit the developer's offices, meet the staff, tour other properties he/she has developed

Does the developer have any outstanding compliance or other issues with TDHCA

What is the financial strength of the developer?

Run a D & B on the developer

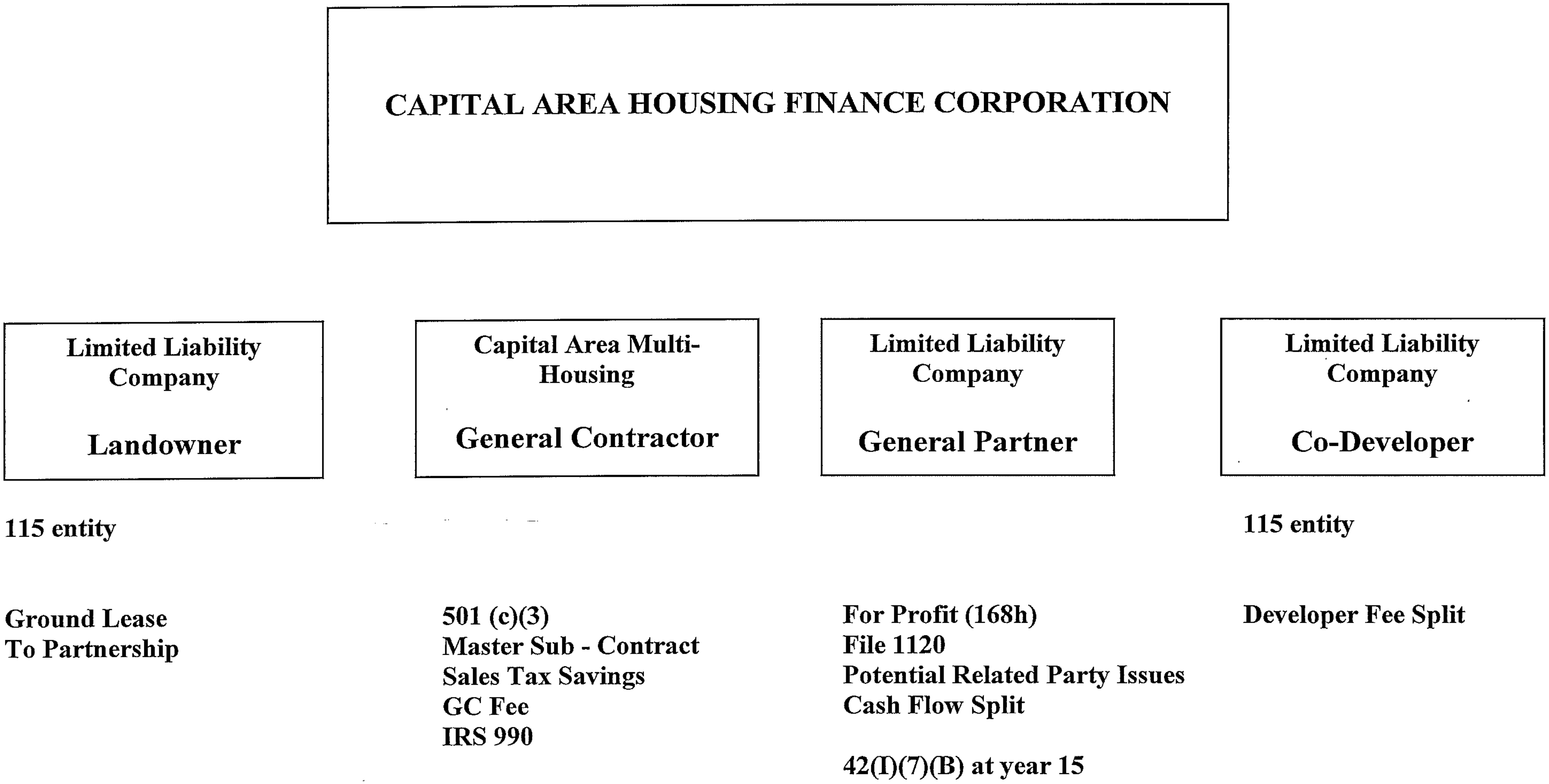
Are the guarantees real or paper? Are there personal guarantees?

Does the developer have a succession plan for their organization? What happens if he/she is incapacitated?

What is the investor's plan if this occurs?

Does the developer act as his/her own contractor? Who are the subcontractors they normally use? Do they have a long standing relationship with them?

What is their bonding capacity?



CAPITAL AREA HOUSING FINANCE CORPORATION

Limited Liability Company

Landowner

115 entity

Ground Lease
To Partnership

Capital Area Multi-Housing

General Contractor

501 (c)(3)
Master Sub - Contract
Sales Tax Savings
GC Fee
IRS 990

Limited Liability Company

General Partner

For Profit (168h)
File 1120
Potential Related Party Issues
Cash Flow Split

42(I)(7)(B) at year 15

Limited Liability Company

Co-Developer

115 entity

Developer Fee Split