Managing the Exit Tax Burden of the QALICB
Part One of Two

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The tax credit investor (investor) in a leveraged new markets tax credit (NMTC) financing commonly enters into a put option agreement entitling it to sell its interest in the qualified community development entity (CDE) to an affiliate of a qualified active low-income community business (QALICB) for a nominal amount after the end of the seven-year compliance period (the exit transaction). Once a portion of the qualified low-income community investment (QLICI) loan is used to repay the leverage loan, the affiliate and QALICB have effectively eliminated the burden of paying the remaining portion of the QLICI loan. Although the elimination of this burden creates an economic benefit for the family of entities that includes the QALICB and affiliate (entity family), the full amount of that benefit may not be reflected in their taxable income at the time of the exit transaction.

Part One of this two-part article summarizes the reasons that the entity family may realize little or no cancellation of indebtedness (COD) income from the exit transaction. In Part Two, I will discuss planning strategies for reduction and deferral of the COD income recognized in the exit transaction.

Example With Dollar Amounts
An investor contributes $3 million to Investment Fund LLC (the fund) 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 the 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 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 during the first seven years only, generating sufficient interest for the CDE to make the required interest payments on the leverage loan.

At the end of seven years, QALICB refines 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 the affiliate for $1,000.

Initial COD Analysis
The QALICB family has paid $1,000 to eliminate a $3 million obligation, realizing an economic benefit of $2,999,000. Does the QALICB or the affiliate have COD income in that amount? It is possible that no COD income is recognized in the exit transaction and if COD income is recognized, the amount of income is substantially less than $2,999,000.

Because the B loan is not canceled, COD income may arise only to the extent required by Internal Revenue Code (IRC) §108(e)(4), which states, in part:

For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness

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by the debtor.

IRC §§267(b) and 707(b)(1) describe a wide array of relationships. Let’s assume that the affiliate and the QALICB are related. If the exit transaction causes the QALICB to be treated as if it had acquired the B loan for the amount paid by the affiliate, the QALICB will recognize $2,999,000 of COD income under Treas. Reg. §1.61-12. However, IRC §108(e)(4) requires treatment only “to the extent provided in regulations.” What do the regulations say?

Treasury Regulation §1.108-2(a) provides that COD income may arise by reason of a related-party acquisition of indebtedness if either the indebtedness is acquired directly by the related party (a direct acquisition), or the holder of the indebtedness becomes related to the debtor in an “indirect acquisition.” Assuming the CDE is respected as a separate entity for tax purposes, the exit transaction is not a “direct acquisition.” Let us consider whether it is an “indirect acquisition.”

Under Treas. Reg. §1.108-2(c)(1), a transaction in which the debtor and the holder of the debt become related is an indirect acquisition only if “the holder acquired the indebtedness in anticipation of becoming related to the debtor.” It is not clear that the CDE “acquired” the B loan when it loaned $3 million to the QALICB. The CDE originated the B loan; before the origination, there was no loan to acquire.

Similarly, it is not clear that the CDE made the B loan “in anticipation of” the exit transaction. When the CDE made the B loan, the loan was an economically advantageous investment whether or not the investor ultimately exercised the put option. There is no direct authority on either of the foregoing points. In sum, it is possible that the exit transaction does not give rise to an “indirect acquisition” within the meaning of Treas. Reg. §108(e)(4), and it is possible that the IRS will not argue that the exit transaction causes the QALICB to recognize COD.

Nonetheless, because the B loan constitutes more than 25 percent of the CDE’s gross assets on the date of the exit transaction, the QALICB must report COD income as though an indirect acquisition occurred, unless the QALICB attaches a statement to its tax return setting forth certain facts about the B loan and describing facts and circumstances supporting the QALICB’s position that an indirect acquisition did not occur. (See Treas. Reg. § 1.108-2(c)(4).) Thus, it will not be possible for the QALICB to fly safely under the radar.

Warning: If, concurrently with the exit transaction, the affiliate acquires the 0.01 percent membership interest in the CDE that is not held by the fund, and the CDE is an LLC treated as a partnership for tax purposes, the CDE will become a disregarded entity, and the affiliate may be treated as acquiring the CDE’s assets. (See Rev.
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Rul. 99–6, 1999–1 C.B. 432, Situation 2.) In that case, the affiliate will be treated as acquiring the B loan in a “direct acquisition,” and the arguments for not treating the exit transaction as an “indirect acquisition” will be irrelevant.

Let’s assume that the exit transaction is treated as an “indirect acquisition” and the QALICB is therefore treated as if it had acquired the B loan. How much COD income does the QALICB recognize?

Treas. Reg. §1.108-2(f)(2) provides that if the holder did not “acquire the indebtedness by purchase” during the six-month period ending on the “acquisition date,” the amount of COD income is “measured by reference to the fair market value of the indebtedness on the acquisition date.” The “acquisition date” is the date on which the holder and the debtor become related, which is the date on which the exit transaction occurs. Since the CDE did not acquire the B loan by purchase during the six-month period ending on that date, the amount of COD income is the difference between the adjusted issue price of the B loan ($3 million) and the fair market value of the B loan on the date of the exit transaction. (See Treas. Reg. §1.61-12(c)(2)(ii).)

A thorough examination of the determination of the fair market value of the B loan is beyond the scope of this article. Suffice it to say that if the B loan has a below-market interest rate and a long term, the fair market value of the loan will be less than its face amount, but it still should be substantially greater than the $1,000 put price.

Deferral Only

Suppose that the fair market value of the B loan at the time of the exit transaction is $2 million. If the exit transaction is treated as an indirect acquisition, the QALICB recognizes $1 million of COD income. If the exit transaction is not treated as an indirect acquisition, the QALICB recognizes no COD income.

In both cases, the entity family has an additional economic benefit that has not been recognized as COD income, and the tax burden on that benefit is deferred, not avoided.

If the exit transaction is treated as an indirect acquisition, triggering $1 million of COD income, the QALICB will still be obligated on the $3 million B loan but will be treated as issuing to the CDE a $2 million obligation with $1 million of original issue discount (OID). (See Treas. Reg. §1.108-2(g)(1).) The OID will give rise to offsetting income and deductions for the CDE and the QALICB. If the B loan is not paid in accordance with its terms, the QALICB will recognize $2 million of COD income at some future time. If the QALICB pays the balance of the B loan, and the proceeds are distributed to the affiliate, the affiliate will recognize a $1,999,000 capital gain.

If the exit transaction is not treated as an indirect acquisition, and

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the CDE is treated as a partnership for tax purposes, the basis of the B loan in the CDE’s hands will be reduced to $1,000 under IRC §743(b)(2) because its basis before the exit transaction ($3 million) exceeds its fair market value ($2 million) by more than $250,000. If the QALICB subsequently pays the balance of the B loan, the CDE will recognize $2,999,000 of gain. The gain would appear to be capital gain, as the reduction of the CDE’s basis in the B loan occurred after the CDE acquired the loan and does not appear to create market discount as defined in IRC §1278(a)(2)(A).

Next month: planning strategies for reduction and deferral of the COD income recognized in the exit transaction.

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