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LIHTC Rehabs: Purchasing Properties for Rehabilitation with Low-Interest Loans

Traps for the Unwary

By Rachel L. Toker • April 2011

As low income housing projects age and require rehabilitation, purchasing such a property by assuming an outstanding low-interest loan already in place can be an attractive way for a developer to proceed with the acquisition and rehabilitation of a low income housing tax credit (LIHTC) multi-family rental project. But if any debt obligation will stay in place post-transfer, buyers and sellers need to consider original issue discount (OID) and cancellation of indebtedness (COD) rules in order to avoid unpleasant surprises, including reductions in eligible basis and reductions or loss of LIHTCs.

In general, if a secured loan is significantly modified (within the meaning of Treasury regulations) to more favorable terms when assumed by a buyer, that modification will result in a deemed exchange of the original debt instrument for the modified instrument for tax purposes, which, under certain circumstances, can create COD income.[1] Although the buyer will be the primary beneficiary of the modified debt terms, any COD income created through such a modification is recognized by the seller as the seller's income (unless the parties agree otherwise), since the IRS views the modification of the loan as occurring immediately prior to the transfer of the property.[2] For assumed loans that are significantly modified, the deemed "exchange," for income tax purposes, will trigger COD income to the seller under the OID rules of Section 1274 of the Internal Revenue Code (the "Code"), if the modified loan bears an interest rate below the applicable federal rate (AFR) ("below-market" for these purposes). The amount of COD income to the seller will be calculated based upon the difference between the face amount of the original debt obligation and the imputed principal amount of the debt obligation (as determined under the OID rules).[3] The OID rules will require the buyer to recharacterize a portion of the principal amount of the assumed loan as interest (which is re-calculated assuming the AFR as the interest rate).[4] The imputed principal amount of the assumed loan after this recharacterization will serve as the principal amount of the debt for tax purposes (with a corresponding increase in interest on that debt) and cause the seller to recognize COD income in the amount of the reduction. This reduction in the principal amount of the assumed loan will also result in a reduction of eligible acquisition and depreciable basis because it will reduce the imputed acquisition price of the real property. LIHTC eligible basis must reflect this reduction.[5]

Furthermore, in circumstances where the seller and buyer are related parties and the imputed sales price is below fair market value, the seller may be deemed to have made a partial contribution of the property to the owner/borrower (i.e. the LIHTC project partnership) in the amount of the difference

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1 *See* I.R.C. §§ 108 and 1001; Treas. Reg. §§ 1.1001-1 to 1.1001-3. What constitutes a significant modification when amending a debt instrument of this kind is determined in accordance with Treas. Reg. § 1.1001-3. Not necessarily intuitive, simply the extension of loan term as part of such an exchange, if greater than one half of the original loan term or 5 years, can constitute a significant modification. *See* Treas. Reg. § 1.1001-3(e)(3)(ii). Where the maturity date and interest rate of the existing loan are substantially modified upon the buyer's assumption of the existing loan, the debt will be deemed to have been significantly modified within the meaning of Treas. Reg. § 1.1001-3, and, consequently, there will be a deemed exchange of "old debt" for "new debt" under Treas. Reg. § 1.1001-1(a) upon the closing of the assumption of the loan.

2 *See* Treas. Reg. § 1.1274-5(b).

3 *See* Treas. Reg. § 1.1274-5(a).

4 *See* Treas. Reg. § 1.1274-2.

5 On the other hand, in the case of a LIHTC project using tax-exempt bond financing, this imputed purchase price adjustment could make it easier for the LIHTC project partnership to satisfy the 50% test that must be satisfied in order to avoid having to compete under a state's volume limit for the LIHTCs, since the purchase price of the property would be reduced (thereby reducing the total amount of land and building basis).

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between the fair market value of the property and its imputed acquisition price.[6] This deemed capital contribution could create a deemed capital account for the seller in the owner/borrower. If the seller's deemed capital account (or profits interest) in the owner/borrower is more than 50% of the total capital or profits interests in the owner/borrower, this relationship would violate the requirements for the 4% acquisition tax credit, and the owner/borrower could become ineligible for any acquisition LIHTCs allocated to the project.[7]

There are, however, certain government loans with effective interest rates less than AFR, even after modification, that appear to escape the application of the OID rules. Often, certain government loans at above-AFR interest rates are accompanied by interest rate subsidy agreements (from the same government lender) that create an effective interest rate at substantially below AFR (typically, a 1% per annum effective interest rate). Although the interest rate of the loan is effectively below AFR,[8] the IRS has nevertheless treated the loan as having an interest rate above AFR — at least in certain circumstances. Modifications of such loans would escape the application of the OID rules.

In the case of the Department of Housing and Urban Development (HUD) Section 236 IRP program,[9] the IRS has determined that the interest reduction payments (i.e. interest rate subsidies) from HUD should be treated like rent paid to the owner/borrower, regardless of whether or not HUD makes the payments directly to the lender as part of the interest due under the Section 236 loan, and not as a reduction of interest that the owner/borrower pays to lender under the loan.[10] The IRS further ruled that the total amount of interest paid to the lender, including the portion paid by HUD, was deductible by the owner/borrower as payments of interest on the loan. The rationale of Revenue Ruling 76-75 is that the interest credit subsidies should be viewed as rental subsidies similar to the Section 8 program. The Tax Court upheld the IRS's treatment of the interest rate subsidy in *Graff v. Commissioner*[11] reasoning that interest reduction payments "took the place of rents that otherwise would have been charged the tenants."

This rationale is also generally thought to be applicable to loans and interest reduction payments under another large government affordable housing program, the USDA Rural Development - Rural Housing Service (RD/RHS) Section 515 program, which uses similar loan and interest credit agreement structures. As with the Section 236 program, a federal agency provides an interest rate subsidy agreement to accompany an above-AFR loan for the purpose of providing low-cost financing for housing that will be made available to low-income tenants at affordable rents. Other factors also suggest that the interest rate on a section 515 loan, for purposes of any OID analysis, should be the face amount. RD/RHS interest credit agreements generally provide that RD/RHS can elect to suspend, modify or terminate the interest rate subsidy if it determines that the subsidy is not needed for the benefit of the tenants. Thus, there is no guarantee that the interest rate will be subsidized by RD/RHS, and the availability of the subsidy is expressly tied to the purpose of providing affordable housing. The treatment mandated by Revenue Ruling 76-75 requires the owner/borrower to include the interest subsidy in gross income and the interest it pays on the loan in its deductions. Thus, notwithstanding the post-modification effective interest rates of certain government loans accompanied by interest rate subsidy agreements, the above analysis would seem to exempt those government loans from generating COD income (and a reduced purchase price on assumption) so long as those loans, post modification, bear a nominal interest rate at AFR or greater.

The question becomes could one cause non-government loans that are modified as part of an acquisition to escape the creation of COD income (and reduced purchase price) through the creation of a non-federal interest rate subsidy programs? What if a state or local government or nonprofit lender establishes a housing preservation program that subsidizes interest rates using separate interest rate credit agreements that function to reduce an owner/borrower's monthly payments for the life of the loan, subject to various restrictions on rent and the use of the property for affordable housing? As interest rates rise again, and today's market loans become low-interest loans below the AFR, developers may be attracted to rehabilitation projects in which they can buy aging properties in exchange for the assumption of the outstanding below-AFR loan, but buyers and sellers will want to avoid the COD and OID problems associated with them. It may be that developers are better off modifying the loans to bear interest at a rate of at least AFR and working with the lender to put a new interest rate subsidy agreement in place. It would seem that, as long as the interest rate subsidy agreement clearly requires that subsidized rents be available to low-income tenants in need of affordable housing, the problems of below-AFR loans can be avoided by using interest rate subsidy agreements rather than negotiating and assuming below-AFR loans.[12] In sum, for rehabilitation projects with assumed debt, it might just be that low-interest loans that seem too good to be true, really are.

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6 In certain circumstances, if there is reason to believe that the reduction in sales price below fair market value is a grant from the seller "or other form of income" to the buyer, the owner/borrower might find that it has received unanticipated taxable income because the imputed acquisition price for the real property is less than its fair market value.

7 See I.R.C. § 42(d)(2)(D).

8 With an interest rate credit agreement in place that is also being assumed (often reducing the effective interest rate to 1%), the loan would appear to have an effective interest rate below AFR.

9 This program is governed by Section 236 of the National Housing Act, 12 U.S.C. § 1715z-1.

10 Rev. Rul. 76-75.

11 *See Graff v. Commissioner*, 74 T.C. 743 (1980), *aff'd*, 673 F.2d 784 (5th Cir. 1982).

12 This result may also suggest that state, local, and nonprofit housing preservation programs should focus on providing interest rate subsidies rather than direct low-interest loans to developers of rehabilitation projects.