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Planning Exit Strategies for NMTC Loan Funds

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Unwind strategies for new markets tax credit (NMTC) loan fund transactions are driven primarily by the benefits to be provided to the borrowers, the leverage loan terms and tax considerations.

As stated in my article "Structuring NMTC Loan Funds is Key" (June 2018 Novogradac Journal of Tax Credits), there are as many loan fund structures as there are allocatees. This is also the case for loan fund exit strategies. This article briefly describes certain unwind strategies based on delivery of either potential debt forgiveness or lower interest rates and other favorable terms to the borrowers, assuming the qualified low-income community investments (QLICIs) are loans.

The unwind strategies would be determined at the outset of the transaction based on the economic terms of the loan fund. Similar to single-project NMTC transactions, there will likely be put and call options with respect to the tax credit investor's (investor) interest in the investment fund. However, the counterparty for such options may be the allocatee or fund manager, as described below. In addition, for loan fund transactions that do not include potential debt forgiveness, the borrowers exit by repaying the loans without necessarily participating in the NMTC aspects of unwinding the loan fund.

Potential Debt Forgiveness

Similar to single-project transactions, the loans may be structured as A/B promissory notes and provide potential forgiveness of all or a portion of the B note, attributable to the investor's equity investment that indirectly funded the loan. The debt forgiveness may be at the option of the subsidiary community development entity (sub-CDE) lender or the investor, as described below. Generally, the QLICI loan term will be at least seven years and may provide for limited amortization.

Example 1–Sub-CDE Lender Put Option

Bank leverage lender finances 100 percent of the qualified equity investment (QEI)/QLICIs. Assume that the loan fund has a one-year investment period, the leverage loan matures

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seven years after the final QEI is made and QEIs are made as QLICIs close.

Put option: On the leverage loan maturity date, the sub-CDE has an option in its sole discretion to put the QLICI loans to the borrowers (or an affiliate) for a discounted principal amount equal to the leverage loan advance that indirectly funded such QLICI, plus accrued interest and fees or costs due to the parties. The put price would take into consideration prior principal amortization payments made by the borrower (held by the sub-CDE lender).

No call option: Generally, the borrower would not be granted a fair market value call option to purchase the loan from the sub-CDE lender. A call option to purchase a QLICI loan is usually deemed exercised at closing under the Treasury regulations (see Treas. Reg. Section 1.1272-1(c)(5)). If deemed exercised, the full principal amount of the loan would not be respected as debt for tax purposes (i.e., not a QLICI).

Considerations: Borrowers may recognize debt cancellation income upon exercise of the put option, depending on the facts. This structure is not used for revolving loan funds and may require that the borrowers have an understanding of NMTCs and/or engage tax credit counsel.

Investor put/call options: The investor would have the right in its sole discretion to put its interest in the investment fund to the allocatee or fund manager (or other transaction party), for a nominal amount. The allocatee or fund manager may be granted a fair market value call option if the investor does not exercise the put option.

Intermediary CDE lenders: If the QLICI is a loan or investment by a sub-CDE in an intermediary CDE lender, the intermediary CDE lender's exercise of the put option of the B note would require the consent of the sub-CDE providing the allocation.

Example 2–Affiliate Leverage Lenders

Separate leverage lenders affiliated with the borrowers finance each QEI/QLICI. The leverage loans mature 30 years after closing.

Investor put/call options: The investor may enter into put and call options with each affiliate leverage lender with respect to a specific class of membership interests in the investment fund. Each class of membership interests in the investment fund would relate to a class of membership interests in the sub-CDE lender with respect to the applicable QLICI. Similar to single-project transactions, at unwind, the outstanding QLICIs may be distributed to the investment fund in redemption of the applicable class of membership interests in the sub-CDE lender and assigned to the applicable leverage lender. The put options would be exercisable in the sole discretion of the investor for a nominal purchase price. The call options would be exercisable for a fair market value purchase price.

Considerations: Due to the borrower affiliate leverage loans, there are additional compliance risks, increasing tax opinion and NMTC indemnification requirements. Notwithstanding the foregoing, by using a loan fund structure, transaction costs are reduced, including the annual operating expenses of the sub-CDE lender and the investment fund.

Reduced Interest Rates/Revolving Loan Funds

If the total principal amount of each QLICI loan is required to be repaid, the portion attributable to the

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investor's tax credit equity provides a cushion for underwriting credit risks, servicing expenses and back end fees. For the borrower, this approach will be substantially the same as a standard commercial loan (except for the favorable terms and NMTC covenants). The borrower is not involved in the unwind of the loan fund, except that a defaulted loan may be distributed to the investment fund and assigned to the leverage lender post-compliance period.

Example: Revolving loan fund

Bank leverage lender finances 100 percent of the QEIs/QLICIs. The loan fund has a one-year investment period, the leverage loan matures seven years after the final QEI is made, and QEIs are made as QLICIs close. QLICIs (including redeployments) mature no later than maturity date of the leverage loan. QLICIs amortize and reinvestment is required.

Investor put/call options: The investor will have the option in its sole discretion at maturity of the leverage loan to put its interest in the investment fund to the allocatee or fund manager (or other transaction part(ies)) for a nominal amount, and such put counterparty may have a call option for a fair market value purchase price.

Allocation of principal repayment proceeds: After repayment of the leverage loan, principal payments that have been received by the sub-CDE lender attributable to the investor's tax credit equity, may be applied to pay certain fees, and/or fund distributions to the members of the sub-CDE lender and the investment fund. Various fees may be deferred and paid from QLICI principal payments in order to provide a cushion for repayment of the leverage loan and for loan servicing and redeployment costs. In addition, after repayment of the leverage loan, reasonable compensation may be paid to parties that provide services and/or bear certain risks regarding loan performance and recapture, subject to compliance with tax considerations. Tax counsel will review the overall structure to determine that the investor should be respected as a partner for federal income tax purposes of the investment fund (or the sub-CDE lender, if the investment fund is a disregarded entity).

Outstanding QLICIs: Any QLICIs that have not been repaid at the end of the term of the loan fund may continue to be held by the sub-CDE lender due to the sub-CDE lender's relationships with the borrowers or to preserve the intended economics. Defaulted QLICIs may also be distributed and assigned to the leverage lender, or held by the investment fund.

Considerations: The unwind of a revolving loan fund can be invisible to the borrowers. The QLICIs may be documented similar to commercial loans, expanding the potential borrowers and access to NMTC-enhanced debt.

Tax Considerations

The key tax considerations are the same as in single-project transactions, with alternative strategies depending on the facts: the investor is required to be respected as a partner of the investment fund (or the sub-CDE lender, if the investment fund is a disregarded entity for federal tax purposes), the QLICIs must be respected as debt of the borrowers in the full principal amount of the loans, substantially all of each QEI must be treated as invested in a QLICI in the manner required under the Treasury Regulations and the QEIs must not be treated as redeemed. The Internal Revenue Service has not issued specific guidance with respect to the unwinding of NMTC transactions. The strategies described above are subject to modifications based on

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future guidance. The transaction structure would be reviewed by tax counsel consistent with standard tax opinion practices based on the then current authorities.

Conclusion

Attention to the exit strategy at the outset of a loan fund transaction facilitates closing and implementation of the loan fund. The allocatee/fund manager would coordinate the overall structure of the loan fund negotiating terms with its partners to achieve the intended benefits to the borrowers and expand access to NMTC financing. ❖

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