MHIC New Market Tax Credits Audit and Tax Preparation Workshop

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Agenda – MHIC NMTC Workshop

- New Markets Program Overview
- Sample Transactions/Structures
- Life Cycle of a NMTC Deal
  - Development/construction/placement in service
  - Operating
  - Unwinding/Exit
- Appendix A: Other Audit and Accounting Considerations
- Appendix B: Tax Preparation Issues

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New Markets Tax Credits

- Federal tax credit authorized in 2000 to stimulate economic investment in targeted areas
- NMTC program is overseen by:
  - Community Development Financial Institutions (CDFI) Fund which accepts applications, awards credit allocation and evaluates program compliance and impact
  - IRS which oversees tax compliance relative to Code Section 45D
- NMTC program has been extended year to year by Congress (Sept 2012 application expected to be awarded early 2013 pending reauthorization)

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New Markets 101 – A Brief Overview

- Community Development Entities (CDE) use "substantially all" of the proceeds from Qualified Equity Investments (QEI) to make Qualified Low-Income Community Investments (QLICI) in Qualified Active Low-Income Community Businesses (QALICB)
- Credits claimed - 39% of QEI over 7 years
  - 5% for Years 1-3; 6% for Years 4-7
  - No return of capital (QEI) for 7-year period

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New Markets 101 – A Brief Overview (cont.)

- CDEs must be for-profit entities
  - CDEs can be corporations, partnerships or LLCs
- CDEs can be:
  - Community Development Financial Institutions (CDFIs)
  - Small Business Investment Companies (SBICs)
  - Community Development Corporations (CDCs)
  - Affiliates of financial firms or real estate developers

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New Markets 101 – A Brief Overview (cont.)

- CDEs must:
  - Be certified by the CDFI Fund
  - Have a primary mission of community development
  - Maintain accountability to residents of low income communities through their representation on the governing or advisory board

- CDEs are established and maintained by MHIC at the "fund level" of each transaction

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New Markets 101 – A Brief Overview (cont.)

- Qualified Equity Investment (QEI)
  - Investment in a CDE and designated a QEI by CDE
  - Either stock or a capital interest originally issued in exchange for cash
  - "Substantially all" of QEI must be used to make Qualified Low-Income Community Investments (QLICIs)
- QEIs are made from the proceeds of investor equity and debt capital aggregated at the "Fund" level and transferred to CDEs (both of which are <u>controlled by MHIC</u>)

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New Markets 101 – A Brief Overview (cont.)

- Qualified Low-Income Community Investment
  - Equity investment in or loan to a Qualified Active Low Income Community Business
  - Financial counseling and other services to businesses and residents of low-income communities
  - Qualified activities between multiple CDEs

- MHIC NMTC QLICIs are generally <u>loans</u> or <u>equity interests (or both)</u> in qualifying real estate developments

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QLICIS

- Equity Projects
  - Received equity investment from an MHIC CDE – owner/master tenant
  - Organized as limited partnership or limited liability company
  - Calendar year-end filers (12/31)
  - <u>Full</u> tax and audit requirements – see NMTC Guide
- Loan-Only Projects
  - Receiving only loan capital from an MHIC CDE
  - Organized as limited partnership, limited liability company, nonprofit, or business trust
  - Calendar or fiscal year ends
  - <u>Limited</u> tax and audit requirements
- Contact your project's asset manager with questions as to the type of project or filing requirements

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New Markets 101 – A Brief Overview

- Qualified Active Low-Income Community Business
  - *A - Gross-income requirement* – at least 50% of the gross income is derived from operating within a low-income community. Entity is deemed to meet this requirement if it meets requirement B or C below, if 50% is applied to those requirements instead of 40%.
  - *B - Use of tangible property* – at least 40% of the use of the tangible property of such entity (whether owned or leased) is within any low-income community.
  - *C - Services performed* – at least 40% of the services performed for such entity by its employees are performed in a low-income community.

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New Markets 101 – A Brief Overview (cont.)

- Qualified Active Low-Income Community Business
  - *Employees of QALICB* – At least 40% of the entity's employees are individuals who are low-income persons. If an employee is a low-income person at the time of hire, that employee is considered a low-income person throughout the time of employment, without regard to any increase in employee's income after the time of hire. If the entity has no employees, it is deemed to satisfy requirements A and C if it meets requirement B when 85% is applied to that requirement rather than 40%.
  - *Collectibles* – Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles held primarily for sale to customers in the ordinary course of business.

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New Markets 101 – A Brief Overview (cont.)

- Qualified Low-Income Community Business
  - *Nonqualified financial property* – less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.
  - *Residential Rental Test* – For mixed use buildings at least 20% of the rental revenue must be generated from commercial rental of the property.
  - *Excluded Business Test* – The QALICB cannot operate a massage parlor; hot tub facility; suntan facility; country club; racetrack or other facility used for gambling; sale of alcoholic beverages for consumption off premises; development or holding of intangibles for sale; private or commercial golf course; or farming

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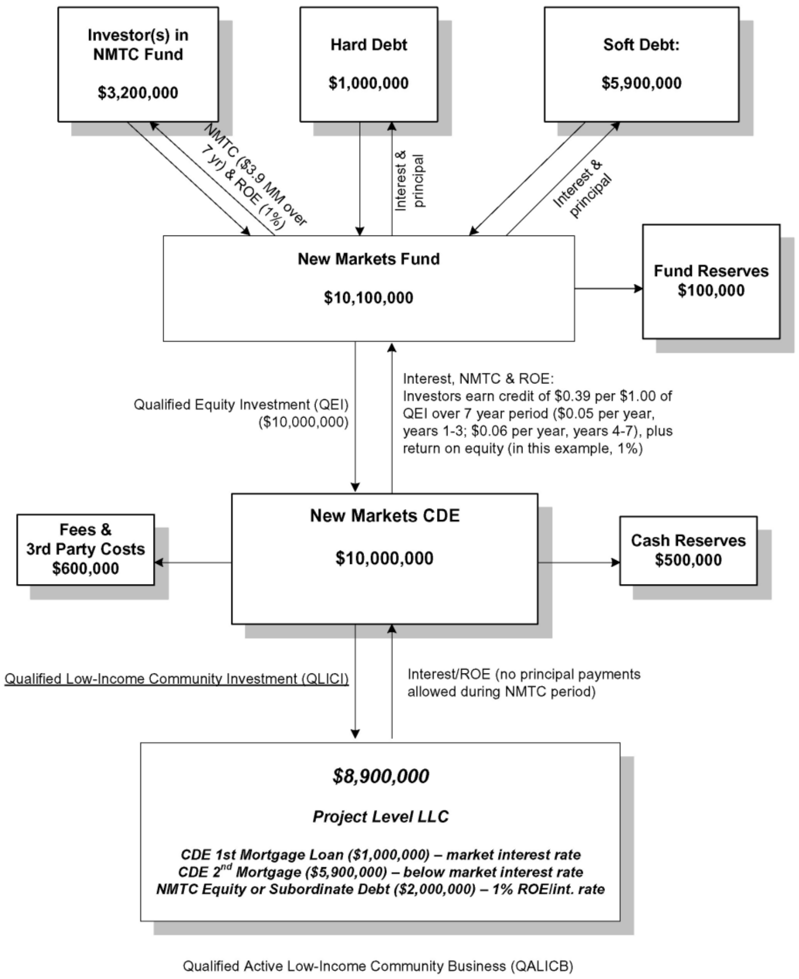
Leveraged Structure



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Leveraged Structure (cont.)

- MHIC NMTC transactions typically employ a "leveraged structure"
  - Funds ordinarily lent directly to a project from banks, sponsors, or other third parties are instead circulated through the NMTC Fund structure
  - Provides deeper subsidy for the project as project loans also qualify as QEI and increases Fund investor equity contributions
  - Used for projects receiving equity, loans or both

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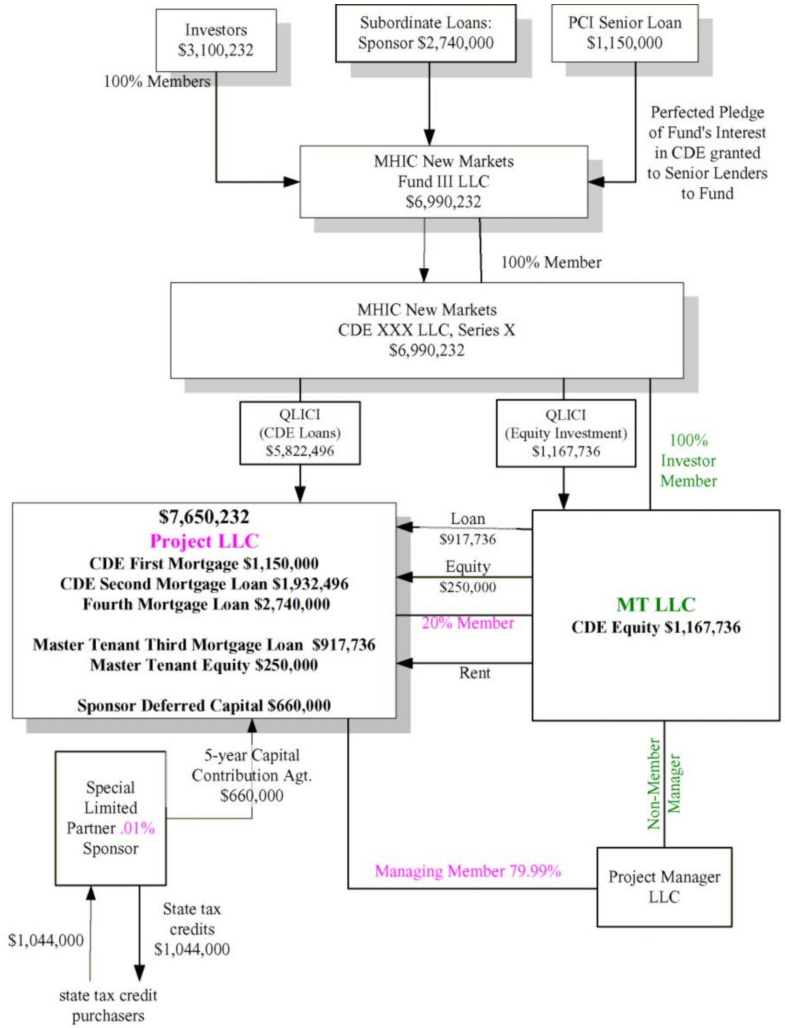
Master Tenant Structures



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Master Tenant Structures (cont.)

- Still employing a leveraged structure
- Tax-motivated structure typically used to facilitate claiming Federal Historic Rehabilitation Tax Credits (HRTC)
  - Prevents projects from being considered a prohibited “tax exempt use” property
  - May be used to bifurcate undesirable operating losses (depreciation) from desired tax credit benefits
  - May also be used to ensure compliance with 20% commercial rents requirement

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Master Tenant Structures (cont.)

- Accounting Issues
  - Multi-entity structures – consolidation accounting
  - Books and record-keeping
  - Related party disclosures
  - Leasing arrangements
- Tax Issues
  - Federal historic rehabilitation tax credits
  - Disregarded entity – See MHIC filing requirements
  - Special elections (first year)
  - Imputed income of Master Tenant

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Project Filing Requirements

- NMTC projects vary widely based upon transaction structure, type of QALICB, type of financing issued, fiscal year end and other aspects
  - A variety of tax and reporting requirements exists based on project variability
- Please refer to the NMTC Audit & Tax Requirements in the Audit Prep Guide to determine your project's filing requirements and deadlines

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Suggested Schedule for 12/31 Projects

December 1	Audit and Tax Engagement Letter Signed
December 15	Audit preliminary work completed and Loan and equity balances reconciled with MHIC Finance Department
January 15	Begin Audit Fieldwork
January 31	Audit Fieldwork Completed
February 15	Review Draft Audit and Tax Returns with Management
March 1	Deadline for Submission of Drafts to MHIC
March 15	Deadline for Submission of Finals to MHIC (Please wait for "Go Final" letter) – 8 days after approval to "Go Final".

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Submission Deadlines for 12/31 Projects

- **<u>Draft copies due Thursday, March 1, 2013</u>**
  - *Draft audits must be submitted through the new portal system -- Hard copy documents are no longer accepted.*
  - *Contact your MHIC asset manager if you have any problem using the portal*
  - *<u>Drafts of audit returns submitted for March 1st deadline should be prepared as if ready to be issued final. Incomplete drafts will be considered late.</u>*

- **<u>Final Copies due Thursday, March 15, 2013 Or Within eight (8) calendar days of the date MHIC issues a “Go final” letter.</u>**
  - Final audited financial statements should be submitted through the portal system
  - <u>Final audits must include</u> a signed original Independence letter (see format in Tab 3, exhibit A of the Tax and Audit Prep Guide 2012).

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Tax Submission Deadlines

- **Draft copies due Thursday, March 1, 2013**
  - *Drafts must be submitted through the new portal system -- Hard copy documents are no longer accepted.*
  - *Please contact your MHIC asset manager if you have any trouble using the portal*
  - *Drafts of tax returns submitted for March 1st deadline should be prepared as if ready to be issued final. Incomplete drafts will be considered late.*

- **Final Copies due Thursday, March 15, 2013 Or Within eight (8) calendar days of the date MHIC issues a "Go final" letter.**
  - Submit final copies through the portal
  - Final tax returns must be submitted to MHIC electronically, MHIC must also receive a copy of the Partnership Declaration and Signature for Electronic Filing forms (Form 8453-P for Federal & 8453P for State) signed by the General Partner or Limited Liability Member along with a copy of the returns (Federal & State) that were filed.

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Life Cycle of a NMTC Deal

(Accounting and Audit Considerations)

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Life Cycle of A NMTC Deal

Development Phase Thru Placement in Service

Key Considerations:

- Understand entity structure and sponsor responsibilities
  - Bookkeeping, audit and tax requirements
- Read/Review documents
  - Create summary of key items
  - Think ahead to transaction exit!
- Hiring qualified CPA/review financial projections
- Understand flow of funds from CDE to QALICB
  - Distinguishing loans v. equity transactions
  - Separating multiple CDE notes and any advances from sponsor
  - Accounting for construction escrows
- Tracking development costs of project – capital vs. amortized vs. expenses
- Do you need a cost certification?

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Life Cycle of A NMTC Deal

Development Phase Thru Placed in Service (cont.)

Other considerations and pitfalls:

- Placed in service one month before year end – audit & tax requirements?
- Development cost overruns and sponsor guarantees
- Accounting for acquisition
  - Allocating cost between land and building – fair value basis
  - Conveyance of property from sponsor or related entity to project's owner
- Capitalizing construction period interest and taxes
- Separately tracking personal property - equipment, appliances and furniture
- Segregate non-qualifying costs (for HRTC projects)
- Accounting for non-cash activities – conveyance, deferred interest on loans

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Life Cycle of A NMTC Deal

<u>Operating Phase</u>

Key Considerations:

- Project lease issues
  - Lease commencement & sponsor guarantees
  - Additional rent provisions - operating costs & sublease
  - Master tenant leases – net rental distribution to Fund/CDE
  - GAAP requirements for straight-lining expense
- Making lease and debt service payments
- Communicate changes in project status to Asset Manager
  - Cash flow difficulties
  - Change of tenants
  - Casualties/other losses
- Completing annual reporting requirements
  - MHIC monitoring reports/community impact
  - Audits & Tax returns

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Life Cycle of A NMTC Deal

Operating Phase (cont.)

Other considerations and pitfalls:

- Please use GAAP accounting for financial statements – income tax method is not acceptable
- Funding of various reserve accounts – meeting requirements
- Estimated useful lives of fixed assets – tax basis vs. GAAP
- Material tenants accounts receivable – should be scrutinized carefully to determine issues of collectability and allowance for doubtful accounts
- Debt not reconciled to MHIC statements – Principal of each CDE mortgage loan should be reconciled to MHIC billing statements
- Soft Debt – monitor surplus cash flow payment requirements (built into CDE loans)

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Life Cycle of A NMTC Deal

Operating Phase (cont.)

- Disclosure of guarantees and/or other related party transactions
- Entity fees – consider special fees and guaranteed payments authorized in the agreements
  - Following formula for payment or considering need for accrual
  - Disclosure in the financial statement footnotes
- Be aware of key QALICB compliance issues
  - Gross income test – 50%
  - Services provided test – 40%
  - Tangible property test – 40%
  - Nonqualified financial property test – 5%
  - Qualified tenancy – 20% rule/excluded businesses

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Life Cycle of A NMTC Deal

Unwinding /Exit Phase (Year 7) – Considerations

- Communicate plans with your Asset Manager at MHIC
- Prepare for exit
  - Assess occupancy of commercial space – are the tenants bankable?
  - Understand timing of CDE loan maturities
  - Plan for continuation/refinance of hard debts
  - Dealing with leverage lenders – sponsor vs. third party
  - CDE NMTC equity loans
- Do a financial model
  - Are there taxable entities? What are the tax implications?
  - Will project be conveyed from QALICB?
  - Consider impacts of possible debt forgiveness
  - Consult with CPA and attorney – model capital accounts
- Understanding the Put/Call Options
  - Unwinding of entity structure – responsibilities of sponsor

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Appendix A: Other Accounting and Audit Considerations

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Management Responsibilities

- Books and records are maintained on an accrual basis of accounting for all entities – Sponsor, operating partnership (owner) and master tenant (if applicable)
- All transactions, including cash and noncash, are properly recorded in the general ledger and reconciled at year end
- Development and operating activity are consolidated and reconciled in same general ledger
- All accounts are accurate and supported by documentation
- Maintaining all relevant documents relating to the project
- Separate cash accounts set up for all entities

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Consolidation Topics

- ASC Topic 810 (Consolidation Topic) – Consolidation of operating partnership and master tenant with general partner – general partner may be may be considered the primary beneficiary of operating partnership and master tenant
- Application of EITF 04-5 – possible consolidation of operating partnership with sponsor/general partner
- Financial statements presentation format – consolidating vs. consolidated

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Audit and Tax Preparation Documents

- Entity/Transaction Organization Chart
- Schedule of accumulated sources of funds drawn to date
- Copies of requisitions
- Contractor invoices (as requested by auditor)
- Development Fee agreements and schedule of payments
- Construction and Architect contracts/ change orders
- Purchase and Sale / Settlement Sheet
- Wire Notices
- Partnership Agreement or LLC Operating Agreement
- Financial forecast model
- Sources and Uses Development Budget
- Tax Opinion
- Financing agreements – commitment letter, mortgages, loan agreements, promissory notes, guaranties
- Leases
- Trial balance and general ledger
- Pass-through agreement – Historic Tax Credit
- Put and call arrangements / side letters

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Back Up Audit and Tax Workpaper Requirements

Loan-only Projects

Audit and Tax

- None unless specifically requested

Equity Projects

Audit Workpapers Required

- Working trial balance and financial statement grouping sheets.
- Bank reconciliations and related statements and confirmations. If no confirmation, please document how tested.
- Detail accounts receivable aging schedule including all A/R in excess of 90 days.
- Mortgage escrows and replacement reserves. If no confirmations, please document how tested.
- Fixed asset schedules and related depreciation
- Calculations for asset impairment if applicable
- Deferred costs and related amortization.
- Mortgage and loans payable along with related interest and confirmations. If no confirmations, please document how tested.
- Partners' equity showing changes in limited partner and general partner equity.

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Back Up Audit and Tax Workpaper Requirements

Equity Projects (cont.)

Audit Work Papers Required (cont.)

- Revenue and expense analytical review.
- Management representation letter.
- Legal letter from attorneys, if applicable.
- Auditor independence letter (See Exhibit A in manual).
- Memorandum summarizing consideration of ASC Consolidation Topic 810 of master tenant (if applicable)

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Back Up Audit and Tax Workpaper Requirements
(cont.)

Equity Projects

Tax

- Book to tax conversions. (See Exhibit C in manual)
- Fixed asset and depreciation schedule for MACRS and Alternative Minimum Tax (AMT) depreciation methods.
- Classification of loans - Recourse/Non-recourse.
- Details of any special tax allocations (profit – loss – credits – liabilities).
- Calculation of any Historic Rehabilitation Tax Credits claimed
- Minimum gain analysis 704(b) identifying each non-recourse debt.

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Appendix B: Tax Preparation Issues

Tax Preparation for 12/31 Equity Projects

- Federal Forms to be Filed:
  - Form 1065 – U.S. Return of Partnership Income
  - Schedule M-3 – Net Income (Loss) Reconciliation for Certain Partnerships
    - If not required to file by instructions, please complete as a “voluntary filer” by checking Box E
  - Form 8825 – Rental Real Estate Income and Expense of a Partnership or an S-Corporation
  - Form 3468 – Investment Credit
    - Required for HRTC projects claiming QRE in the current year

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Tax Preparation for 12/31 Equity Projects

- Massachusetts Form 3 - Partnership Return of Income
- Please note that New Markets Tax Credits are claimed directly at the NMTC Fund level based upon qualifying equity investments made to community development entities (CDE’s) established by MHIC There are <u>no</u> special tax reporting or compliance forms required at the QALICB related to the NMTC

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Tax Preparation for 12/31 Master Tenants

- Master tenants of some projects may be owned 100% by an MHIC NMTC CDE qualifying as "disregarded entities" for tax purposes. MHIC requires project sponsors to arrange for the preparation of IRS Form 1065 and Massachusetts Form 3 as well as the work paper back-up requirements for submission to MHIC in accordance with the established due dates. These tax filings will be used on **pro-forma basis** by the upper tier accountant preparing the CDE tax filings and **should not** be filed by the sponsor with the IRS or Massachusetts DOR.

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Tax Preparation for "Loan Only"

- Non-equity or "loan only" projects may or may not adhere to calendar fiscal years
- Tax filings of "loan only" projects will not be used in the preparation of the MHIC Funds' tax returns, but are required to be filed with MHIC for review by asset managers

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First Year Tax Elections

- Organization costs – beginning in 2010 may elect to deduct up to $10,000 where total organization costs are $60,000 or less – IRC 709(b)
  - Dollar for dollar phase out over $60,000
  - Costs exceeding deduction amortized – 180 mos.
- Ratable accrual of property taxes – IRC 461(c)
- Allocation of liabilities under Regs 1.752-5 (b)

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Other Tax Preparation Issues

- Allocation of partnership liabilities
  - Recourse – any partner bears economic risk of loss
    - Applicable to many CDE project loans which must be allocated to the CDE partner
    - Sponsor developer notes allocable to sponsor; sponsor guaranties
  - Nonrecourse – no partner bears economic risk of loss
  - Impact on Minimum Gain test – early reallocation of losses may be necessary where project equity is thin

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Other Tax Preparation Issues

- Guaranteed Payments –
  - Must be allocated to MHIC CDE partner on K-1
  - Not subject to self-employment
- Please carefully review the tax opinion prepared for the project to address any unique tax issues associated with your project

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Federal Historic Rehabilitation Tax Credits

- Investment tax credit which is included as a general business credit under IRC section 38
- Two types –
  - A certified historic structure is a building located in the National Park Service's National Register – 20% Credit
  - Other qualified building located in a registered historic district and certified by Secretary of the Interior as of "historic significance to the district" and placed in service pre-1936 – 10% Credit

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Certification by National Park Service

- Three-part application –
  - Part I – Evaluation of significance of the Property
    - Buildings previously listed in the National Register need not complete Part I
  - Part II – Description of rehabilitation work
    - Applies to certified historic structures seeking 20% credit
  - Part III - Request for Certification of Completed Work
    - Approves eligibility for 20% credit

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Federal Historic Rehabilitation Tax Credits (cont.)

- Must meet “substantial rehabilitation” test
- Credit to be claimed by taxpayer (investor) based on Qualified Rehabilitation Expenditures (QRE) multiplied by applicable credit percentage (10% or 20%)
- Project reports only QRE and project type on its tax return
- QRE generally includes all capitalizable depreciable costs allowed under IRC 168 for commercial and residential rental property incurred in connection with a substantial rehabilitation

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Federal Historic Rehabilitation Tax Credits (cont.)

- QRE excludes land and building acquisition, enlargements, equipment and other property, site work
- QRE also excludes “tax exempt use” property
- QRE are claimed in the year the rehabilitation is placed in service
- Depreciable basis of property and capital accounts reduced by HRTC
- Risk of recapture for 5 years

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Tax Issues – HRTC Projects

- Election to Treat Lessee (Master Tenant) as purchaser of property for purpose of HRTC
  - Election made on Federal tax returns of building owner and Master Tenant
  - IRC Section 50D and Regs 1.48-4 – pass through of HRTC to lessee
  - Building owner is not required to reduce depreciable basis of property
  - Master Tenant must also impute income equal to the credit taken spread over the depreciable life of the property
  - Maintain a schedule of imputed income reported annually on the Master Tenant's tax return

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Tax Issues – HRTC Projects (cont.)

- Real property that is owned by partnerships having tax exempt entities as partners and/or leased to a tax exempt entity in a disqualified lease is treated as tax exempt use. Section 168(h)(6)(F)(ii) provides that a tax-exempt entity can elect not to be treated as such. Election must be made in the year that the project is placed in service.
  - Preserves ability to claim HRTC
  - Made by all exempt partners or controlled entities

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Massachusetts HRTC

- Awarded by Mass Historic Commission in fixed credit amounts
- Allowable credits calculated according to Federal rules up to fixed credit allocation
  - No depreciable basis adjustment applies
- Taxpayer claiming credit need not take an equity stake in the project
  - Credits transferred by contract to credit purchaser
  - Typically involves “special limited partner” receiving special allocation of credit from operating partnership
  - Proceeds of credit sale invested or loaned to project

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Massachusetts HRTC (cont.)

- Forms to consider:
  - Individual certificate HRC
  - Allotment HRC
  - Transfer/Sale HRC

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Cost Certification

Required to support QRE claimed on Form 3468

Preparation issues include:

- Allocation of costs between QRE and non-QRE
  - Exclusion of acquisition
  - Accounting for environmental remediation
  - Accounting for personal property
  - Building enlargements
  - Allocating costs of financing
  - Reserves

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Comments & Questions

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