Freddie Mac Multifamily

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HISTORIC TAX CREDITS

Background

The Historic Tax Credit (“HTC”) program encourages investment in the rehabilitation of “certified” historic buildings by giving an investor (the “Investor”) a tax advantage. The tax credit that an Investor receives directly offsets the Investor’s income taxes.

- Whether or not a building is a “certified” historic building is determined by the Secretary of the Interior and administered through the National Park Service and the State Historic Preservation Officer in the state/commonwealth where the property is located.
- An Investor must maintain its interest in the property for at least 5 years after the date that the property is “put into service” (which essentially means the date that the certificate of occupancy is issued after the rehabilitation work is completed) and generating income. After that 5 year period, the Investor’s interests are typically bought out by the sponsor.

How the Tax Credit Investor Owns its Interest; Master Lease Structure

In an HTC transaction, the owner of the property (the “Borrower”) master leases the entire property to an entity (the “Master Tenant”).

- The Investor holds ownership interests in both the Borrower and the Master Tenant. Typically, the Investor holds a 10% to 20% ownership interest in the Borrower and a 99.9% ownership interest in the Master Tenant.
- The interests held by the Investor in both the Borrower and Master Tenant are passive (unless the sponsor performs a “bad act,” at which time the Investor can take over control of the Borrower, Master Tenant and the management of the Property).
- The remaining interests (which are the controlling interests) in the Borrower and Master Tenant are held by the sponsor/guarantor.

In the master lease structure, the historic tax credits are “passed through” to the Master Tenant and, through the Master Tenant, to the Investor (the holder of a majority interest in the Master Tenant).

Cash Flow

The Borrower is not the entity that receives all of the rent/income generated by the property even though it owns the property. As the property is master leased to the Master Tenant, the Master Tenant receives all of the rent/income and is typically the party responsible for payment of all operating costs. The Master Lease will contain the amount of "base rent" the Master Tenant must pay to the Borrower (typically the "base rent" is a fixed number, but it can be a percentage of excess profit to the Borrower).

- The "base rent" paid by the Master Tenant to the Borrower must be in an amount sufficient for Borrower to make all payments the Borrower retains responsibility for paying under the Master Lease (a Borrower must be able to pay its bills) and the Freddie Mac loan documents ("Loan Documents"). So, if the Borrower is required to pay real estate taxes per the Master Lease, the base rent must be in amount at least equal to or greater than real estate taxes plus the required debt service payments under the Loan Documents.

Loan Documents, Transfers and the SNDA

The Borrower will execute the standard Freddie Mac Loan Documents at origination of the loan. The Investor does not want to have a "direct borrower relationship" with a lender for liability purposes and, as such, the Investor (who typically owns a 99.99% interest in the Master Tenant) will cause Master Tenant to take all steps necessary to avoid executing any document with a lender (because that would establish a "direct borrower relationship"). Note that the Investor is required to own a direct interest in the Borrower in accordance with IRS rules; however, this interest is a minority, non-controlling interest and HTC investors do not consider this minority non-controlling interest to be enough to establish a "direct borrower relationship."

Freddie Mac has additional loan documents to accommodate the Master Tenant/Master Lease structure, which are to be included in the commitment or early rate lock application.

- The Master Tenant is very motivated to ensure that the Master Lease is not terminated for any reason during the 5-year holding period (the period of time that the Investor must maintain its interest in the property) because the Investor will suffer a significant "recapture event" and incur major tax liability.
- In order to protect its interests, the Investor will want the right to take over management of the Borrower, the Master Tenant and the property in the event the sponsor has performed a "bad act" (e.g., fraud, theft, declaration of bankruptcy, a default under the Loan Documents). The Investor will request the standard Freddie Mac Buy-Sell Rider, permitting the Investor to take over control and cure any possible default under the Loan Documents prior to Lender declaring a default.
- Note that if the Investor does assume control, the Investor will need to provide a replacement guarantor (just like any other buy-sell that Freddie Mac encounters).After the expiration of the 5-year holding period, the Investor may want to exit the transaction and require the sponsor to purchase the Investor's interests in the Borrower and Master Tenant (this is a "put option").

This is another pre-approved transfer typically requested in HTC transactions and is addressed in the standard Freddie Mac Buy-Sell Rider.

The one document of significance to the Investor in this form of HTC transaction is the Subordination, Nondisturbance and Attornment Agreement (the “SNDA”) because this is the document that will establish a relationship with the Master Tenant and Lender (but not a “direct borrower relationship”).

- The SNDA will provide (like any other subordination, nondisturbance and attornment agreement with any other tenant) that a Lender will not terminate the Master Lease so long as there is no default under the Master Lease and will provide that a Lender give the Master Tenant notice of any default under the Loan Documents (and give Master Tenant an opportunity to cure such default).

If you have any questions regarding HTCs in connection with a Freddie Mac Multifamily transaction, please reach out to the Multifamily Attorney working on your transaction.

Freddie Mac is not rendering tax or legal advice and appropriate tax and legal counsel should be consulted on all tax and legal aspects and ramifications of the Historic Tax Credit and its structure.