The Financial Structure of a Lease Purchase Project
An Analysis of the Year 16 Sale Price Components

The upfront financial structure of a lease purchase project must be thoughtfully constructed so that the Equivalency Principle is honored. Each of the following Year 16 sale price components should be structured in such a way to honor the Equivalency Principle.

- **Bank debt**: The remaining bank debt in a project in Year 16 is easy to quantify. CHN’s first nine partnerships utilized a fifteen-year amortization schedule to eliminate bank debt from the lease purchase buyer’s purchase price. As projects became tighter, CHN shifted to 25 and 30 year amortization schedules.

- **Secondary debt**: Secondary debt often includes significant interest accruals and deferrals. Although secondary debt in Year 16 is less than the appraised value of the home, this debt and accrued interest can destroy a lease purchase program if not property structured. Several rules must be followed in order to minimize the negative impact of secondary debt.

1. The non-profit sponsor must originate all secondary debt. This makes it easier for the non-profit sponsor to acquire the properties in Year 16, and is a necessary condition for items #2 and #3.
2. Request public financing in the form of grants rather than loans. Grants to the non-profit are then loaned to the partnership.
3. If grant funds are not available, borrow the funds at a 0% rate of interest to avoid interest accruals. The non-profit can then loan the funds to the partnership at AFR (Applicable Federal Rate) or AFR minus 1, if required by the tax attorney.

By following these rules, the non-profit can accurately quantify the secondary debt remaining on the property after it takes title from the partnership.

- **Capital improvement debt**: It might be necessary for the partnership to make significant capital improvements to the property before Year 16 -- improvements that exceed the replacement reserves. As such, the guaranteed maximum purchase price must include a worst case estimate of the debt-financed cost of these improvements. The Cleveland Housing Network estimates that up to $5,000 might need to be borrowed per property for capital improvements. This number is included in calculating the guaranteed maximum purchase price.

- **Exit taxes**: The Right of First Refusal (ROFR) grants the non-profit sponsor a right to purchase the project from the partnership at a price equal to the sum of “all remaining debt plus exit taxes.” Exit taxes are taxes that the partners pay
on their gains. The rule that CHN uses is that, if a partner’s capital account does not go negative, and if there are no net sale proceeds, then there will be no exit taxes.

Exit taxes are a “wild card” in calculating the guaranteed maximum purchase price, and therefore must be controlled. CHN has reached an agreement with its syndicator that the general partner can take all actions necessary to prevent the limited partner’s capital accounts from going negative. After Year 10 (after all tax credits have been used), the preferred approach for keeping limited partner capital accounts from going negative is for the general partner to issue a partial guarantee, thereby shifting losses to the general partner. The general partner’s capital account can go negative, because the GP does not utilize the annual tax benefits, so these benefits can be carried forward to cover any capital gains tax liabilities in Year 16. There are few viable approaches to eliminating exit taxes associated with a limited partner’s capital account going negative before Year 11. However, this is unlikely to occur in the current tax credit market conditions, in which investors are paying almost 80 cents on the tax credit dollar, compared to 50 cents ten years ago.

- **Closing costs and governmentally-imposed costs**: There are numerous costs associated with the Year 16 lease purchase transaction, including 1) Closing, title and financing costs incurred when the non-profit sponsor purchases the project from the partnership, 2) Sellers costs (title, closing and staff time) when the non-profit sells the home to the lease purchase buyer, and 3) Governmentally imposed costs (code violations generated by point of sale inspections, etc.). The first two categories of costs can be quantified (i.e. $1,000-2,000, depending on whether there is a need to refinance), but the third category cannot be quantified because it cannot be predicted what legislation and regulations will be enacted in the future (during the ten year period of time between when the Option Agreement is signed and when the option is exercised). As such, governmentally imposed costs are exempted from the maximum guaranteed purchase price promised in the Option Agreement.

- **A contingency for the unknown**: An improperly calculated guaranteed maximum purchase price, if underestimated, can have a profound negative impact on the non-profit organization (if it decides to proceed with the sale despite incurring losses) or on the lease purchaser (if the non-profit decides not to purchase the project from the partnership). As such, when calculating the guaranteed maximum purchase price, it is important to include a buffer. The Cleveland Housing Network adds a $3-5,000 contingency to the guaranteed maximum purchase price to hedge against this uncertainty.

By carefully following the above rules, the Cleveland Housing Network has been able to limit the guaranteed maximum purchase price to $8,000 - $20,000 (depending on the partnership) for its 1,100 lease purchase units, and $20,000 -
$28,000 for all the newer limited partnerships (each of which have a higher rent structure and therefore the Equivalency Principle is honored.)

The most common mistake in packaging the financing of a lease purchase tax credit partnership is allowing the secondary debt to flow directly from the public entity to the partnership, especially if this debt has significant interest accruals / deferrals.

Another potential challenge in packaging a lease purchase project is determining with your public sector partners whether their resources will be granted or loaned to the non-profit sponsor. The discussion revolves around two compelling but contradictory public policy objectives -- “public resources should remain in the public domain” (the public policy rational for making a loan) vs. “the key to breaking the cycle of poverty is not only increased income, but asset accumulation and achieving the dream of homeownership” (the policy imperative for making a grant). If the public entity decides to make a loan, then it is often important to select a shorter-term (15-year) bank loan amortization schedule so that the Equivalency Principle can be followed.