The Breadbox Loan Program White Paper

Anytown, USA Transaction Example

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Breadbox™

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DEVELOPMENT PROJECT IN ANYTOWN, USA

A private development entity ("PDE") and City entered into a development agreement dated as of March 1, 2019 which provides for the development of a shopping center and apartments. The City agrees to provide $15 million of economic incentive through a bond issue secured by incremental sales taxes from the project. The City issues bonds which provides the PDE with $15 million for agreed, eligible costs. The PDE will expend $5 million for public roads and utilities which will be dedicated to the City, with the remaining $10 million being spent on the construction of privately owned depreciable buildings.

Under the Breadbox Program, the following events will occur:

1. The developer (PDE) is a partnership for tax purposes, and the three equal individual partners (Partners), Tom, Dick and Harry, have each contributed $1 million of capital, for a total of $3 million.
2. The governmental entity (GE) is willing to contribute $10 million to the development project (Project) for private economic development, which under the Breadbox approach will be in the form of a loan. (If GE simply made a capital contribution to PDE, the Partners would each have $3.33 million of income and, at an assumed 50% combined Federal and state tax bracket (41% Federal (37% marginal rate plus 3.8% Medicare tax) plus 9% state), owe $1.667 million in tax each.)
3. In the proposed transaction, GE will make a non-recourse, non-interest bearing loan (Loan) of $10 million to PDE, which will be a co-borrower on the Loan with the Repayment Trust (Trust). PDE will make a contribution to the Trust of $2 million to enable the Trust to have the funds necessary, after 50 years, to repay the Loan.
4. PDE will use the $10 million proceeds of the Loan to construct depreciable real estate (Building), which will be depreciated over 40 years; $1 million (the remaining capital contributed by the Partners) will be used to acquire nondepreciable land (Land). The Land and the Building constitute the Project.
5. As a result of the Loan, the Partners will each have a tax basis in the PDE of $4.33 million, consisting of $1 million of cash contributed and $3.33 million of debt allocated to each Partner.
6. The transaction funding occurs in 2020.

On these facts and assuming today's tax rates, the analysis is as follows (numerical calculations are approximations):

a. **Depreciation Deductions.** Each Partner would be allocated depreciation deductions with respect to the Building of $83,333 per year ($10 million divided by 40 years divided by 3 Partners), or $3.33 million per Partner over the useful life of the Building, which would result in a tax benefit to each Partner of $41,666 per Partner per year, or $1.667 million over 40 years.

b. **Future Basis in PDE (2060).** Assuming all other income is distributed, each Partner would have a basis in PDE in 2060 (when the Building is fully depreciated) of $1 million.

c. **Deemed Distribution upon Loan Repayment (2070).** If none of the Partners die prior to the Loan being repaid by the Trust (assume 2070), each Partner would receive a deemed distribution in 2070 of $3.33 million as a result of the Loan repayment. This distribution would be taxable to the extent that such amounts exceed each Partner's basis in PDE. Thus, each Partner would have $2.33 million of income in 2070.

d. **Tax Consequences of Deemed Distribution (2070).** This income would be a capital gain. The resulting tax liability at an assumed 33% combined Federal and state tax bracket (24% Federal (20% capital gain rate plus 3.8% Medicare tax) and 9% state) would be $770,000, which creates a net tax benefit since the depreciation deductions recaptured had benefited the Partners at a 50% marginal tax rate.

e. **Sale of PDE Interest Prior to Loan Repayment (2040).** Assume that Dick decides in 2040 to sell his interest in PDE for its fair market value, at which time the value of the Project is $11 million (i.e., there has been no increase or decrease in value since 2020). Although Dick contributed only $1 million, because the Loan has effectively been pre-funded, his interest should be worth 1/3 of $11 million, or $3.667 million (i.e., the defeased Loan does not reduce the amount of cash received on sale). Dick had previously received depreciation deductions of $1.667 million, which would reduce his basis in PDE to $2.667 million. Dick would receive a cash payment of $3.667 million but also be deemed to receive consideration equal to his share of the Loan, or $3.33 million. Thus, the consideration he receives for tax purposes would be $7 million, resulting in taxable gain of $4.333 million. The resulting tax liability, assuming (1) a rate of 38% to the extent of prior depreciation deductions (29% Federal (25% marginal rate plus 3.8% Medicare tax) on real property depreciation recapture plus 9% state rate), and (2) a 33% combined Federal and state tax rate (24% Federal (20% capital gain rate plus 3.8% Medicare tax) and 9% state) on the rest of the gain, would be $1.513 million. Thus, Dick would receive after-tax cash flow of $2.154 million (which is $1.154 million more than his initial investment), in addition to the $833,333 tax benefit Dick previously received from the depreciation deductions.

f. **Death of Partner Prior to Loan Repayment (2040).** Assume that Tom dies in 2040, at which time the value of the Project is $11 million (i.e., there has been no increase or decrease in value since 2020). Tom's heirs inherit the PDE interest with a basis that is increased to fair market value, $3.667 million at that time (as in example (e) above, because the Loan has effectively been pre-funded, the interest in PDE should be worth 1/3 of $11 million), plus the share of the Loan, or $3.333 million, for a total basis in PDE of $7 million. Assuming that Tom's heirs were to dispose of his interest in PDE at that time, there should be no tax gain or loss. Tom's heirs would receive a cash payment of $3.667 million but also be deemed to receive consideration equal to the share of the Loan, or $3.333 million. Thus, the consideration received by Tom's heirs for tax purposes would be $7 million; the same amount as the heirs' basis in the PDE interest, resulting in taxable gain of $0. Thus, Tom's heirs would receive after-tax cash flow of $3.667 million (which is $2.667 million more than his initial investment), in addition to the $833,333 tax benefit Tom previously received from the depreciation deductions.

g. **PDE Debt Incurrence (2070).** Assume that Mary holds her interest in PDE until 2070, at which time the Loan is repaid. In order to avoid a deemed distribution, Mary causes the PDE to incur $10 million of debt to acquire and hold $10 million of Treasury bills at that time. This new debt would increase all of the Partners' bases in PDE, so that the deemed distribution resulting from the repayment of the Loan would not result in any tax liability in 2070.

h. **Sale of Project (2030).** Assume that the Partners decide to sell the Project in 2030, which is ten years after it was placed in service. Assume that the purchase price is $16 million, which is $5 million more than the original cost of the Building and the Land; a purchaser would pay $16 million in cash, because the cash payment would not be reduced as a result of the defeased Loan. Each Partner would have received depreciation deductions of $833,333 over the 10 years, so each Partner's basis in the PDE would be $3.5 million. Each Partner would receive taxable income in the sale of $8.66 million, consisting of his share of the Loan ($3.33 million each, assuming the purchaser takes the Project subject to the Defeasance Trust arrangement) plus cash of $5.33 million each. Taxable gain to each of the Partners would be $5.166 million. The resulting tax liability to each Partner, assuming (1) a rate of 38% to the extent of prior depreciation deductions (29% Federal (25% marginal rate plus 3.8% Medicare tax) on real property depreciation recapture plus 9% state rate), and (2) a 33% combined Federal and state tax rate (24% Federal (20% capital gain rate plus 3.8% Medicare tax) and 9% state) on the rest of the gain, would be $1.746 million. Thus, each Partner would receive $3.584 million after tax (which is $2.584 million more than his initial investment) and also would have received tax depreciation over ten years which was worth $416,666 ($833,333 at a 50% combined Federal and state tax rate).

i. **Failure to Repay Loan Amount (2070).** It is expected that the funds held by the Defeasance Trust will be sufficient, in all reasonably foreseeable circumstances, to pay off the Loan no later than 2070. But what if they aren't? In that case, and assuming that the Partners still hold their interests in the PDE, there will be cancellation of debt income (CODI) to both the Defeasance Trust and, more importantly, the PDE to the extent that the funds available are less than the unpaid principal balance of the Loan. The Defeasance Trust would be insolvent, so the CODI would be excluded from income for the Defeasance Trust. With respect to the partners, assuming that they are neither insolvent nor bankrupt, they would have CODI equal to the amount of the deficit which would be taxable as ordinary income at that time. If one of the Partners died in the interim (see f, above), that Partner's heirs would still have CODI equal to that Partner's share of the deficit. The CODI would increase their basis in the PDE, so there would be no deemed distribution (see c, above) to that extent.