Sample Projections

The project described in the projections involves the construction of three new buildings and the acquisition and rehabilitation of one historic building. There are 56 units in the project, six of which are market-rate units. Thirty-one (31) of the units receive rental assistance (ACC).

The existing building was a certified historic structure and was eligible for both federal and state historic credits. However, the existing building was placed in service within the past ten years and was not eligible for acquisition credit.

Sources of financing for the project included a construction loan in the amount of $9,500,000 that has a 4.7766% interest rate and a 24-month term. The construction loan was replaced by a first mortgage loan in the original principal amount of $1,000,000 which had a 5.68% interest rate, was amortized over 35 years, and matured in 15 years. Subordinate financing consisted of:

1. A second priority seller note in the amount of $1,232,257 which has a 2.64% interest rate (AFR) and a 55-year term.
2. A third priority loan in the amount of $8,000,000 from the housing authority which has a 1% interest rate and a 55 year term.
3. A fourth priority CDBG loan in the amount of $2,670,000 which does not bear interest and has a 35-year term.
4. A deferred developer fee of $200,000 that does not bear interest.

The total development cost was $19,254,024. The developer received a developer fee of $1,333,029 and the housing authority received a developer fee of $333,257.

The project had qualified rehabilitation expenditures of $1,465,028 for purposes of the federal and state historic credits. The LIHTC investor contributed $272,468 (0.93 per credit) for the federal historic credit and the state historic credit was certificated and resulted in proceeds of $293,006 (0.85 per credit).

The total projected tax credit over the 10-year compliance period are $6,130,697 with $390,341 received in the first year and $222,728 in the eleventh year.

The costs included in eligible basis for the construction and rehabilitation was $16,354,045 after being reduced by $293,006 for the federal historic credits and $32,037 for rebates. The basis was increased by 130%. Based on the applicable fraction of 89.29%, the qualified basis was $18,982,374. Because the project was financed with tax-exempt bonds, it was only eligible for the 4% credit (3.23%).
The investor provided equity of $5,820,749 in five installments:

- $832,242 + $40,870 on admission of the limited partner
- $832,242 + $40,870 on 50% completion
- $832,242 + $40,870 on 100% completion
- $1,387,070 + $68,117 on cost certification
- $1,664,484 + $81,740 on stabilization

I. **Terms to Know**

A. **Capital Account**: A capital account is a “record” of each partner’s share in the partnership’s economic activity. A partner’s capital account reflects the amount such partner will receive upon liquidation of the partnership if the partnership’s assets are sold at book value.

B. **Minimum Gain**: Minimum gain is created as a partnership claims deductions that decreases the partnership’s book basis in the property that secures nonrecourse debt below the balance of such nonrecourse debt. A partnership’s minimum gain is generally equal to the excess of the partnership’s non-recourse liabilities over the adjusted tax basis of the property securing such debt. The gain is “minimum” because it represents the gain that would result in the worst-case scenario in which the partnership receives no consideration other than satisfaction of the non-recourse debt in exchange for the asset transfer.

C. **Deficit Restoration Obligation**: The unconditional obligation of a partner to restore a specified amount of negative balance in its capital account upon a liquidation of the partnership or the partner’s interest in the partnership.

D. **Recourse Debt**: Debt for which the lender may sue the borrower directly for any deficiency.

E. **Partnership Nonrecourse Debt**: Nonrecourse debt, i.e., debt for which the lender’s sole recourse is the property securing such debt, which is made by a party that is unrelated to any partner in the partnership.

F. **Partner Nonrecourse Debt**: Nonrecourse debt, i.e., debt for which the lender’s sole recourse is the property securing such debt, which is made by a partner (or a related party) to the partnership.

**Allocations and Capital Accounts**

A. **Partnership Non-Recourse Debt**

1. The capital account approach is based on the idea that loss allocations should have economic effect on the partners by reducing their claim on partnership capital.

2. But what if the partnership has negative book equity, and negative capital accounts, such that the lender is bearing the risk of loss?
3. A limited partner with a negative capital account is no longer bearing the economic risk of loss relating to further deductions/losses.

4. Allocations of deductions attributable to nonrecourse debt (“Nonrecourse Deductions”) cannot have economic effect because the creditor/lender bears the economic risk of loss of such loss or deduction.

5. However, if the partnership agreement complies with certain safe harbor requirements, then allocations of Nonrecourse Deductions will be respected even if made to a partner with a negative capital account.

B. Safe Harbor Requirements

1. Other allocations in the partnership agreement have economic effect;

2. Nonrecourse deductions are allocated in a manner that is reasonably consistent with allocations of other significant partnership items attributable to the property securing the debt;

3. Partnership agreement contains a “minimum gain chargeback” provision; and
   - Minimum Gain Chargeback – a provision generally requiring that, if there is a net decrease in partnership minimum gain during a taxable year, each partner must be allocated items of income and gain for such year in an amount equal to such partner’s share of the net decrease in partnership minimum gain.

4. All other material allocations and capital account adjustments are respected.

C. What impacts capital accounts:

1. Capital Accounts are INCREASED by:
   a) cash contributions actually made to the partnership (promissory note not enough);
   b) FMV of property contributed to the partnership (net of liabilities); and
   c) share of income or gain.

2. Capital Accounts are DECREASED by:
   a) cash distributions;
   b) FMV of property distributed to the partner (net of liabilities assumed by the partner);
   c) share of losses; and
d) share of HTC and 50% ETC (but not LIHTC).

D. Why are Capital Accounts Important?

1. They govern liquidating distributions; and

2. They are key in determining whether allocations of losses and LIHTC to the investor will be respected.

E. Allocation of LIHTCs

1. LIHTC follows depreciation losses

2. Depreciation (and LIHTC) cannot be allocated to a partner with a negative capital account unless EITHER 1) the partner has agreed to a DRO (investors are typically not willing to agree to a DRO other than a limited DRO in the early years before 100% of the investor’s capital has been contributed) OR 2) there is sufficient partnership (i.e., “good”) minimum gain to support such allocation.

3. “Good” Minimum Gain is minimum gain generated by a partnership nonrecourse liability.
   - Nonrecourse deductions sourced from “good” minimum gain can be allocated to the investor.

4. “Bad” Minimum Gain is minimum gain generated by a partner nonrecourse liability.
   - Nonrecourse deductions sourced from “bad” minimum gain must be allocated to the partner that bears the economic risk of loss (typically the sponsor/general partner).

5. Minimum gain trumps. Accordingly, even if the LP has a positive capital account if “bad” minimum gain is being generated, losses sourced from the “bad” minimum gain must be allocated to the partner that bears the economic risk of loss.

F. Stacking Rules

1. The stacking rules dictate how the adjusted tax basis of an asset that secures multiplies liabilities is allocated among such liabilities. The stacking rules require that basis be allocated to liabilities in the reverse order of payment priority (e.g., first to a second mortgage and then to a first mortgage).
   - Example: Partnership acquires depreciable real property for $1,000,000, which is financed by two mortgage loans, a first mortgage loan of $800,000 and a second mortgage loan of $200,000. Assume depreciation of $100,000 per year for 10 years. In year 2, the adjusted basis of the property is $900,000, which is allocated $800,000 to the first mortgage loan and $100,000 to the second
mortgage loan. If the second mortgage loan is nonrecourse debt, there will be $100,000 of minimum gain in year 2, which may be “good” or “bad” depending on whether the second mortgage loan is partnership or partner nonrecourse debt.

**Ways to Avoid Negative Capital Accounts**

A. Reduce Soft Loan Interest Rates

1. Loan interest is deductible and generates additional losses (p. 8)
2. Reducing interest rates will slow down losses
3. Impact on Investor Yield
4. Can we reduce interest on any loans in the Projections example?
   - √ Seller Loan: Running at 1.00%
   - √ RH Funds: Running at 1.00%
   - √ But will lenders agree to reduce interest rate?
5. Special Allocation of Losses to General Partner
   - Investor receives 99.99% of losses (p.2)
   - Specially allocating losses to GP will slow down losses to LP
6. What are “special allocations?”
7. How are losses “specially allocated” to another partner from a mechanics standpoint?
8. What type of losses can be allocated?
   - During Credit Period: Only **Non-Depreciation** Losses (Credits follow depreciation) (p.8)
   - After Credit Period: Any losses (including depreciation) (p.8, p.19)
9. Legal Concerns and Challenges with Special Allocation of Losses
   - Will special allocation to GP be respected by the IRS?
     - Confirm GP DRO (LPA)
     - Will allocation have substantial economic effect? NOT substantial if:
       - (i) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced and
(ii) strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished

• Avoid specially allocating LP losses to for-profit GP rolling up to individual

10. Impact on Investor Yield

Special Rules/Fixes – How to Avoid “Bad” Minimum Gain

A. Disaffiliation (79/21)

2. Convert partner nonrecourse debt to partnership nonrecourse debt by causing the lender to be unrelated to the partners of the partnership. As a result, any minimum gain generated will be “good” minimum gain.

• For these purposes, a person is related to a partner if the person and the partner bear a relationship to each other that is specified in Sections 267(b) or 707(b)(1), except 80% is substituted for 50% each place it appears in such sections. Treas. Reg. §1.752-4(b)(1).

• Sponsor/developer divests itself of more than 20% of the ownership of the general partner when the sponsor/developer will have loans to, or deferred fees payable from, the partnership, which loans are projected to generate “bad” minimum gain during the credit period.

• Under the tiering rules in Treas. Reg. 1.752-4, the GP must elect to be taxed as a corporation.

B. 10% De Minimis Rule

1. Exception for loans from a partner or related person where the partner’s interest in each item of income, gain, loss, deduction or credit for every taxable year is 10% or less and the loan constitutes “qualified nonrecourse financing.”

• Qualified nonrecourse financing is financing borrowed from a qualified person or represents a loan from any federal, state or local government.

• “Qualified person” is any person which is actively and regularly engaged in the business of lending.

C. Other Fixes

1. Convert partner nonrecourse debt to recourse debt (this assumes there is sufficient partnership minimum gain being generated at the time the investor’s capital account is exhausted).
2. Change the priority of the loans so that the most junior debt is partnership nonrecourse debt (this may not be possible depending on the other lenders involved).

- Lien priority is not the same as payment priority, i.e., an unrelated subordinate lender can still be paid ahead of a related party lender provided the unrelated subordinate lender’s mortgage is subordinate in lien priority to the related party lender’s mortgage.

**Impact of Negative Capital Account on Exit Strategies**

**A. Exit Taxes**

1. Negative capital account – exit tax liability upon exit – who pays?
   a) ROFR
   b) Buyout Option
   c) Put
   d) Minimum gain does not impact exit tax liability

2. How to solve
   a) Special allocation of losses
   b) Investor may waive on GP call and put
   c) Loss flip after credit period

**B. Distribution of Sale Proceeds**

1. Liquidation – Proceeds distributed per capital accounts
2. Sale/Refinance
3. Concerns and challenges from Sponsor perspective
4. How to address
5. Legal considerations