FINANCIAL PROJECTIONS AND CAPITAL ACCOUNTS
THE BASICS

PART I – REVIEWING FINANCIAL PROJECTIONS

Description of Projections

The projections are based on a 4% tax-exempt bond financed LIHTC project. The project has 104 units, all of which are low-income. The project involved construction of a four-story building with one- and two-bedroom units with eight units set aside for individuals with disabilities. The project is eligible for the 130% basis boost.

The project is a later phase of a larger development with market-rate units, artist’s studios, and a 20,000 square foot medical facility.

Total development costs of $17,259,367 resulted in an eligible basis of $14,206,833 after deducting $100,000 for commercial parking. The annual LIHTC is $603,932 resulting in investor equity of $5,555,622 based on 0.92 per credit investment. Equity is paid in $1,111,124 at closing, $1,444,462 at 75% completion, $1,666,687 at stabilization, and $277,781 on issuance of the 8609.

There was $10,010,000 of bond financing split into three issues of $2,100,000, $4,160,000, and $3,750,000. The three components had an interest rate of 4.40%, 2.95%, and 1.00%, respectively. The only subordinate debt was a seller note in the amount of $1,250,000 which carried a 2.85% interest rate and matures in 420 months. The seller note is projected to be fully repaid in 2033. There was a developer fee of $1,500,000, $443,745 of which was deferred. The deferred fee is payable from cash flow, bears interest at 2.85% and is payable in full in ten years.

The buildings are depreciated over 30 years, but there is bonus depreciation taken in 2020 for site improvements and personal property. This enabled the project to avoid 163 interest limitations.

The project is projected to be sold for $6,282,218, the outstanding debt, in December 2037 resulting in a $757,612 tax benefit to the investor.

The overall IRR to the investor is 5.36%.

To understand a transaction, it is crucial to understand the financial projections. Projections may be prepared by an accountant hired by the developer or by the investor. It is hard to truly understand a transaction and negotiate the terms of the limited partnership agreement without properly prepared projections.

Background (p. 3)

A. Number of Buildings – The number of buildings is important in an LIHTC project. In some cases, there may be some analysis required of what constitutes a building. Consider if the development is going to be treated as a single project or separate buildings.
B. Number of Units – Frequently, the manager’s unit may be treated inconsistently. Typically, the manager’s unit is not counted as a low-income unit.

C. Low-Income Units – Verify that the number of low-income units is consistent with the tax credit calculation.

D. Square Footage – This is important for calculating the applicable fraction for mixed income developments. Remember that the applicable fraction is based on the lesser of the percentage of low-income units or the square footage of low-income units.

E. Minimum Set Aside Test – Determine if the project is using the 20/50, 40/60 test, or IA test.

F. Commercial Space – Unless the project is in a QCT and has an eligible community service facility, commercial space is excluded from eligible basis. The allocation of costs between residential rental property and non-residential uses is typically, but not always, based on square footage.¹

G. Census Tract – The census tract is important for determining if project is eligible for 130% basis boost for new construction and rehabilitation. It is also important for determining if community service facilities may be includible eligible basis. On-line tools are available to determine if census tracts have been designated as QCT.

H. Credits Reserved / Allocated – Both the amount of allocation and the year of allocation are important.

I. Other Credits – Are there federal historic credits? Are there any state credits?

J. Investment per Credit – How is the transaction “priced”?

K. Credit Rate – Is the credit rate fixed or floating? What rate is being used?

L. Date – When does construction commence? When is it projected to be completed? When does rent up begin? Are the dates consistent with the LOI, LPA, construction contract, and tax credit deadlines?

Assumptions

A. Vacancy (p. 14) – Is the vacancy rate reasonable? Does it match investor and lender requirements? Should a different rate be used to evaluate potential cash flow?

B. Increases in Rents (p. 14) – Are these reasonable? Do they match investor, lender, and credit agency limitations? Should a different rate be used to evaluate potential cash flow? Are there restrictions on rent increases in loan documents or credit allocation requirements that need to be considered?

¹ 26 CFR § 1.103-8(b)(4).
C. Increase in Expenses (p. 14) – Are these reasonable? Does it match investor, lender, and credit agency requirements? Should a different rate be used to evaluate potential cash flow? Frequently, investors require that expenses be trended at a higher rate than income which can result in projected deficits in later years.

D. Reserves (p. 5 and p. 15) – Do the reserves match lender, investor and credit agency requirements?

**Timing**

A. Commencement of Construction (p. 3) – Review if the commencement date is accurate. Delays in closing may not be reflected in older projections, causing inaccuracies in placed in service and lease-up dates.

B. Substantial Completion (p. 3) – Make sure that the substantial completion date is consistent with the completion date in the construction contract.

C. Lease Up (p. 3) – It is important that the lease up schedule is realistic. Failure to meet lease-up schedules will result in the general partner making credit adjuster payments to the investor. Pay attention to year-end implications and how failure to meet lease-up by year end can impact credit adjusters.

D. First Year of Tax Credit Period (p. 16 and p. 22) – Does the first year of the tax credit period realistically match the lease-up schedule?

E. Permanent Loan Funding (p. 4) – Is the timing of lease up / stabilization in the projections consistent with the permanent lender conditions for permanent loan funding?

F. Equity Payment Schedule (p. 4) – Verify that the pay-in schedule is consistent with the letter of intent or limited partnership agreement.

G. Credit Rate (p. 3 and p. 21) – Has the correct credit rate been used? Is the rate fixed or floating?

**Sources and Uses of Cash**

A. Sources

1. Loan Sources (p. 5 and p. 12) – Verify that the types and amounts of sources are accurate. Pay particular attention to distinctions between construction and permanent debt and the timing of the availability of the funds. Note if any loans are inaccurately labeled grants.

2. Equity Contributions (p. 4) – Confirm that the contribution by the limited partner and general partner are accurate.

3. Operating Income (p. 16) – Review commencement of rental income. This can be more complex on acquisition / rehab projects.
B. Uses

1. Reserves (p. 5, p. 7, p. 15) – Confirm that funding conforms to investor, lender and credit agency requirements. This should include initial and on-going funding requirements.

2. Construction Costs (p. 5) – Review amount and timing. Pay attention to whether construction contingency, off-site, landscaping, and other expenses are included in eligible basis.

3. Deferred Developer Fee (p. 18) – Review that the deferred developer fee can be repaid in a reasonable period of time. Confirm that it is repaid before the required date for payment contained in the limited partnership agreement and is consistent with credit agency rules on deferral and repayment.

4. Incentive Management Fees (p. 18) – Review whether incentive fees are treated as deductible expenses or distributions.

Forecasted Net Operating Rental Income

A. Commercial Income (NA) – If there is commercial revenue, verify the source and determine if any adjustment of eligible basis is required.

B. Parking Income (p. 21) – If there is any parking revenue, make sure that the cost of constructing or rehabilitating parking structures that generate revenue is excluded from eligible basis.

C. Other Income (p. 17) – Ensure that sources of other income are allowable under credit agency rules, and whether they are included in tenant “rent” limits.

Allocations to Limited Partner

A. Capital Account (p. 34-35) – Review the limited partner’s capital account to determine if additions and deductions are properly reflected. Review if the capital account goes negative during the credit period / compliance period.

B. Potential Section 704(b) loss reallocation (p. 34-35) – Is there any reallocation as a result of negative limited partner capital account?

C. Gain or loss from sale at end of compliance period (p. 32) – Do the projections contain an analysis of the property at the end of the compliance period?

D. Tax credits (p. 22 and p. 37) – Are tax credits allocated to the limited partner consistent with the tax credit allocation and calculation for LIHTC?

E. Cash received – Are the cash distributions to the limited partner consistent with the LOI? LPA?
**IRR (p. 36)**

Sometimes the investor will not share this calculation.

A. Review that the calculation of IRR is consistent with the other numbers in the projection, including capital contributions, LIHTC, distributions, depreciation, losses, etc.

B. Factors that impact IRR include:
   1. The length of time between capital contributions and the start of the tax credit stream;
   2. The amount of the tax credits;
   3. The amount of tax savings through losses generated after consideration of the depreciation; and
   4. Net sales proceeds at the close of the compliance period.

C. Analysis – Calculation of IRR can be more of an art than a science. If you run the same numbers through two different programs calculating IRR, you are likely to get two different results. Investors use different assumptions regarding timing, tax rate and other factors. Consequently, it is important to define the method of calculating IRR when adjusters are based on a fixed IRR to the investor.

**Forecasted Sale (p. 32)**

When reviewing the forecasted sale, it is important to evaluate:

A. Does the projected sale reflect the business terms?

B. What is the economic outcome to the partners as a result of a sale at an assumed price?

C. Do the projections need to be revised to develop an exit strategy for the parties?

D. What is the feasibility of the exercise of a right of first refusal by a non-profit general partner under Section 42(i)(7)? A negative limited partner capital account will result in exit tax liability and an increased purchase price under 42(i)(7). Note how increasing losses (27.5-year depreciation, higher interest rates on loans, etc.) can increase the exit price.

**Construction Costs (p. 5)**

A. Determine if the threshold test for LIHTC rehabilitation credit or historic credits have been satisfied.

B. Determine if any items are missing.

C. Determine if there is any issue as to when costs were incurred or will be incurred for the purpose of including costs in LIHTC eligible basis or qualified rehabilitation expenditures.
Costs scheduled to be incurred after the end of the first year of the credit period generally cannot be included.

**Tax Credit Calculation (p. 5 and p. 21)**

It is important to review the development costs to determine what items may be properly included in eligible basis. Go back and review Section 6 of Module 2 to refresh your recollection of the rules. One item that requires additional analysis is construction interest. Capitalization commences once physical production activities begin.

Physical production activities include: clearing, grading, or excavating of raw land; demolishing a building or gutting a standing building; engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables, and wiring; undertaking structural, mechanical, or electrical activities with respect to a building or other structure; or engaging in landscaping activities. Planning and design and incidental repairs are generally not considered physical production. Capitalization ends on the date that a unit is placed in service and all production activities reasonably expected to be undertaken are completed. Consequently, only a portion of construction interest is capitalized and included in eligible basis.

Real estate taxes are not treated the same as construction interest for the purpose of calculating eligible basis. If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to the property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.

1. Landscaping – Items that are close to the improvements may be included in eligible basis while general site landscaping is not.

2. Developer Fee – Developer fee is included to the extent related to eligible work and incurred. Careful drafting of the development fee agreement is required.

3. Impact Fees – Impact fees incurred by a taxpayer in connection with the construction of a new residential rental building are includable in eligible basis.

4. Construction Loan Fees – Permanent loan fees are not included, while fees exclusively for a construction loan may be included.

5. Demolition – Demolition of a building is generally considered to be land and not included in eligible basis. However, interior demolition of a building as part of rehabilitation may be included in eligible basis.

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4 Rev. Rul. 2002-9; IRC 263A.
6. Relocation – Not included for relocation prior to demolition of building, but may be
   includable for relocation incidental to rehabilitation. IRS does not agree that relocation
   is included in basis.

7. Contingency – Hard and soft cost contingencies are included in basis only to the extent
   expended on eligible costs.

8. Title and Recording – Costs related to the permanent loan are not included, while
   owner title policy costs and fees related to a construction loan are included.

9. Off Site Improvements – Capitalize to land, land improvements, building or other asset
   depending on particular facts.

Note that certain items must be deducted from basis before any 130% basis boost is applied. First,
 federal grants used to finance capital items in eligible basis reduce basis. In addition, if market
 rate units of a higher quality than affordable units, the non-qualified portion of higher quality units
 must be excluded from basis. Finally, historic credits claimed on a project\(^5\) reduce basis. Some
 transactions are structured so that the basis reduction is avoided by using a master lease structure
 (see Module 3).

Another item to review is whether the project is eligible for a 130% basis boost and if it is
 properly assigned. 130% boost for projects in QCT are determined eligible under:

1. Does not apply to acquisition costs

2. Verify that property is in QCT or has received a discretionary boost from the credit
   allocator.

**Depreciation & Amortization (p. 20)**

Several areas should be reviewed in the depreciation portion of the projections. First, does
the depreciation schedule for the building match the LOI and LPA? Also review if proper
depreciation schedules are used for personal property and improvements and other items. Is there
any bonus depreciation and, if so, are there any issues with tax-exempt use property?

Assess whether there is any tax-exempt use property, in which case a 30-year depreciation
period should be used.

**Developer Fee (p. 10)**

The projections frequently include a calculation of the developer fee permitted under the
applicable QAP. Is the fee within what is permitted by the credit allocator? If the fee is payable
from cash flow, will it be paid within a reasonable period?

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\(^5\) 42(d)(5)(B)(V).
Loans (p. 11 and p. 12)

The projections include a description of the loans for the project. It is important to determine if the projections are consistent with the LOI and/or LPA and the provisions contained in the actual loan documents. This analysis should include reviewing the loan amounts, interest rates, loan terms, repayment terms, and whether the loan is treated as recourse or non-recourse.

Capital Accounts / Minimum Gain (pgs. 33-35)

Sometimes the investor does not share the capital account analysis portion of the projections. LIHTC follows depreciation, so if losses can be allocated to the limited partner, depreciation and credits follow. If a limited partner’s capital account goes negative, then if there is not sufficient minimum gain, losses (depreciation) and, consequently, credits may be reallocated to the general partner. If there is a partner nonrecourse debt, that needs to be evaluated even if the limited partner’s capital account remains positive. Consequently, it is important that the capital account analysis be reviewed.

Minimum gain is created as a partnership claims deduction (typically depreciation) that decrease the partnership’s book basis in the property below the balance of the non-recourse debt on the property. If there is sufficient minimum gain, allocations of losses to the limited partner may be respected even if the limited partner’s capital account is negative. If a partnership purchased a property for $1,000,000, took $500,000 in depreciation deductions, and then refinanced the property with $1,500,000 of non-recourse debt because the fair market value of the property was now $2,000,000, the minimum gain would be $1,000,000 ($1,500,000 minus the property’s adjusted basis (purchase price ($1,000,000) minus depreciation ($500,000))).