# Sophisticated Tax, Legal, and Accounting Issues

## Today’s Speakers

Nate Bernard
**Nixon Peabody LLP**
Moderator

Nick Anderson
**Nixon Peabody LLP**

Charles A. Rhuda, III, CPA
**Novogradac**

Pam Swanson
**Nixon Peabody LLP**

# Agenda | Part I

1. Understanding capital accounts and how they affect the parties' expectations
2. Structuring Exits at the time of the initial partnership closing
3. Developer expectations on liquidation and the role of capital accounts

# Basics of Capital Accounts

- IRS rules require either a strict formula approach (using capital accounts) or the **“partners' interest in the partnership” approach**. Since tax benefits are so important in a housing deal, no one wants the uncertainty of the partners’ interest method.
- When using capital accounts, it is necessary to compute a partner’s investment (increase), its share of profits (increase), losses (decrease), non-deductible charges (like syndication costs, decrease), additional contributions (increase) and distributions (decrease).
- The rules require that **on liquidation**, distributions **must** be made in accordance with capital accounts.

# Allocating Credits Among Partners

### It would all be so easy if we could just SELL the low income tax credits.

The person sponsoring the project could strike a deal with an investor to get 90 cents per dollar of credits, or whatever the market was, and then the sponsor could just keep the property while the investor got the credits.

### Unfortunately, federal credits don't work that way.

The federal tax rules don't allow people to engage in transactions purely to transfer tax benefits. Instead, the transactions are required to look (more or less) like "normal" business dealings. Then, LIHTCs run to the person or entity that owns the facility, and then get shared among the principals of that entity. The allocations must comply with complex tax regulations.

# Allocations of Credits

**IRS has elaborate rules for allocating tax benefits, especially tax credits among the parties**

*(More on the next slide)*

- Over the years, tax rules have been developed for each credit, based on the Tax Code or regulations.  The LIHTC is allocated in accordance with the partners' interest in depreciation related to the housing project.
- Wide range of ratios possible, but 99.99% - .01% for operations (including depreciation) and 10/20%-90/80% for "residuals" (i.e., proceeds of sale) are very popular ratios for LIHTC deals.
- The GP can still get development and management fees which are thought to be outside the partnership interests.

NP

# Special Allocation Rules

**The Section 704 regulations provide rules for allocating many tax items, including depreciation and tax credits**

## Two basic rules:

Either comply with:

- the “partners’ interest in the partnership” rule, OR
- the technical “Substantial economic effect” rules of  the regulations

Investors will not want to use the partners’ interest in the partnership method; too much is at stake to trust the IRS to agree with the taxpayers.

So, all tax credit transactions use the technical rules instead.

# The Partners' Interest in the Partnership Method

**"The partners' interests in the partnership" method is based on a nebulous concept that doesn't call for a clear answer**

For example, if a partner has a 99% interest in operating cash flow and a 20% interest in proceeds from the sale of the project, what percentage represents his "interest in the partnership"?

Is it 99%, or 20%, or 60% (this being just about the average of the two)?

Or is it yet another percentage?

NP

# Capital Account Method

**Even though the Capital Account method is complicated, investors greatly prefer its precision, and tax lawyers will give them an opinion when they use it**

There are many requirements:

/ Maintain Capital Accounts

/ Liquidate in Accordance with Capital Accounts

/ Almost always: Allocate losses to those with Positive Capital Accounts (with some limited modifications). Special rules apply where there are negative capital accounts, relying on DROs, minimum gain, and related party debts or guarantees.

# Liquidations in Accordance with Capital Accounts (1)

Assume that after year 15, the partnership has a basis in its property of $5M, but the property is worth $8M.

There is $5M of debt on the property.

The GP and LP each have capital accounts of zero.

The property is sold for $8M, resulting in a gain of $3M (this is $8M of sales price less $5M of basis).

The $8M of proceeds is used to pay off the $5M of debt, which leaves $3M to distribute.

We allocate 90% of the $3M of gain to the GP ($2.7M), and 10% of the $3M of gain to the investors ($300K), giving them capital accounts of $2.7M and $300K, respectively.

Finally, we liquidate in accordance with capital accounts, distributing $2.7M (90% of the proceeds) to the GP and $300K (10% of the proceeds) to the investor, just as everyone intended.

# Liquidations in Accordance with Capital Accounts (2)

**But:**
Depending on the kind of deal, the investor may still have a large positive capital account 15 years later.

**New Example** – assume that after year 15, the partnership has a basis in its property of $5M, but the property is worth $8M. There is $2M of debt on the property.

The GP has a capital account of $0, and the LP has a capital account of $3M. The property is sold for $8M, resulting in a gain of $3M (this is $8M of sales price less $5M of basis).

The $8M of proceeds is used to pay off the $2M of debt, which leaves $6M to distribute.

Even if we allocate all $3M of gain to the GP, the capital accounts of the partners will be $3M each, so if we liquidate in accordance with capital accounts, the investor will get 50% of the liquidation proceeds, not 10% as was promised.

# The Liquidation in Accordance with Capital Accounts Problem

**In the previous example, the GP expected to get 90% of proceeds, but only got 50%, because the LP started with a high capital account**

Anticipating this problem, some GP tax advisors will ask for:

/ Disregard capital accounts, and just use waterfall

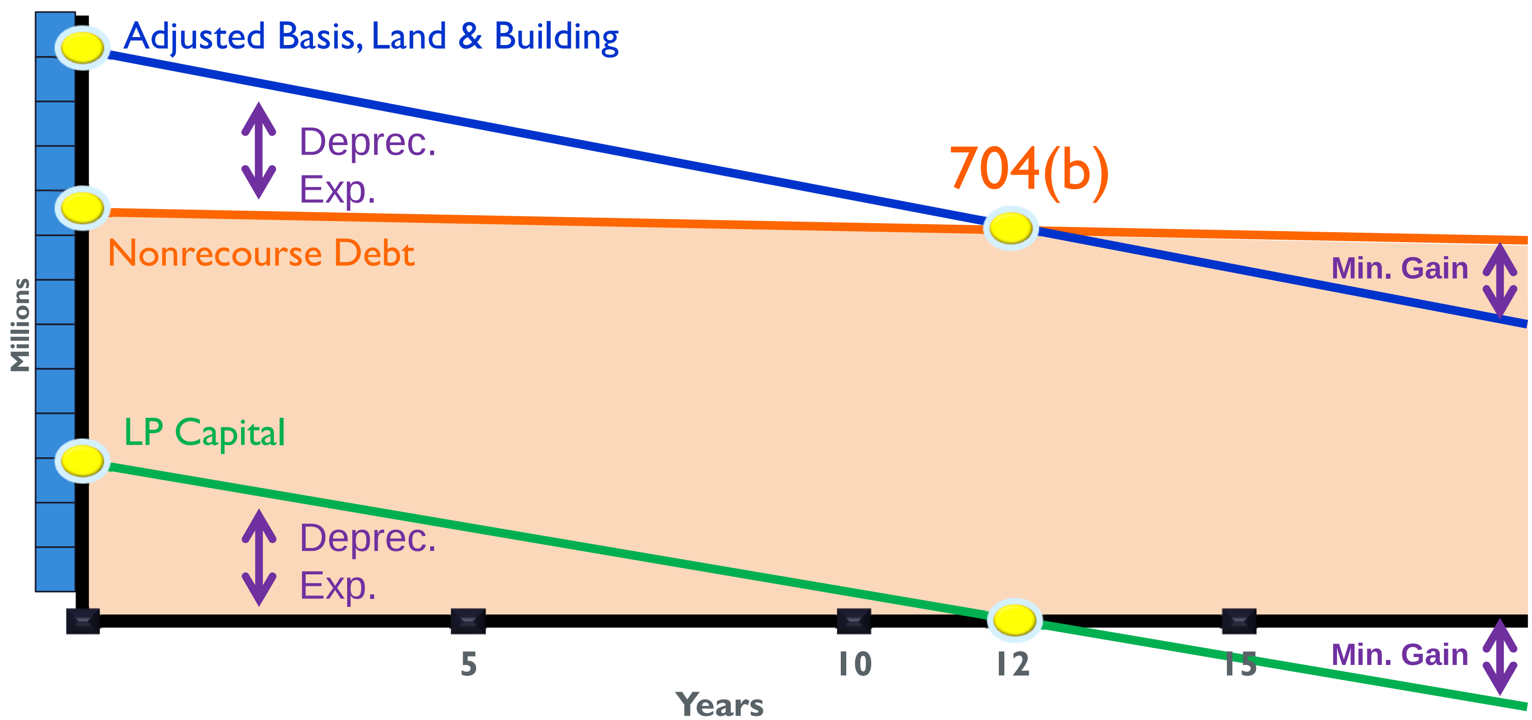
/ Treat distributions as not being a “liquidation” so that capital account distributions are not required

/ Contractual right to buy LP’s interest for 20% of value, regardless of capital accounts

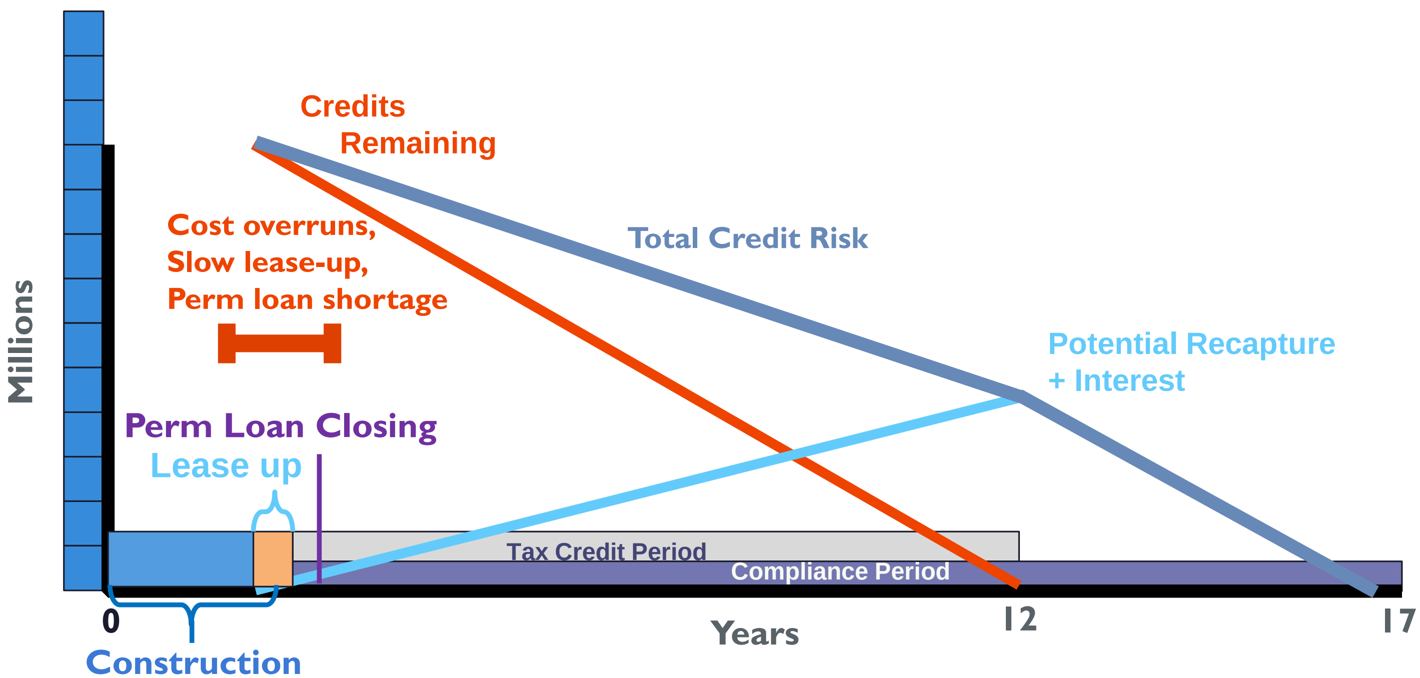
Each of these is not consistent with 704 regulations, which means that LP can’t get a good tax opinion. So, LP shouldn’t agree to any of these.

# A Visual Presentation of Capital Accounts

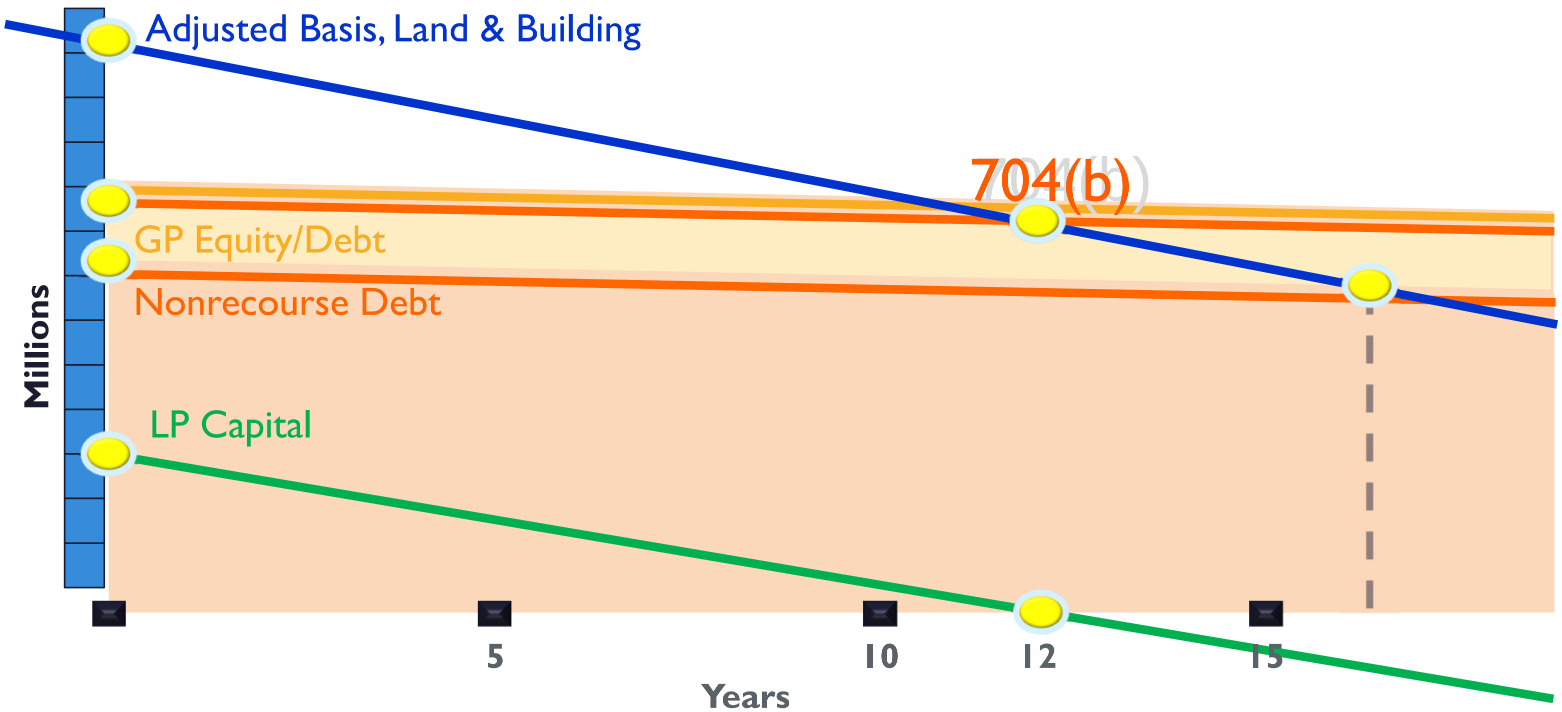
# Initial Capital Account Underwriting



# Risks & Rewards Timeline of a Low-Income Housing Tax Credit Investment



# Consequences of Unexpected GP Funding




NP

# Understanding Nonprofit Rights

## Right of First Refusal

/ Not an option/triggered by sale of the Project

/ Permitted to be less than fair market value but must meet minimum price under Section 42(i)(7) of the Code

## Fair Market Value Call Options

/ Can be for a purchase of the Investor Interest or Project

/ In the control of the General Partner for a set period of time

/ Purchase price must be “fair market value”

## Investor Put

/ In the control of the Investor

/ Can have a nominal price

NP

# Understanding Nonprofit Rights

## Right of First Refusal

/ Not an option

/ Practiced application seems to work as an option (no competing sale)

## Fair Market Value Options

/ Length and nature of restrictions

/ Implications of high loss transactions

/ Debt accumulations

/ Tax-exempt bond transactions

# Right of First Refusal

- Code allows an exception to the requirement that the Project must be valued at FMV
- Qualified Nonprofits (and certain others) are permitted to exercise a right of first refusal for the minimum purchase price in 42(i)(7) of the Code
- Price is typically debt plus taxes but other amounts are often negotiated in (such as unpaid adjusters to Investor)
- Typically triggered by a bona fide offer to sell the Project. How this is triggered often gets negotiated into the Partnership Agreement
- Much recent litigation over the phrase “bona fide”

NP

# Call Options

Call Option Agreements are typically granted for a specified period of time after the end of the Credit Period or Compliance Period

Call Options are in the control of the General Partner and therefore the price must be fair market value. A below fair market value call option calls into question whether the Partnership/ Investor are an owner

If a call option exercised prior to end of Compliance Period there is usually a guaranty required as a condition of exercising the Call Option

NP

# Determining Fair Market Value of Option

- Call Option of Project traditionally based on value of Project in a hypothetical sale
- Fair market value determined by an appraisal – who chooses appraiser is negotiated into documents
- Value of Interest can either be fair market value of interest or what the Investor would receive if the Project were sold at FMV
- Typically parties will try to negotiate factors that appraiser may use in valuing Project. Need to make sure language does not overly direct appraiser
- Does the value of the interest include the Investor's capital account?

# Investor Put Option

Investor Put Option is in the control of the Investor and is typically a nominal amount

Investor Put can occasionally be for a higher amount but that also raises tax concerns

Typically exercised at end of Compliance Period but we occasionally see them at the end of the Credit Period

NP

# Agenda | Part II

1. Kinds of Dispositions
2. Sale of Partnership Interest and Negative Capital Accounts
3. Revisiting the Capital Account Problem and addressing Developer and Investor expectations in Year 15
4. Partnership Sells Property and Applying the Capital Account Rules
5. Tax Liability on Account of Negative Capital Account
6. Charitable Donations
7. Portfolio Sales and Issues

NP

# Kinds of Dispositions

Most likely transactions:

**Sale of LP's interest**

**Sale of Asset and make liquidating distributions**

**Charitable Donation of asset by the partnership**

**Charitable Donation of interest by investor**

# Sale of Partnership Interest

## Determining Price

/ Put for bargain price

/ Sale for waterfall value

/ Sale for waterfall value, reduced by discounts

- Lack of control
- Lack of marketability
- Usually thought to be 20% each, or 36% total discount (80% times 80% is 64%)

/ Sale for Percentage Interest

/ Charitable Donation; need an appraisal

NP

# Tax Liability on Account of Negative Capital Account

**When the LP's capital account is negative, the LP can have a tax liability, even if  the project is put for a bargain price or donated**

- The negative capital account represents losses taken against debt
- With any sale, the partner is now considered to have sold for the cash received plus its share of the debt
- So, there can be phantom income

NP

# Illustration 1

Sales price is $1M in cash. Assume Basis in interest is $600K, and the LP's share of debt is $1M

This represents a negative capital account of ($400K)

Gain is $1M of cash plus debt of $1M, less basis of $600K, or $1.4M

This is the same as $1M of cash plus negative capital account of ($400K), also $1.4M

# Illustration 2

Sales price is $200K in cash. Assume Basis in interest is $600K, and the LP's share of debt is $1.5M

This represents a negative capital account of ($900)

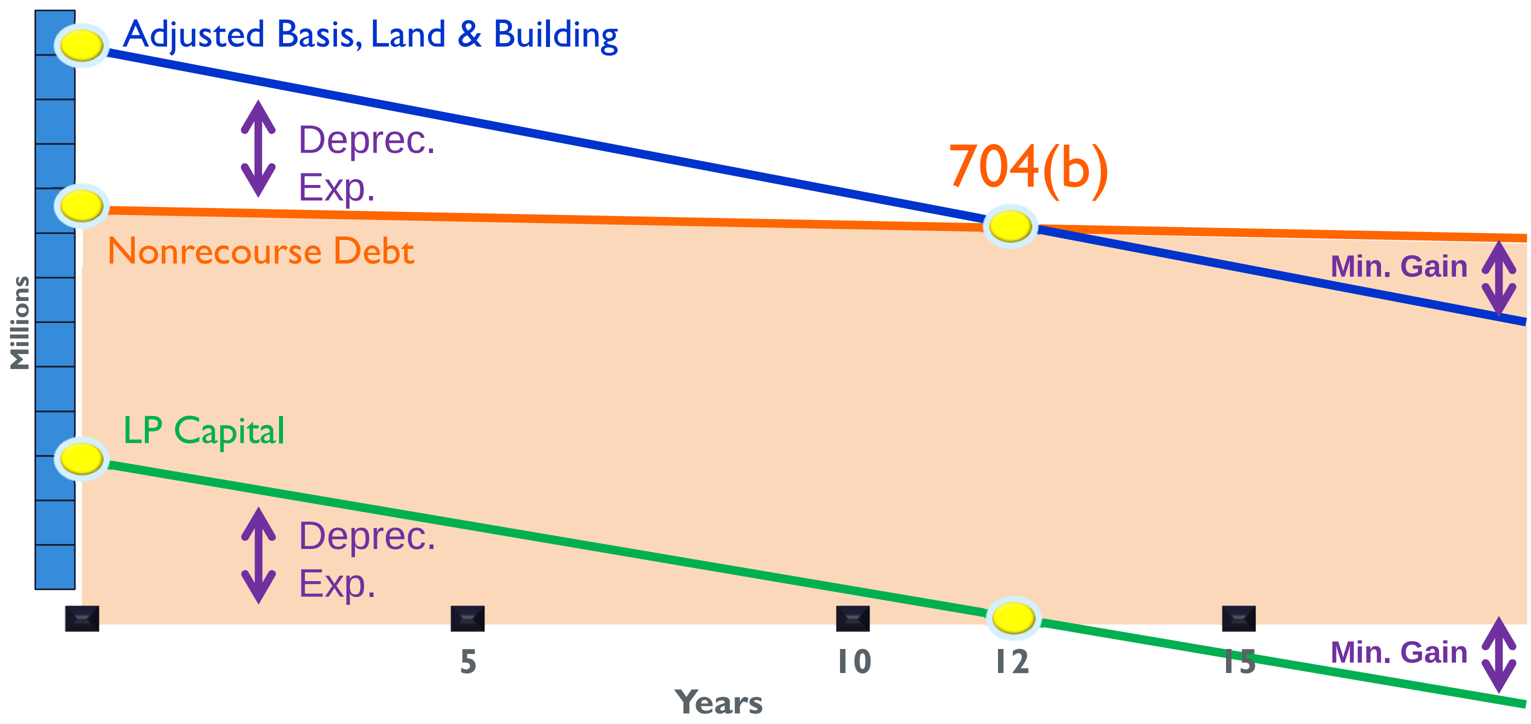
Gain is $200K of cash plus debt of $1.5M, less basis of $600K, or $1.1M

Note that income is $1.1M; for a corporate taxpayer (21% rate), the tax liability is $231K, but the cash distributed is only $200K

NP

# Revisiting the Capital Account Issues

# Initial Capital Account Underwriting



# Sale of the facility by the Partnership

- Partnership recognizes the gain, and gives information returns to the partners. Gain is allocated to the partners and increases their basis
- Distributions in accordance with capital accounts;
  **Note** that this is often not the percentage in the partnership waterfall!
- Sometimes this results in gain or loss (if basis is less or more than the amount received)
- **Again:** there can be phantom income
- **And:** The GP may not be happy with the result, depending on the LP's capital account at the time of sale.

# Illustration | Assumptions

Partnership has a basis in property of $5M; the project is subject to debt of $3M.  It sells the property for $5.5M in cash, resulting in a $500K gain ($5.5M sales price, less $5M basis).

The partnership uses $3M of the proceeds to pay off the debt, leaving $2.5M of cash to distribute.

Assume that before the sale, GP has a basis and capital account of $0, and LP has a capital account of $2M and a basis of $5M.

The parties agree that the GP is supposed to get 80% and the LP is supposed to get 20% in the waterfall.

NP

# Illustration | Analysis

So, gain is $500K. This is allocated among the partners, usually to bring their capital accounts as nearly as possible into the agreed ratio, 80/20

If we allocate the entire gain to GP, that will bring its capital account to $500K; remember that the LP's capital account is already $2M

Of course, we have $2.5M to distribute, and it goes $500K to the GP (20%) and $2M to the LP (80%)

The GP also has to pay the tax on the partnership's $500K of gain; the LP has no tax liability.

The GP did not get anything close to its expected 80% of the available cash

# Qualified Contracts

## State housing agency application process

/ One year period to find buyer

/ If no buyer LURA terminates subject to 3-year rent restriction, no cause eviction

## Contract Price Formula

/ FMV non low-income portion, plus

/ As to Low-income portion

- outstanding debt, plus
- adjusted investor equity, plus capital contributions, minus
- cash distributions from the project

*This is covered in another panel*

NP

# Avoiding Tax Credit Recapture 1

## What can cause recapture?

- Reductions in Eligible Basis (cost of the property)
- Reduction in Qualified Basis (percentage low income)
- Noncompliance (e.g., with local law)
- Transfers of Partnership Interest

## Following Transfer, there’s no recapture if TP has a reasonable expectation of continued compliance

- GP/MM is “in the business.” LURA continues in place.
- Statute of limitations stays open till 3 years after TP notifies IRS of a recapture event.
- Negotiate protections with the buyer and GP

# Avoiding Tax Credit | Recapture 2

/ Former rule often required recapture bond when investor left the investment

/ Makes sense with small and individual investors, but current investors tend to be better capitalized than the bonding companies!

/ Since 2008, Recapture Bonds are not required, but elimination of recapture bond doesn’t eliminate risk of recapture

/ Nonetheless exiting Investor may require the equivalent of a recapture bond

# The Good, the Bad, and the Ugly

Illustration of the topics we’ve discussed before

# The Good | Pre Sale

| | GP | LP |
|---|---|---|
| Ending Capital Account Prior to Sale | $ (25,000) | $ (575,000) |

NP

# The Good | Sale

| | | | |
|---|---|---|---|
| Sales Price | | | $ 8,450,000 |
| Fixed Assets | $ 7,600,000 | | |
| Less Acc. Depreciation | (4,750,000) | $ 2,850,000 | |
| Land | | 100,000 | |
| Basis | | | 2,950,000 |
| Gain (Loss) on Sale | | | $ 5,500,000 |

NP

# The Good | Sale Applied

| | | GP | LP |
|---|---|---|---|
| Ending Capital Account Prior to Sale | | $ (25,000) | $ (575,000) |
| Allocation of Sale proceeds: | $ 5,500,000 | | |
| Negative Capital Accounts | | 25,000 | 575,000 |
| To Equal terminal distributions | | 4,562,868 | 337,132 |
| Reallocation to Pay LP Exit Taxes (Assume 21%) | | (152,848) | 154,848 |
| Capital Account Before Liquidating Distribution | | 4,566,787 | 489,980 |

NP

# The Good | Cash to Distribute

| | |
|---|---|
| Sales Price | $ 8,450,000 |
| Mortgage | - 3,450,000 |
| Transaction Costs | - 100,000 |
| | 3,550,000 |
| Cash to distribute | $ 4,900,000 |

# The Good | 90/10

| | | | |
|---|---|---|---|
| Capital Accounts Pre Sale | | | |
| | | GP | LP |
| Ending Capital Account Prior to Sale | | $ (25,000) | $ (575,000) |
| | | | |
| Allocation of Sale proceeds: | $ 5,500,000 | | |
| Negative Capital Accounts | | 25,000 | 575,000 |
| Equal to terminal distributions | | 4,562,868 | 337,132 |
| Exit Tax Reallocation | 21% | (152,848) | 152,848 |
| Capital Account Before Liquidating Distribution | | 4,410,020 | 489,980 |
| Cash to Distribute | $ 4,900,000 | | |
| Fund Reserves | | | |
| Credit Adjusters | | | |
| Exit Tax Distribution | | | (152,848) |
| Deferred Developer Fee | | | |
| Other Affiliate Loans | | | |
| 90% to GP and 10% to LP | | (4,410,020) | (180,365) |
| Terminal Capital Account | | $ - | $ - |
| Cash Received | | $ 4,410,020 | $ 489,980 |
| | | 90% | 10% |

NP

# The Not-So-Good | Pre Sale

| | GP | LP |
|---|---|---|
| Ending Capital Account Prior to Sale | $ (1,000,000) | $ 2,300,000 |

NP

# The Not-So-Good

| | | | |
|---|---|---|---|
| Sales Price | | | $ 11,300,000 |
| Fixed Assets | $ 11,500,000 | | |
| Less Acc. Depreciation | (4,800,000) | $ 6,700,000 | |
| Land | | 1,700,000 | |
| Basis | | | 8,400,000 |
| Gain (Loss) on Sale | | | $ 2,900,000 |

NP

# The Not-So-Good

| | | | |
|---|---|---|---|
| Capital Accounts Pre Sale | | | |
| | | GP | LP |
| Ending Capital Account Prior to Sale | | $ (1,000,000) | $ 2,300,000 |
| Allocation of Sale proceeds: | $ 2,900,000 | | |
| Negative Capital Accounts | | 1,000,000 | - |
| To Equal terminal distributions | | 1,900,000 | - |
| Exit Tax Reallocation | | 21% | - |
| Capital Account Before Liquidating Distribution | | 1,900,000 | 2,300,000 |

# The Not-So-Good

| | | |
|---|---|---|
| Sales Price | | $ 11,300,000 |
| First Mortgage | $ 6,750,000 | |
| Second Mortgage | 250,000 | 7,000,000 |
| Transaction Costs | | 100,000 |
| | | 7,100,000 |
| Cash to distribute | | $ 4,200,000 |

# The Not-So-Good

| | | GP | LP |
|---|---|---|---|
| Ending Capital Account Prior to Sale | | $ (1,000,000) | $ 2,300,000 |
| | | | |
| Allocation of Sale proceeds: | $ 2,900,000 | | |
| Negative Capital Accounts | | 1,000,000 | - |
| Equal to terminal distributions | | 1,900,000 | - |
| | | | |
| Exit Tax Reallocation | 21% | - | - |
| | | | |
| Capital Account Before Liquidating Distribution | | 1,900,000 | 2,300,000 |
| | | | |
| Cash to Distribute | $ 4,200,000 | | |
| Fund Reserves | | | |
| Credit Adjusters | | | |
| Exit Tax Distribution | | - | - |
| Deferred Developer Fee | | | |
| Other Affiliate Loans | | | |
| 90% to GP and 10% to LP | | (1,900,000) | (2,300,000) |
| Terminal Capital Account | | $ - | $ - |
| | | | |
| Cash Received | | $ 1,900,000 | $ 2,300,000 |
| | | 45% | 55% |

NP

# The Ugly | Pre Sale

| | GP | LP |
|---|---|---|
| Ending Capital Account Prior to Sale | $ (450,000) | $ (1,500,000) |

# The Ugly

| | | | |
|---|---|---|---|
| Sales Price | | | $ 8,800,000 |
| Fixed Assets | $ 14,000,000 | | |
| Less Accumulated Depreciation | (7,800,000) | $ 6,200,000 | |
| Land | | 600,000 | |
| Basis | | | 6,800,000 |
| Gain (Loss) on Sale | | | $ 2,000,000 |

NP

# The Ugly

| | | GP | LP |
|---|---|---|---|
| Ending Capital Account Prior to Sale | | $ (450,000) | $ (1,500,000) |
| Allocation of Sale proceeds: | $ 2,000,000 | | |
| Negative Capital Accounts | | 450,000 | 1,500,000 |
| Equal to terminal distributions | | 50,000 | - |
| Exit Tax Reallocation | 21% | (398,734) | 398,734 |
| Capital Account Before Liquidating Distribution | | (348,734) | 398,734 |

NP

# The Ugly

| | | |
|---|---|---|
| Sales Price | | $ 8,800,000 |
| First Mortgage | $ 7,635,000 | |
| Second Mortgage(s) | 1,015,000 | 8,650,000 |
| Transaction Costs | | 100,000 |
| | | 8,750,000 |
| Cash to distribute | | $ 50,000 |

NP

# The Ugly

| | | GP | LP |
|---|---|---|---|
| Ending Capital Account Prior to Sale | | $ (450,000) | $ (1,500,000) |
| Allocation of Sale proceeds: | $ 2,000,000 | | |
| Negative Capital Accounts | | 450,000 | 1,500,000 |
| Equal to terminal distributions | | 50,000 | - |
| | | | |
| Exit Tax Reallocation | 21% | (398,734) | 398,734 |
| Capital Account Before Liquidating Distribution | | (348,734) | 398,734 |
| Cash to Distribute | $ $50,000 | | |
| Fund Reserves | | | |
| Credit Adjusters | | | |
| Exit Tax Distribution | | | (398,734) |
| Deferred Developer Fee | | | |
| Other Affiliate Loans | | | |
| 90% to GP and 10% to LP | | - | - |
| Terminal Capital Account | | $ (348,734) | $ - |
| Cash Received | | $ - | $ 398,734 |
| | | 0% | 797% |

# Charitable Donation

**Donations of the partnership's property or the partners' interest does NOT avoid tax consequences associated with negative capital accounts**

Basis is allocated between the net value of the property and the debt, and the debt is treated as cash received in a taxable sale.

# Illustration 4 | Part 1

**Donation to Charity**

- Assume the property's gross value is $3M, and it is subject to $2M of debt, and the LP is the 99.99% partner. So, the net value of interest is just about $1M. Assume also that there is $2M of debt, also 99.99% allocable to the LP.
- Also assume that LP's basis in its interest is $600K. (In other words, LP has used up its capital account, and also taken $1.4M of losses against the $2M of debt.)
- On these facts, 1/3 of the property's gross value ($3M) is represented by the value above the debt ($1M), and 2/3 of the value is represented by the debt ($2M)

NP

# Illustration 4 | Part 2

/ Consistent with this 1/3-2/3 ratio, the LP is considered to have donated 1/3 of the gross value ($1M), and sold 2/3 of the gross value ($2M)

/ Similarly, the LP's basis of $600K is split 1/3 to the donation ($200K) and 2/3 to the debt ($400K)

/ The part of the basis allocated to the donation ($200K) is "lost". The LP gets a $1M donation deduction

/ The part of the basis allocated to the sale is used to compute the gain—$2M of debt "relieved" less $400K of basis, or $1.6M of gain

/ So, the partner has a $1.6M gain, but only a $1M donation deduction, and can owe a net tax -- $1.6M less $1M or $600K times 21% rate, or $126K

NP

# Portfolio Sales and Issues

## Determining the Structure of Your Deal

/ The identity of the seller (i.e., LP vs GP side) and contractual restrictions will impact the perceived execution risk from the buyer’s perspective and ultimately the transaction structure.

/ Sale by GP/Developer

- Sale of all interests across the portfolio vs Sale of a non-controlling interest in each property, GP entity, service entity in the portfolio

/ Sale by Syndicator

- Sale of upper tier holding company vs stock vs fund-level interests

## Navigating Contractual Restrictions

/ To what extent does the LIHTC investor hold consent rights over a sale or partial sale of the GP or Syndicator’s interests in portfolio properties?

/ Do lender, bondholder, and state regulatory agency consents (or notice requirements) extend to any transfer by the GP or Syndicator? Are they limited to changes in control or changes in ownership at the LIHTC property level?

/ Are there federally-insured loans in place that grant HUD consent rights over the transaction if structured a certain way?

## Create Efficiencies!

/ Purchasers will impose a deadline on diligence, including obtaining required consents.

/ Examine your portfolio to create efficiencies in the way diligence is organized/presented and third party consents (or notices) are secured.

/ Be prepared – regulated real estate assets have many stakeholders. A one-size fits all structure will not work for all portfolios. Multiple closings and/or structures may be required for your deal.

# Thank you!

Questions?