

Indiana Housing Conference

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LIHTC 401 – Capital Accounts and Related Party Debt Issues

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INDIANA HOUSING CONFERENCE

TAX CREDITS 401

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I. CAPITAL ACCOUNTS

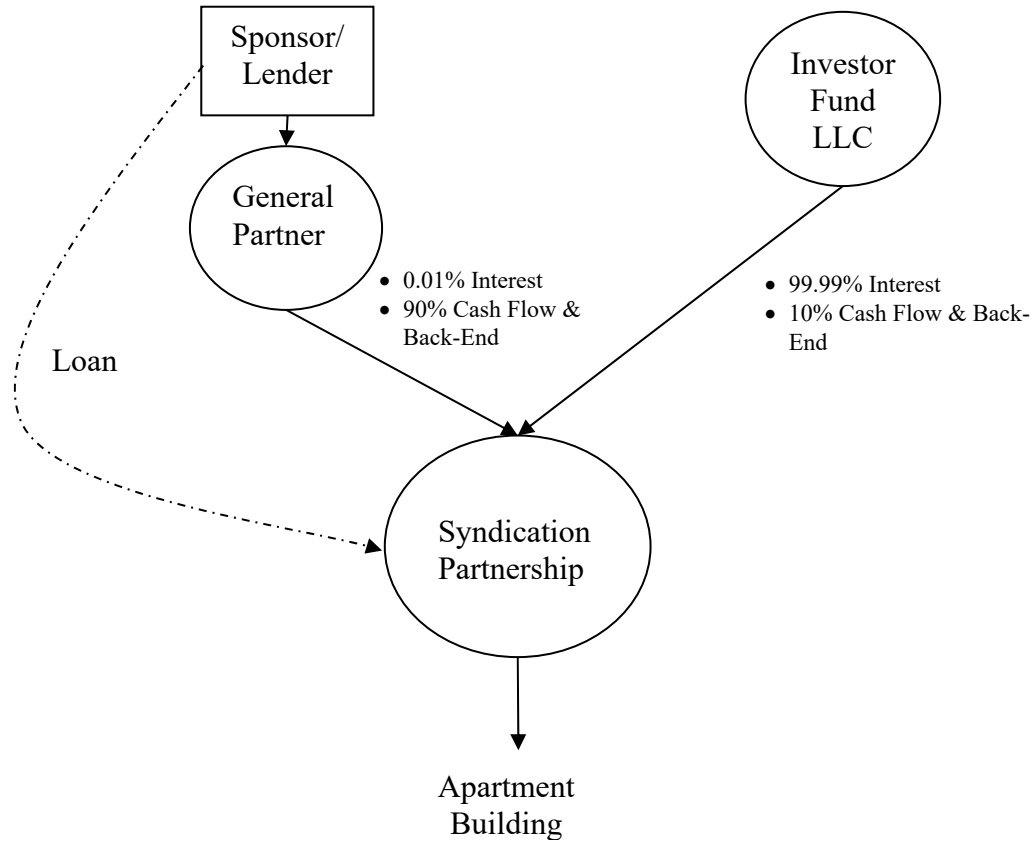
- A. What Is a Capital Account?** Each partner in a partnership receives a capital account. The capital account represents that partners' investment in the partnership. When the partnership liquidates, to the extent there is sufficient proceeds each partner must get back its remaining capital. The capital account is each investors' "piggy bank" for the deal.
- B. Changes in Capital Accounts** – A partner's capital accounts is increased by capital contributions by that partner and by that partner's share of partnership income. The partner's capital account is decreased by partnership distributions to the partner and by that partner's share of partnership losses.
- C. Capital Account Problems** – Capital Account problems come in 2 forms
1. **Zero Capital Account** – If a partner's capital account reaches zero, then its ability to be allocated further partnership losses and Credits will be restricted. In such situations, it may only be allocated additional losses and Credits if the partner has (i) a Deficit Restoration Obligation, or (ii) if the partner has sufficient Minimum Gain.
 - a. **Reduce Depreciation Losses** –
 - (a) **Buildings** - This is most commonly done by electing to have a building take 40 year depreciation rather than 27.5 year. This election is done on a building by building basis.
 - (b) **Personal Property and Site Improvements** - Depreciation can also be slowed down by electing slower depreciation on personal property (9 year instead of 5 year) or site improvements (20 year instead of 15 year), although this is usually not helpful enough. Note that slower depreciation on personal property and site improvements is elected on for all property of that class that is placed in service by the partnership for that year.
 - (c) **Deficit Restoration Obligation ("DRO")** – A partner that has a DRO can go negative in its capital account to the extent of the DRO.
 - (i) **What is a DRO?** A DRO is an obligation by the partner to put cash into the partnership in the event that the partnership is liquidated. Such cash is then available to repay project creditors. DROs are generally discouraged as they create risk that the investor will be required to put in more cash than anticipated. This undercuts the protections of being a "limited" partner.
 - (ii) **Bridge DRO** – Sometimes significant investor's capital contributions may be delayed even though the Project is operating. This can lead to a shortage of capital and impact the ability to take losses and credits in the Project's first years. In such cases a DRO may be viable as it will allow the investor to take the losses and the Project risks have been reduced because the project is operating. The DRO is capped and will be extinguished when the capital is actually contributed.
 2. **Partner Minimum Gain** – Even if a partner has a positive capital account, if the Partnership is generating "Partner Minimum Gain", then losses and Credits must be allocated to the Partner that is generating the Minimum Gain.
 3. **What is Minimum Gain?** – Minimum Gain is the difference between the nonrecourse debt on the Project and the adjusted basis of the Project. To the extent that the debt exceeds the Project's value, there is gain that must be eventually

recognized. Even if the partnership gave the property to the lender for nothing, the partnership would be considered to have exchanged the property for the amount of the debt. Because the debt is higher than the property's basis, there will be gain equal to the difference. Because this gain is unavoidable, the IRS will allow a partner to go negative to the extent that it has minimum gain.

4. **Allocation of Minimum Gain** – The allocation of Minimum Gain is determined by the nature of the debt.
 - a. **Partner (“Bad”) Nonrecourse Debt** – If a partner (or a party related to a partner) bears the risk of loss on the debt, then the debt is allocated to that partner. This is called “Partner Nonrecourse Debt”.
 - b. **Partnership (“Good”) Nonrecourse Debt** – If no partner bears the risk of loss, then the debt is considered “Partnership Nonrecourse Debt” and can be allocated among the partners through the partnership agreement. The partnership agreement will then allocate 99.99% to the limited partner.

c. Related Party Debt Example

The Below makes “Bad” Partner Minimum Gain

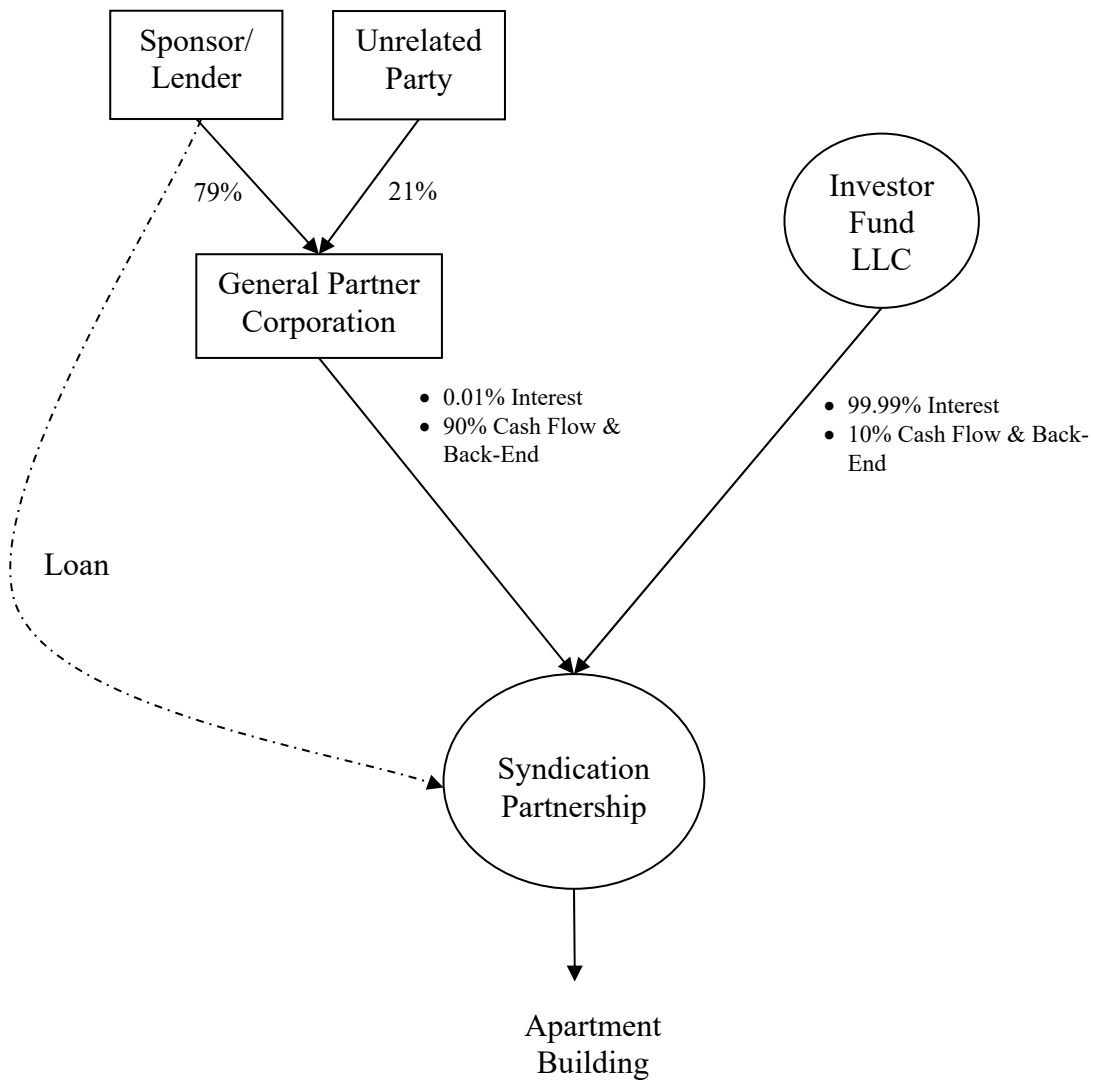


a. **79/21 Cure** – If the Project lender owns less than 80% of a partner in the Partnership, then it will not be considered a related party. This will allow the debt to be treated as Partnership Nonrecourse Debt.

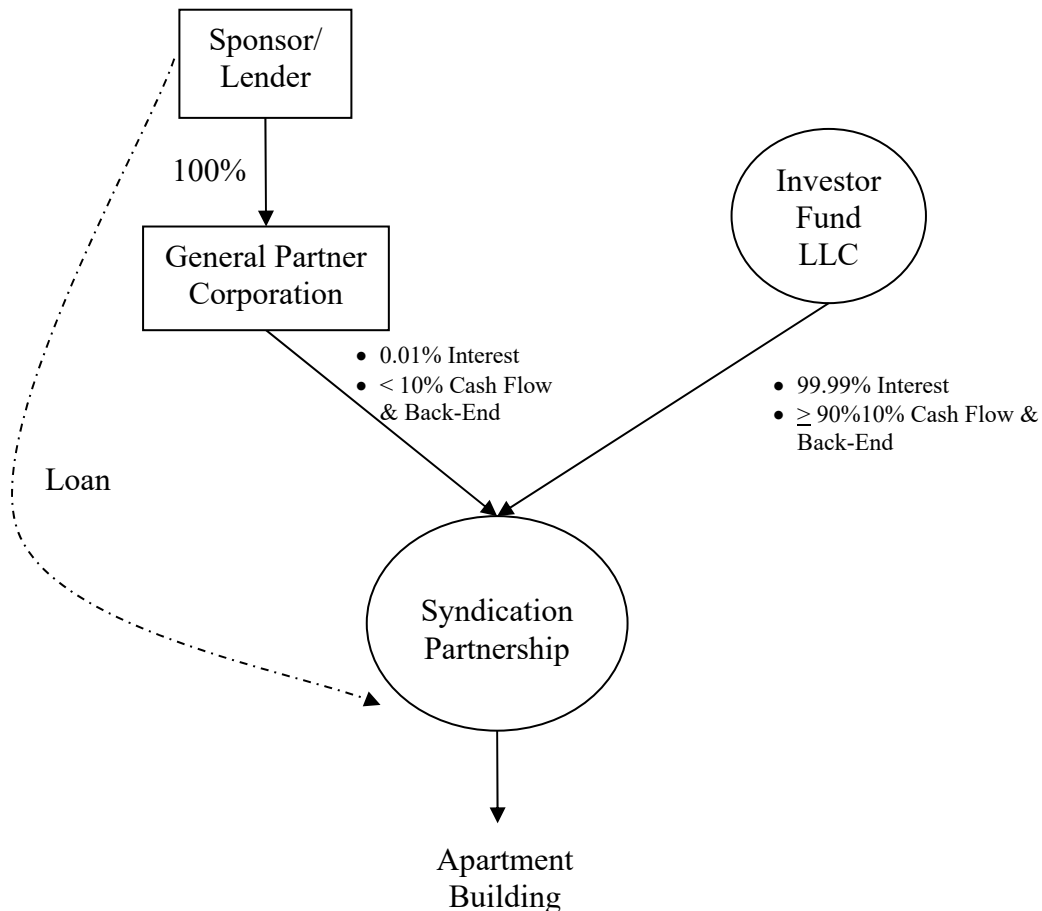
(a) **Must Be a Corporate Partner** – The entity that is a partner in the Partnership must be a corporation or an LLC that elects to be taxed as a corporation on IRS Form 8832.

(b) Only 79% Ownership Must Be Real – Must have 79% of GP’s Vote and Value. Make everything pro rata.

(c) **79/21 Org Chart – Creating “Good” Partner Nonrecourse Debt**



- b. 10% De Minimis Rule** – If the Project lender is a governmental entity (or an entity that regularly engages in the business of lending) and the lenders direct or indirect interest in the partnership is less than 10%, then the debt will be considered unrelated debt.
- (a) **Must limit everything below 10%.** Incentive management fees and residual interests must be capped at less than 10%. General partner fees or any other distributions to partners or related parties must be closely scrutinized.
- (b) **Two General Partners** – If there are 2 General Partners, but one is not related to the lender, then the other general partner can pick up the excess cash flow above 10%.
- (c) **Cash Flow Strategies**
- (i) **Loan Payments**– Often cash flow will be absorbed for the 15-year period paying off the Deferred Developer Fee and applying 90% of cash flow to the related party debt.
- (ii) **Section 42 Right of First Refusal (“ROFR”)** – If the Sponsor is a Qualified Nonprofit, then it can control the back-end with the Right of First Refusal price of debt + taxes.
- (d) **10% De Minimis Org. Chart – Creating “Good” Partner Nonrecourse Debt**



- c. **Stacking Rule** – Minimum Gain is generated layer by layer. If the bottom layer is Partnership Nonrecourse Debt, then it will generate “good” Partnership Minimum Gain. Once the minimum gain exceeds that layer of debt, then the next layer of debt must be analyzed. Recourse debt “stacked” above nonrecourse debt can come into play.
- (a) **Example 1** – Assume that a project has 2 loans. The first mortgage is \$700,000, is interest only, is nonrecourse and is from an unrelated lender. The second mortgage is \$300,000, is interest only, is recourse and is from an unrelated lender. Assume \$100,000 in depreciation per year and the Project’s starting basis is \$1,000,000.
- (i) After the first year the total debt on the Project will be \$1,000,000 and the Project’s adjusted basis will be \$900,000. However, there is no minimum gain because the \$700,000 of nonrecourse debt is less than the \$900,000 remaining basis. The \$100,000 in depreciation would effectively be first applied to the recourse second mortgage. Minimum gain would not be created until the value of the Project is less than the \$700,000 nonrecourse first mortgage.
- (b) **Example 2** – Same facts as Example 1, but the loans are switched. First mortgage is \$300,000 and recourse. Second mortgage is \$700,000 and nonrecourse. Now there would be \$100,000 of minimum gain in the first year that can allow the Investor’s capital accounts to go negative.
- (c) **Example 3** – Same facts as Example 1, but both loans are nonrecourse. First mortgage is \$700,000 and unrelated nonrecourse. Second mortgage loan is \$300,000 but related party nonrecourse. Now there would be \$100,000 of minimum gain in the first year, but this gain would be Partner Minimum Gain and would be allocated to the partner that is related to the lender. If that partner is the General Partner, then the Investor Limited Partner would not get the losses and LIHTC. “Good” Partnership Minimum Gain would start in Year 4
- (d) **Example 4** – Same facts as in Example 3, except the loans are switched. First mortgage is \$300,000 and Related Nonrecourse. Second mortgage loan is \$700,000 but Unrelated Nonrecourse. At the end of the first year, the Project would have a remaining basis of \$900,000 and the debt would be at \$1,000,000. Because the \$100,000 shortfall would effectively be applied against the “junior” unrelated nonrecourse debt, there would be \$100,000 of “Good” Partnership Minimum Gain. The first 7 years generate Partnership Minimum Gain. “Bad” Partner Minimum Gain doesn’t begin until Year 8.

Stacking Rule Example 1
1st Priority Nonrecourse Loan with 2nd Priority Recourse Loan

Building Cost 1,000,000
 Equity 0
 Nonrecourse Unrelated Loan A - 1st Priority 700,000 interest only
 Recourse Unrelated Party Loan B - 2nd Priority 300,000 interest only

Assume Breakeven operations
 For simplicity, assume 10 year depreciation 100,000 per year

Year	1	2	3	4	5	6	7	8	9	10
Building Basis	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	0
Nonrecourse Unrelated Loan A - 1st Prio	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)
Excess Value Over Loan A (minimin gain)	200,000	100,000	0	(100,000)	(200,000)	(300,000)	(400,000)	(500,000)	(600,000)	(700,000)
Recourse Unrelated Party Loan B - 2nd P	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)
Shortage in repayment of Loan B	(100,000)	(200,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)
Repayment of Shortage by GP	100,000	200,000	300,000	300,000	300,000	300,000	300,000	300,000	300,000	300,000
Shortage in repayment of Loan B	0	0	0	0	0	0	0	0	0	0

Minimum gain begins in Year 4

Stacking Rule Example 2
1st Priority Recourse Loan with 2nd Priority Nonrecourse Loan

Building Cost 1,000,000
 Equity 0
 Unrelated Recourse Loan B - 1st Priority 300,000 interest only
 Unrelated Nonrecourse Loan A - 2nd Priority 700,000 interest only

Assume Breakeven operations
 For simplicity, assume 10 year depreciation 100,000 per year

Year	1	2	3	4	5	6	7	8	9	10
Building Basis	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	-
Unrelated Recourse Loan B - 1st Priority	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)
Excess Value Over Loan A (no min. gain because recourse)	600,000	500,000	400,000	300,000	200,000	100,000	0	(100,000)	(200,000)	(300,000)
Unrelated Nonrecourse Loan A - 2nd Priority	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)	(700,000)
Shortage in repayment of Loan B (minimum gain)	(100,000)	(200,000)	(300,000)	(400,000)	(500,000)	(600,000)	(700,000)	(700,000)	(700,000)	(700,000)

 **Minimum Gain Begins in Year 1**

Just by switching the priority of the loans, minimum gain begins 3 years earlier.

Stacking Rule Example 3
1st Priority Unrelated Nonrecourse Loan with 2nd Priority Related Party Nonrecourse Loan

Building Cost	1,000,000										
Equity	0										
Unrelated Nonrecourse Loan A - 1st Priority	700,000	interest only									
Related Party Nonrecourse Loan B - 2nd Priority	300,000	interest only									
Assume Breakeven operations											
For simplicity, assume 10 year depreciation	100,000	per year									
Year	1	2	3	4	5	6	7	8	9	10	
Building Basis	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	0	
Unrelated Nonrecourse Loan A - 1st Priority	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	
	200,000	100,000	0	(100,000)	(200,000)	(300,000)	(400,000)	(500,000)	(600,000)	(700,000)	
Excess Value Over Loan A (minimum gain)											
Related Party Nonrecourse Loan B - 2nd Priority	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	
Shortage in repayment of Loan B (minimum gain)	<u>(100,000)</u>	<u>(200,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	
Partnership ("Good") Minimum Gain				100,000	200,000	300,000	400,000	500,000	600,000	700,000	
Partner ("Bad") Minimum Gain	<u>100,000</u>	<u>200,000</u>	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>	<u>300,000</u>	
Total Minimum Gain	100,000	200,000	300,000	400,000	500,000	600,000	700,000	800,000	900,000	1,000,000	


First 3 years of minimum gain is "Bad" Partner Minimum Gain and is allocated to the related party. Unhelpful for LIHTC projects as this would also cause a reallocation of LIHTC during the Credit Period

Stacking Rule Example 4
1st Priority Related Nonrecourse Loan with 2nd Priority Unrelated Party Nonrecourse Loan

Building Cost	1,000,000									
Equity	0									
Related Party Nonrecourse Loan B - 1st Priority	300,000 interest only									
Unrelated Nonrecourse Loan A - 2nd Priority	700,000 interest only									
Assume Breakeven operations										
For simplicity, assume 10 year depreciation	100,000 per year									
Year	1	2	3	4	5	6	7	8	9	10
Building Basis	900,000	800,000	700,000	600,000	500,000	400,000	300,000	200,000	100,000	0
Related Party Nonrecourse Loan B - 1st Priority	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>
Excess Value Over Loan A (bad minimin gain)	600,000	500,000	400,000	300,000	200,000	100,000	0	(100,000)	(200,000)	(300,000)
Unrelated Nonrecourse Loan A - 2nd Priority	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>
Shortage in repayment of Loan B (good minimum gain)	<u>(100,000)</u>	<u>(200,000)</u>	<u>(300,000)</u>	<u>(400,000)</u>	<u>(500,000)</u>	<u>(600,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>	<u>(700,000)</u>
Partnership ("Good") Minimum Gain	100,000	200,000	300,000	400,000	500,000	600,000	700,000	700,000	700,000	700,000
Partner ("Bad") Minimum Gain	-	-	-	-	-	-	-	<u>100,000</u>	<u>200,000</u>	<u>300,000</u>
Total Minimum Gain	<u>100,000</u>	<u>200,000</u>	<u>300,000</u>	<u>400,000</u>	<u>500,000</u>	<u>600,000</u>	<u>700,000</u>	800,000	900,000	1,000,000

First 7 years of minimum gain is "Good" Partnership Minimum Gain and can be allocated to a Limited Partner.

"Bad" Partner Minimum Gain and reallocation of losses does not begin until Year 8. By rearranging the debt stack, we have delayed Bad Partner Minimum Gain 7 years.