2018 CAHEC PARTNERS CONFERENCE

THE IMPORTANCE OF CAPITAL ACCOUNTS IN LOW-INCOME HOUSING TAX CREDIT TRANSACTIONS

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CAPITAL ACCOUNTS

BASICS:

Capital Accounts are INCREASED by:

a) cash contributions actually made (Promissory Note not enough);
b) FMV of property contributed (net of liabilities); and
c) share of income or gain.

Capital Accounts are DECREASED by:

a) cash distributions;
b) net FMV of property distributions;
c) share of losses; and
d) share of HTC and 50% ETC (but not LIHTC).

Capital Accounts are VERY important for two reasons:

1. they govern liquidating distributions; and
2. they are key in determining whether allocations of losses and LIHTC to the investor will be respected.

Capital Accounts and Liquidating Distributions

Liquidating Distribution Example: General Partner and Limited Partner enter into a LIHTC Partnership. General Partner contributes services, Limited Partner contributes $7,000,000 and Partnership borrows $3,000,000 (non-amortizing) to construct a building. All credits and losses are allocated to Limited Partner. Cash flow and capital transaction proceeds are to be split 90% to General Partner and 10% to Limited Partner. Assume Partnership rental income equals all of its expenses and $300,000 of annual depreciation is generated.

Starting Balance Sheet

Assets:		
	Building	$10,000,000
Equity:		
	Limited Partner	$7,000,000
	General Partner	$0
Debt:		$3,000,000

Capital Accounts at the end of the 15 year Compliance Period (after Limited Partner has claimed all LIHTC and $300,000 of annual losses):

	Start CA	Losses	Cash Distributions	End CA
Limited Partner	7,000,000	<4,500,000>	0	2,500,000
General Partner	0	0	0	0

Year 15 Balance Sheet

Assets:		
	Building	$5,500,000
Equity:		
	Limited Partner	$2,500,000
	General Partner	$0
Debt:		$3,000,000

If the building is sold for its $5,500,000 book value, $3,000,000 of the proceeds will be used to repay the loan.

Question: What happens to the other $2,500,000 of cash? Does General Partner get 90% of it?

Answer: No. Capital accounts control the distribution of liquidation proceeds, so all $2,500,000 goes to Limited Partner.

The Building must be sold at a profit above its book value for the General Partner to start benefitting from its "90% back-end interest".

For example, if Building is sold at the end of Year 15 for $6,500,000, there would be a $1,000,000 book gain and the CA's would be adjusted as follows:

	Start CA	Sale Gain	Pre-Liquidation CA
Limited Partner	2,500,000	100,000	2,600,000
General Partner	0	900,000	900,000

After the $3,000,000 loan is repaid, the remaining proceeds would be distributed $2,600,000 to Limited Partner and $900,000 to General Partner.

Capital Accounts and Allocations of Losses and Credits

Under the Internal Revenue Code, the allocation of LIHTC follows the allocation of depreciation. That is why partnership agreements typically allocate 99.99% of all losses to the investor limited partner.

In general, an investor can be allocated losses (and LIHTC) as long as it has a positive Capital Account. If the investor's Capital Account has been reduced to zero, then its ability to continue claiming losses (and LIHTC) is based on a complicated set of "stacking rules" that focus on what source of financing is most at risk. Under these rules, an investor can continue claiming losses (and LIHTC) even though its Capital Account will be negative as long as the next level(s) of at risk financing are not provided or guaranteed by another partner (such as the General Partner) or its affiliates.