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Buying & Selling Older Tax Credit Partnerships:

The Effect of Capital Accounts, Waterfalls, and Renegotiations

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Outline of Today's Presentation

- Exit Strategies
  - Negotiated Sales
  - Sale Options exercised by Investors
  - Purchase Options exercised by General Partners
  - Right of First Refusal
  - Bargain Sales
  - Other Considerations

- Negotiating the Sales Price
  - Investor Perspective
  - General Partner Perspective
  - Other Considerations

Outline of Today's Presentation

- When the Tax Code and the Partnership Agreement Differ
  - Discussion of 704(b)
  - Discussion of 743(b)

- Where Does the Money Go? The Impact of Positive Capital Accounts on Cash Flow
  - Examples

Commonly Used Exit Strategies

Negotiated Sales

- Negotiated Sales
  - Most commonly seen in older deals where the partnership agreement does not stipulate a trigger for the exit of the investor
  - Even when a trigger is stipulated, sometimes the parties will negotiate away from the terms of the partnership agreement

Purchase and Sale Options

- Investor Sale Options - the terms of the partnership agreement sometimes give the investor an option to:
  - Force a purchase of it’s interest (Put Option)
  - Force a sale of the project
- General Partner Purchase Options - the terms of the partnership agreement sometimes give the GP an option to purchase Investor’s interest at FMV
  - The partnership agreement should not stipulate the FMV

Right of First Refusal – IRC Sec. 42(i)(7)

- Purchase of property or partnership interest by a qualified non-profit, tenant, or government agency ("Qualified Contract")

- Purchase price cannot be less than: outstanding debt on building, plus all federal, state, and local taxes attributable to sale

- Note there is an anti-abuse provision within Sec. 42(i)(7) that excludes debt originated within 5 years of the sale from the purchase price

Bargain Sales

- Bargain Sale – a transaction structured as a partial donation and partial sale to a charity; the consideration received by the donor is less than FMV of the property transferred to the charity.

- Transaction is bifurcated
  - FMV less proceeds equals charitable donation
  - Remainder is treated as a sale to the charitable organization
  - Basis is split pro-rata

- Debt is considered an addition to proceeds

- This strategy is not frequently used

Other Considerations when Planning Exit Strategy

- The transfer of a partnership interest vs transfer of a partnership's assets can sometimes have different tax and legal consequences

- Be aware of the allocations within the partnership agreement
  - Who pays the exit taxes?
  - Are reserves transferred or distributed?
  - What happens if there are unpaid developer fees?

- Re-syndication issues
  - 10 Year Rule

Negotiating the Sales Price

From Investor’s Perspective

- What is the Investor’s tax capital position?
- What will the exit taxes be and who will pay?
- Is there a disposition fee due to the investor?
- What is the audit exposure?
- Where in the life cycle is the project?
- What is the value of holding the asset and the impact of a sale on the investor’s goals in the community?

From Investor's Perspective

- What is the physical condition/risk of the project?

- Is there a relationship with the GP that needs to be maintained?

- How much reliance can be placed on the GP's promise to indemnify?

From General Partner’s Perspective

- Are there refinancing opportunities? Can this be coordinated with the acquisition of the partner’s interest?
- How will third party loans be repaid?
- How difficult will re-syndication be?
- How is the project performing?
- What is the physical condition/risk of the project?

Other Negotiation Considerations

- Remember to be flexible; changes can be made to the original understanding of the parties as reflected in the partnership agreement
- Review closing documents and subsequent documents for indications that the agreement changed
- Allow plenty of time to address issues and obstacles

What Part Does the Tax Code Play?

Discussion of 704(b)

- 704(b) is a safe harbor provision with three basic requirements
  - Capital accounts must be properly maintained
  - Existence of Deficit Restoration Obligations/Qualified Income Offsets
  - Liquidation must be made in accordance with positive capital accounts

- Capital Account Maintenance – capital accounts are properly maintained when each partner’s capital account is:
  - Increased by contributions, income and gain allocations
  - Decreased by distributions, loss and deduction allocations
  - All capital accounts start at zero and return to zero upon liquidation

Discussion of 704(b)

- Liquidation – distributions must be made in accordance with positive capital account balances

  - A partnership that liquidates in accordance with the liquidation waterfall of its partnership agreement rather than in accordance with positive capital accounts will not satisfy the safe harbor

Discussion of 743(b)

- Sec 743(b) provides for an adjustment to the basis of partnership property upon the sale or exchange of a partnership interest or upon the death of a partner when an optional election under Sec 754 is being made or has previously been made, or when there is a substantial built-in loss immediately after the transfer
  - A substantial built-in loss exists when the partnership's adjusted basis in the partnership property exceeds the FMV by more than $250,000

Discussion of 743(b)

- Partners acquiring a partnership interest need to pay attention to whether the acquisition results in a step-up or step-down as this impacts whether a gain or loss is recognized upon any subsequent transfers of the partnership interest or liquidation of the partnership

Takeaways

- It is critical to plan ahead

  - The timing of the acquisition of the investor’s ownership interest in relation to the sale of the project’s assets to a new entity needs to be fully analyzed.
  - Likewise timing issues are important when deciding whether a cost segregation study makes sense.
  - Throughout the compliance period monitor the tax capital accounts and compare them to the pro forma
  - Understand the cost & benefits of electing out of bonus depreciation

- Learn from past deals as you are negotiating the next one

Where does the cash go?
Examples

Example 1 – Asset Sale with Negative Capital

ABC LP is a typical $10M LIHTC project. Allocations per the partnership agreement are as follows:

	AB	C
Profits/Loss/Capital*	.01%	99.99%
Distribution of Cash Flow	45%	55%
Distribution of Net Proceeds from Sale or Refinance	50%	50%
Liquidating Distributions	75%	25%

* Many partnership agreements provide that upon liquidation gains from the sale or disposition first shall be allocated among the partners that have negative capital account balances in proportion and to the extent of their negative capital accounts.

Example 1 – Asset Sale with Negative Capital

The ABC LP sources are $2.3M in mortgage and notes payable, $1M in deferred developer fees, and $6.9M in equity contributions. The uses are $200K for cash reserves, $1.5M for land, $7.5M for building, and $1M for land improvements, appliances, and other personal property. In Year 1, ABC LP elects to take 50% bonus depreciation. Additionally, the partnership's operating loss before depreciation is $105K per year.

ABC Balance Sheet as of Year 1

Cash & Reserves	200,000
Land	1,500,000
Building	7,500,000
Land Improvements	900,000
Personal Property	100,000
Accumulated Depreciation	(793,864)
Total Assets	9,406,136
Accounts Payable	105,000
Mortgages & Notes Payable	2,300,000
Deferred Developer Fee	1,000,000
LP Capital	6,001,126
GP Capital	10
Total Liabilities & Equity	9,406,136

Example 1 – Asset Sale with Negative Capital

The cumulative net loss for Years 1-15 is ($6,926,830). The respective capital balances are reflected below:

Capital Account Balances:	AB (GP) Loss	AB (GP) Contributions	AB (GP) Capital		C (LP) Loss	C (LP) Contributions	C (LP) Capital
Year 1	-90	100	10		-898,774	6,899,900	6,001,126
Year 2	-11		-1		-430,558		5,570,568
Year 3	-11		-12		-430,558		5,140,010
Year 4	-11		-23		-430,558		4,709,452
Year 5	-11		-34		-430,558		4,278,894
Year 6	-11		-45		-430,558		3,848,336
Year 7	-11		-56		-430,558		3,417,778
Year 8	-11		-67		-430,558		2,987,220
Year 9	-11		-78		-430,558		2,556,662
Year 10	-11		-89		-430,558		2,126,104
Year 11	-11		-100		-430,558		1,695,546
Year 12	-11		-111		-430,558		1,264,988
Year 13	-11		-122		-430,558		834,430
Year 14	-11		-133		-430,558		403,872
Year 15	-11		-144		-430,558		-26,686

Example 1 – Asset Sale with Negative Capital

ABC Balance Sheet as of Year 15

Cash & Reserves	10,000
Land	1,500,000
Building	7,500,000
Land Improvements	900,000
Personal Property	100,000
Accumulated Depreciation	(5,352,279)
Total Assets	4,657,721
Accounts Payable	115,000
Mortgages, Notes Payable, Accrued Interest	3,569,551
Developer Note Payable	1,000,000
LP Capital	(26,686)
GP Capital	(144)
Total Liabilities & Equity	4,657,721

Example 1 – Asset Sale with Negative Capital

In Year 16, the project's assets are sold for a sales price of $5,416,260. The adjusted basis of the project is $4,647,721 resulting in a gain of $768,539. After the payoff of the partnership's liabilities, the net proceeds from the liquidation of the partnership's assets is $731,709. The net proceeds plus the remaining project cash of $10,000 is distributed under the terms of the liquidating waterfall of the partnership agreement.

ABC Year 16 Tax Capital Reconciliation		AB	C	Total
BOY Equity		(144)	(26,686)	(26,830)
Allocate Gain To Bring Capital To $0		144	26,686	26,830
Remaining Gain/Loss Allocation		556,282	185,427	741,709
EOY Equity Before Liquidating Distribution		556,282	185,427	741,709
Liquidating Distribution (75%-25%)		(556,282)	(185,427)	(741,709)
Adjustment To Close Capital Account Balances		(0)	(0)	(0)
Ending Equity		0	0	0

Example 2 – Asset Sale with Negative Capital

Assume the same facts as Example 1, except:

- In Year 10, the LP forces a GP capital call of $1M to pay down the deferred developer fee

Example 2 – Asset Sale with Negative Capital

The cumulative losses for years 1-15 are ($6,926,830). The respective capital balances are reflected below:

Capital Account Balances:	AB (GP) Loss	AB (GP) Contributions	AB (GP) Capital		C (LP) Loss	C (LP) Contributions	C (LP) Capital
Year 1	-90	100	10		-898,775	6,899,900	6,001,126
Year 2	-11		-1		-430,558		5,570,568
Year 3	-11		-12		-430,558		5,140,010
Year 4	-11		-23		-430,558		4,709,452
Year 5	-11		-34		-430,558		4,278,894
Year 6	-11		-45		-430,558		3,848,336
Year 7	-11		-56		-430,558		3,417,778
Year 8	-11		-67		-430,558		2,987,220
Year 9	-11		-78		-430,558		2,556,662
Year 10	-11	1,000,000	999,911		-430,558		2,126,104
Year 11	-11		999,900		-430,558		1,695,546
Year 12	-11		999,889		-430,558		1,264,988
Year 13	-11		999,878		-430,558		834,430
Year 14	-11		999,867		-430,558		403,872
Year 15	-11		999,856		-430,558		-26,686

Example 2 – Asset Sale with Negative Capital

ABC Balance Sheet as of Year 15

Cash & Reserves	10,000
Land	1,500,000
Building	7,500,000
Land Improvements	900,000
Personal Property	100,000
Accumulated Depreciation	(5,352,279)
Total Assets	4,657,721
Accounts Payable	115,000
Mortgages & Notes Payable	3,569,551
Developer Note Payable	0
LP Capital	(26,686)
GP Capital	999,856
Total Liabilities & Equity	4,657,721

Example 2 – Asset Sale with Negative Capital

In Year 16, the project's assets are sold for a sales price of $5,416,260. The adjusted basis of the project is $4,647,721 resulting in a gain of $768,539. After the payoff of the partnership's liabilities, the net proceeds from the liquidation of the partnership is $1,846,709. The net proceeds plus the remaining project cash of $10,000 is distributed under the terms of the liquidating waterfall of the partnership agreement.

ABC Year 16 Tax Capital Reconciliation		AB	C	Total
BOY Equity		999,856	(26,686)	973,170
Allocate Gain To Bring Capital To $0			26,686	26,686
Remaining Gain/Loss Allocation		556,390	185,463	741,853
EOY Equity Before Liquidating Distribution		1,556,246	185,463	1,741,709
Liquidating Distribution (75%-25%)		(1,392,532)	(464,177)	(1,856,709)
Adjustment To Close Capital Account Balances		(163,714)	278,714	115,000
Ending Equity		0	0	0

Example 3 – Asset Sale with Positive Capital

Assume the same partnership agreement as Example 1:

- Instead of having an $105,000 operating loss before depreciation, the partnership has an $50,000 per year operating income before depreciation.

- In Years 6-9, the partnership distributes surplus cash of $11,000 per year.

- In Year 10, in order to pay down the deferred developer fee, the partnership refinances for $2.5M more than its liabilities, pays down the $1M deferred developer fee, and distributes the remaining $1.5M pursuant to the terms of the PA.

Example 3 – Asset Sale with Positive Capital

The cumulative losses for years 1-15 are ($4,602,278). The respective capital balances are reflected below:

Capital Account Balances:	AB (GP) Loss	AB (GP) Contributions	AB (GP) Capital		C (LP) Loss	C (LP) Contributions	C (LP) Capital
Year 1	-74	100	26		-743,790	6,899,900	6,156,110
Year 2	-28		-2		-275,573		5,880,537
Year 3	-28		-30		-275,573		5,604,964
Year 4	-28		-58		-275,573		5,329,391
Year 5	-28		-86		-275,573		5,053,818
Year 6	-28	-4,950	-5,064		-275,573	-6,050	4,772,195
Year 7	-28	-4,950	-10,042		-275,573	-6,050	4,490,572
Year 8	-28	-4,950	-15,020		-275,573	-6,050	4,208,949
Year 9	-28	-4,950	-19,998		-275,573	-6,050	3,927,326
Year 10	-28	-750,000	-770,026		-275,573	-750,000	2,901,753
Year 11	-28		-770,054		-275,573		2,626,180
Year 12	-28		-770,082		-275,573		2,350,607
Year 13	-28		-770,110		-275,573		2,075,034
Year 14	-28		-770,138		-275,573		1,799,461
Year 15	-28		-770,166		-275,573		1,523,888

Example 3 – Asset Sale with Positive Capital

ABC Balance Sheet as of Year 15

Cash & Reserves	10,000
Land	1,500,000
Building	7,500,000
Land Improvements	900,000
Personal Property	100,000
Accumulated Depreciation	(5,352,279)
Total Assets	4,657,721
Mortgages & Notes Payable	3,903,999
LP Capital	1,523,888
GP Capital	(770,166)
Total Liabilities & Equity	4,657,721

Example 3 – Asset Sale with Positive Capital

In Year 16, the project's assets are sold for a sales price of $5,416,260. The adjusted basis of the project is $4,647,721 resulting in a gain on the sale of $768,539. After the loan payoff, the net proceeds from the liquidation of the partnership is $1,512,261. The net proceeds plus the remaining project cash of $10,000 is distributed under the terms of the liquidating waterfall of the partnership agreement.

ABC Year 16 Tax Capital Reconciliation	AB	C	Total
BOY Equity	(770,166)	1,523,888	753,722
Allocate Gain To Bring Capital to $0	768,539	0	768,539
Remaining Gain/Loss allocation	0	0	0
EOY Equity before Liquidating Distribution	(1,627)	1,523,888	1,522,261
Liquidating Distribution (100% to LP Based on Positive Capital per 704(b) Irrespective of the Partnership Agreement's Terms)	0	(1,522,261)	(1,522,261)
Adjustment To Close Capital Account Balances	1,627	(1,627)	0
EOY Equity	0	0	0

Example 4 – Sale of Partner Interest w/ Step Down

Assume the same facts as Example 3 except in Year 16, rather than selling ABC LP's assets, AB purchases C's partnership interest for $1.

- What is C's gain/(loss)?
  - C's loss is the difference between the proceeds received by C less C's adjusted basis in its ownership interest. C's adjusted basis of its partnership interest is the sum of its tax capital account plus its share of non-recourse debt.
  - The amount realized by C for its interest is the actual cash paid by AB plus C's share of non-recourse debt that is being assumed by AB.

Example 4 – Sale of Partner Interest w/ Step Down

Because the loss upon the sale of the partnership interest is greater than $250,000, under Sec. 743(b) AB's basis in the partnership property will be stepped-down. C's loss on the sale of its interest is calculated below:

Cash Paid for Interest	1
Transferee's share of Partnership Debt	3,900,095
Amount Realized	3,900,096
Less: Adjusted Basis of Partner's Interest (1,523,888 Tax Capital + 3,900,095 Partnership Debt)	(5,423,983)
C's Loss on Sale of Partnership Interest	(1,523,887)

Why would C sell its interest for a loss? The investor may be attracted to a current tax benefit ($1,523,887 x 35% = $533,360); staying in the deal that may not return as good an IRR.

Example 5 – Sale of Partner Interest w/ Step Up

Assume the same facts as Example 3 except in Year 16, rather than selling ABC LP's assets, AB purchases C's partnership interest for its FMV which is deemed to be $1,750,000.

Cash Paid for Interest	1,750,000
Transferee's share of Partnership Debt	3,900,095
Amount Realized	5,650,095
Less: Adjusted Basis of Partner's Interest (1,523,888 Tax Capital + 3,900,095 Partnership Debt)	(5,423,983)
C's Gain on Sale of Partnership Interest	226,112

Example 5 – Sale of Partner Interest w/ Step Up

AB will have a $226,112 step-up under Sec. 743(b) which may decrease AB’s gain upon liquidation of the partnership.

<u>Outside Basis</u>		
Cash Paid for Interest	1,750,000	
Transferee Partners share of Partnership Liabilities	3,900,095	
Transferee Partner's Basis in Partnership		5,650,095
<u>Inside Basis</u>		
Transferee partner's interest in previously taxed capital	1,523,888	
Transferee partner's share of Partnership's liabilities	3,900,095	
Transferee Partner's share of Adjusted Basis to the partnership of the partnership's property		5,423,983
Section 743(b) Basis Adjustment		226,112

Final Thoughts

Learn from the Past:

- During the initial negotiations before the partnership agreement is inked, pay attention to the terms that have triggered unexpected results in the past
- Plan the strategy for the investor’s exit early. Compare the pro forma to actual results on a regular and ongoing basis
- Understand when 704(b) and 743(b) lead to unanticipated results
- Seek experienced advisors to help you navigate these issues before the liquidation has happened.

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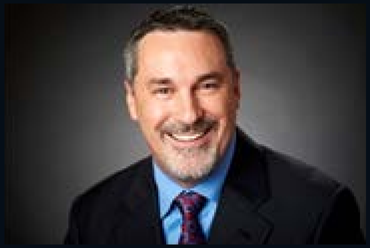
Questions?
Thank you!



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