

Why Does My Tax Lawyer Keep Saying We Need Nonrecourse Debt for My Low-Income Housing Tax Credit Project

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As anyone who has worked on a transaction involving low-income housing tax credits (LIHTCs or Credits) knows, the financial structure of LIHTC transactions becomes very complicated due to the interaction of the LIHTC rules under Section 42 of the Internal Revenue Code of 1986, as amended, and the partnership taxation rules. This essay discusses the basic interaction of those rules using very simplified descriptions in an attempt to make the overall concepts accessible to a non-expert audience. It then addresses a key question that arises in LIHTC transactions: Why does permanent debt generally need to be nonrecourse in transactions involving LIHTC?

I. Interaction of LIHTC Rules and Partnership Taxation Rules: A Simplified Description

LIHTCs are earned when a building participates in the LIHTC program and the building is rented to low-income persons at affordable rents.¹ A building generally earns LIHTCs over a 10-year period called the “credit period”² (sometimes, this credit period can be 11 years).³ LIHTCs are earned by the owner of a low-income building—they cannot be sold. For tax reasons beyond the scope of this essay, the LIHTC project developer and its affiliates generally cannot use the LIHTC.⁴ In order to enable

1. I.R.C. § 42. All references to “Code” refer to the Internal Revenue Code of 1986, as amended.

2. I.R.C. § 42(f)(1).

3. I.R.C. § 42(f)(2).

4. Due to the at-risk rules under Section 49 and the passive activity loss rules under Section 469, the ability for individuals and non-widely held C-corporations

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a tax credit investor (Investor) to use LIHTC, the Investor needs to be a partner of a partnership that owns a building. Because Investors want to limit their potential liability to the amount that they agreed to invest for the LIHTC, the owner will generally be a limited partnership and the Investor will be the limited partner. In exchange for a limited partner interest, the Investor will make a substantial capital contribution that is proportionate to the LIHTC and tax losses expected to be received by the Investor.⁵ The general partner (GP) is usually an affiliate of the project developer. Note that the Investor can also be a member of an owner that has been formed as a limited liability company (LLC) that is treated as a partnership for tax purposes. This essay will use the word "Partnership" to refer to both limited partnerships and LLCs taxed as partnerships.

When LIHTCs are earned by the owner of a building and that owner is treated as a partnership for federal tax purposes, the LIHTCs are allocated among the partners in the same manner as depreciation is allocated among the partners of the owner.⁶ To maximize the Investor equity, projects are commonly structured so that the Investor will receive 99.99% of the LIHTC. Thus, if the Investor wants to receive 99.99% of the LIHTCs earned by the Partnership, it needs to be allocated 99.99% of the depreciation. Depreciation makes up the majority of tax losses for most LIHTC projects and thus 99.99% of the tax losses are generally allocated to the Investor.

The Investor receives a capital account equal to the amount that it agrees to invest in return for the Credits and tax losses expected to be generated by the Partnership.⁷ That capital account is reduced each year by any distributions from the Partnership to the Investor, as well as by the Investor's share of the tax losses of the Partnership.⁸ However, once the Investor's capital account reaches zero, the Investor generally cannot be allocated additional tax losses.⁹ Because LIHTC partnerships always gen-

to use LIHTCs is very limited. In addition, because most LIHTC transactions involve millions of dollars of LIHTCs, most developers do not have sufficient tax liability to be able to use the LIHTCs. As a result, most developers partner with investors that can use the LIHTCs.

5. The ability to deduct tax losses such as depreciation is valuable to Investors because such tax losses allow them to reduce taxable income earned from other parts of their business. A \$100 tax loss will save an Investor \$21 in federal taxes with the current 2018 21% corporate tax rate imposed under Code Section 11(b).

6. Treas. Reg. § 1.704-1(b)(4)(ii).

7. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

8. *Id.*

9. Investors are generally limited partners and do not have an obligation to restore a deficit in their capital account. Thus, loss allocations to an Investor that would drive the Investor's capital account negative would generally not be respected because they would not be considered to be "substantial" under Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3). But see *infra* note 11 regarding the ability to have a negative capital account if a partner has minimum gain.

erate taxable losses, it is not uncommon for the losses to exceed the Investor's capital account before the end of the 10-year credit period. If that happens, the Investor's capital account will be run down to zero, and no more tax losses can be allocated to the Investor.

Once the Investor's capital account reaches zero, any losses and any remaining LIHTC would generally be allocated to the GP—this is referred to as a "reallocation."¹⁰ If such a reallocation is expected to occur based on the financial projections for the transaction, the Investor will contribute less equity because it will receive less Credits. Since, as referenced above, the GP generally cannot use much LIHTCs, in years in which the Investor's capital account is zero (preventing it from benefiting from the LIHTCs), LIHTCs earned by the Partnership will go unused (and will not generate the benefit of the Investor's equity investment in the LIHTC project). This is a result to be avoided since it will typically result in a project that is not financially viable.

II. Treatment of Nonrecourse Debt

Nonrecourse debt often can be used to avoid such reallocations because a partner is allowed to go negative in its capital account up to its share of minimum gain.¹¹ For purposes of partnership taxation regulations, nonrecourse debt is debt for which no partner bears the economic risk of loss.¹² In other words, if the partnership defaults, no partner is required to repay the debt. The partnership tax rules generally allow an Investor's capital account to go negative to the extent of the Investor's share of "Partnership Minimum Gain."¹³ Partnership Minimum Gain generally exists when a **third party nonrecourse** loan for which no partner (or related party) is liable exceeds the basis of the assets encumbered by the liability.¹⁴

A. Minimum Gain

The definition of "Minimum Gain" is key to understanding the role of nonrecourse debt in LIHTC transactions. In technical terms, Minimum

10. Because general partners often have an obligation to restore a deficit balance in their capital accounts, they could be allocated such losses and the resulting LIHTC. *Id.*

11. Treas. Reg. § 1.704-2(i)(5).

12. Treas. Reg. § 1.752-1(a)(2). Note that the definition of "nonrecourse debt" for purposes of the partnership tax rules differs from the definition of "nonrecourse debt" used for purposes of determining the gain or loss recognized from the disposition of property under Section 1001. Under Section 1001, "nonrecourse debt" refers to debt secured by property where, in the event that the borrower defaults on the debt, the lender's only recourse is against the property securing the debt. Thus, a loan where a borrower under state law has recourse to all assets of a Partnership but does not have recourse to any of the partners would be recourse for purposes of Section 1001, but nonrecourse for purposes of Treasury Regulation § 1.752-1(a)(2).

13. Treas. Reg. § 1.704-2(g).

14. Treas. Reg. § 1.704-2(d).

Gain is equal to the positive difference between the amount of nonrecourse debt and the cost basis of the building less any tax depreciation.¹⁵ In non-technical terms, Minimum Gain is literally the minimum amount of gain a partnership could have even if it gave the property back to a lender for nothing. How tax law computes gain in transactions involving nonrecourse debt is critical to this conclusion. Under tax law, if a taxpayer disposes of property and is discharged from a nonrecourse obligation encumbering the property, the taxpayer is deemed to have received consideration from the disposition equal to the amount of the discharged nonrecourse liability.¹⁶ Thus, if a partnership gave the keys to the building back to a \$1,000,000 nonrecourse lender and received no additional consideration, the partnership would be deemed to have an amount received of \$1,000,000. If the Partnership's basis in the building was \$900,000, then the Minimum Gain would be equal to \$100,000; the \$1,000,000 amount received less the \$900,000 of basis.¹⁷

The generation of Minimum Gain can be shown by a simplified example.

Example 1. Assume that a Partnership borrows \$300,000 with a 5% interest only loan and buys an apartment building for \$300,000. Because residential rental property has a 30-year life, assuming an election under Code Section 163(j) is made,¹⁸ the Partnership would have \$10,000 of depreciation for the year and the building's adjusted basis at the end of the year would be \$290,000. Five percent interest on the \$300,000 loan would be \$15,000. If the Partnership generated taxable income equal to the \$15,000 at the end of the year, the Partnership would break even on a cash flow basis. However, the balance of the interest only debt at the end of the year would still be \$300,000 while the building's adjusted basis would be only \$290,000. Thus, if the building were given back to the lender, the Partnership would have \$10,000 of gain. This is the minimum amount of gain possible no matter whether the building is given back to the lender, burns down, or is sold. This \$10,000 is the "Minimum Gain."¹⁹

15. Treas. Reg. § 1.704-2(d)(1).

16. See I.R.C. § 7701(g) ("in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject"); Treas. Reg. § 1.1001-2 (amount realized from disposition of property includes the amount of debt a taxpayer is discharged from); *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983) (amount realized from disposition of property includes nonrecourse debt that exceeded the value of the property).

17. See I.R.C. § 1001 (gain equals amount realized less adjusted basis).

18. I.R.C. § 168(g)(2).

19. One can ask, why does the IRS allow one's capital account to go negative due to minimum gain. The partner is taking more tax benefits (usually depreciation) than the amount of capital it contributed. The reason this is allowed is that

Whether a Partnership will generate minimum gain depends on a number of factors. LIHTC projects that have slow debt amortization, especially interest only loans or loans where interest is accruing, are much more likely to have minimum gain. This is because depreciation will cause the adjusted basis to fall below the debt balance. Also, projects with more nonrecourse debt are more likely to have minimum gain because depreciation can cause the adjusted basis to fall below the debt balance more quickly. The likelihood that a Partnership will generate minimum gain is much higher for projects that receive their credits through the use of tax-exempt bonds.²⁰ Such projects are generally eligible to receive less than half the LIHTC that projects that do not use tax-exempt bonds but instead receive allocated credits from the State Credit Agency authorized to issue the LIHTC.²¹ Because they are eligible for less LIHTC, the Investors in such transactions will contribute significantly less capital. Example 2 shows how tax-exempt bond financed projects receive much less equity and therefore need to borrow funds to make up for the lower equity amount.

Example 2. Assume the eligible basis of a newly constructed building is \$10,000,000 and all of the units qualify for LIHTC. If the building uses tax-exempt bonds to receive its LIHTC, applying the July 2018 rate of 3.29% means that the maximum amount of LIHTC for the building would be \$329,000 per year or \$3,290,000 over 10 years.²² However, if the building did not use tax-exempt bonds and instead received an allocation of LIHTC from the State Credit Agency, the maximum amount of LIHTC

if a partner has such a negative capital account, the IRS knows that someday when the building is disposed of for any reason, e.g., default, fire, or sale, the Partnership will be deemed to have an amount received at least equal to the discharged debt. As a result, partners with a negative capital account will have taxable income allocated to them that reverses their negative capital account. In this way, the IRS is made whole by the partner paying tax on that income.

20. I.R.C. § 42(h)(4).

21. Tax-exempt bond financed projects compute the amount of LIHTCs to which they are entitled using a tax credit rate, i.e., “applicable percentage,” such that present value of the 10-year stream of credits is equal to 30% of the qualified basis of the building. I.R.C. § 42(b)(1)(B)(ii). The applicable percentage for June 2018 is 3.29%. Rev. Rul. 2018-19, I.R.B. 2018-27 (June 18, 2018). Projects financed without tax-exempt bonds that receive an allocation of credits from the state credit agency use an applicable percentage for new construction costs or rehabilitation costs that creates a present value of the 10-year stream of credits equal to 70% of the qualified basis of the building. I.R.C. § 42(b)(1)(B)(i). However, acquisition costs for projects with state allocations still use the 30% rate. I.R.C. § 42(b)(1)(B)(ii). The 70% rate for July 2018 is 7.68%. Rev. Rul. 2018-19. However, under a revision to Code Section 42, the applicable percentage for new construction or rehabilitation costs for projects that do not use tax-exempt bonds is 9%. I.R.C. § 42(b)(2).

22. See footnote 21.

would be \$900,000 per year or \$9,000,000.²³ The tax-exempt bond-financed building has \$5,710,000 less LIHTC than the building financed without bonds. That is 63.4% less LIHTC. As a result, the Partnership owning the tax-exempt bond financed building will need to find other sources of funds to make up the much lower equity the Investor will invest due to receiving \$5,710,000 less LIHTC. This shortfall is commonly solved with additional debt.

In addition to having more debt and more minimum gain, tax-exempt bond transactions also have significantly less Investor equity. Thus the depreciation and losses on a \$10,000,000 tax-exempt bond-financed building will consume the Investor's small amount of capital much more quickly than the exact same amount of losses on a building financed without tax-exempt bonds.²⁴ Therefore the need for good Partnership Minimum Gain (described further below) is much more common in tax-exempt bond transactions.

B. Allocations of Debt and Minimum Gain

Because of the possibility of negative capital accounts, whether or not an Investor is allocated minimum gain is very important for LIHTC transactions. This in turn depends on the type of debt.

1. Partnership Nonrecourse Debt

The general rule is that debt is allocated to the partner that bears the economic risk of loss.²⁵ Minimum Gain generated from nonrecourse debt for which no partner bears the economic risk of loss is called "Partnership Minimum Gain."²⁶

The partners in a Partnership have significant flexibility in choosing how to allocate Partnership Minimum Gain among the partners.²⁷ Generally they choose to allocate 99.99% of the Partnership Minimum Gain to the Investor. As a result the Investor can continue to receive tax losses and LIHTC even though it has exhausted its capital account and the capital account turns negative.²⁸

23. The building financed without tax-exempt bonds would use an applicable percentage of 9%. I.R.C. § 42(b)(2); *see also* footnote 21.

24. The foregoing assumes that the State Credit Agency chooses to allocate LIHTC to the Project in an amount that is higher than what would be earned through the use of tax-exempt bonds. However, it is common that the amount of LIHTCs allocated by State Credit Agencies for a non-bond transaction is much higher than the amount of LIHTCs that would have been earned through the use of tax-exempt bonds.

25. Treas. Reg. §§ 1.752-2 & 1.704-1(b)(2)(iv)(c).

26. Treas. Reg. § 1.704-2(b)(2).

27. *See* note 30.

28. The reason for this is that under the partnership tax rules, if the building is ever disposed of—even if it is turned over to the lender for nothing other than satisfaction of the debt—the owner (and thus the 99.99% investor) will have taxable

Any time Minimum Gain exists, “Nonrecourse Deductions” are created equal to the amount of Minimum Gain created.²⁹ Under Treasury Regulations Sections 1.704-2(c) and 1.704-2(j), nonrecourse deductions first consist of depreciation to the extent there is sufficient depreciation. As long as there is no Partner Nonrecourse Debt, Partnerships can generally allocate 99.99% of nonrecourse deductions to the Investor and as a result the Investor gets 99.99% of the depreciation and 99.99% of LIHTCs.³⁰

In summary, Partnership Nonrecourse Debt allows Investors to go negative in their capital accounts and also allows depreciation and LIHTCs to be allocated to them. Thus it is the best type of debt for a LIHTC transaction.

2. Recourse Debt

If the debt is **recourse**, the above rules do not apply. This is because the GP usually bears the risk of loss on recourse debt. If the Partnership defaults on the loan, then the GP will have to pay off the lender. Because the Partnership would have paid the debt in full (via the GP’s funds), there is no gain and thus no Minimum Gain. As a result, an Investor cannot go negative in its capital account based on such a loan. Thus, when the Investor’s capital account reaches zero and there is only recourse debt, then the Investor will no longer be able to receive LIHTC, resulting in the problems discussed above.

An additional important difference between recourse debt and Partnership nonrecourse debt is that because recourse debt generally does not create minimum gain, it also does not create nonrecourse deductions.³¹ Thus while recourse debt does not allow an Investor to go negative in its capital account, at least it does not force an allocation of nonrecourse deduction to the GP that would then drag depreciation and LIHTCs over to the GP. Therefore, recourse debt is the second best type of debt.

3. Partner Nonrecourse Debt

Significant problems can occur where there is financing that is **nonrecourse but guaranteed** by the GP or someone related to the GP or if the

gain equal to at least the amount of Minimum Gain. From the IRS perspective, that taxable gain makes up for the fact that prior tax losses exceeded the equity put in by the Investor. LIHTC investors can live with this tax result.

29. Treas. Reg. § 1.704-2(c).

30. Under Treas. Reg. § 1.704-2(e)(3), partners can allocate nonrecourse deductions “in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.” Treas. Reg. § 1.704-2 then generally provides that minimum gain is allocated in the same manner as the nonrecourse deductions.

31. It is possible that recourse debt could cause a Partnership to create minimum gain sooner under the “stacking rules” of Treasury Regulation Section 1.704-2(d)(2). This would occur where the recourse debt’s mortgage lien is senior to the mortgage lien of nonrecourse debt. The scope of the stacking rules is beyond the scope of this essay.

loan is from the GP or someone related to the GP. In such a case any minimum gain that is generated is considered "Partner Minimum Gain." Partner Minimum Gain is required to be allocated to the GP because the GP bears the risk of loss related to the loan.³² In addition, any time Partner Minimum Gain exists, Nonrecourse Deductions up to the increase in the amount of Partner Minimum Gain must be allocated to the GP and are called "Partner Nonrecourse Deductions."³³ Because the Nonrecourse Deductions will be primarily composed of depreciation, this will cause LIHTC to be reallocated over to the related party partner. If there is debt from a related party or an affiliate of a related party in an LIHTC transaction, such debt will almost always come from the GP or someone related to the GP. As a result, the presence of GP nonrecourse debt or GP affiliate nonrecourse debt will often cause LIHTC to be reallocated to the GP rather than the Investor. This is true even if the Investor has a positive capital account.

Partner Nonrecourse Debt is the least desirable form of debt. If Partner Minimum Gain is generated, that will force depreciation and LIHTCs to go to the GP. In addition, any Minimum Gain generated will be Partner Minimum Gain allocated to the GP and thus the Minimum Gain will not allow the Investor to go negative in its capital account.

III. Conclusion

This essay illustrated a few important points about how nonrecourse debt can be used to fully maximize LIHTC investment. As described above, third party nonrecourse debt gives a project the best chance to allow an Investor to fully utilize all the LIHTC by allowing the creation of Partnership Minimum Gain. Such Partnership Minimum Gain can be allocated to the Investor and can allow the Investor to go negative in its capital account and thus continue to be allocated LIHTC. In contrast, recourse debt does not create Minimum Gain and still reduces the ability of Investors to be allocated 99.99% of the LIHTC. When the Investor's capital account reaches zero, it will no longer be allocated any tax losses or LIHTC. Nonrecourse debt from the GP or nonrecourse debt guaranteed by the GP is the least desirable kind of debt from a LIHTC perspective. It can create Partner Minimum Gain, which forces LIHTC to be reallocated to the GP even if the Investor has a positive capital account. As previously stated, the above explanation is a significant simplification of the actual rules. Thus, the discussion included here is not equally applicable to every LIHTC transaction. Financial projections for each LIHTC project must be carefully analyzed.

32. Treas. Reg. § 1.704-2(i)(1).

33. Treas. Reg. § 1.704(2)(i)(2).