Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits

March 2018 • Volume IX • Issue III

Published by Novogradac & Company LLP

Should Old Partnerships Be Amended to Address H.R. 1

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In the wake of the tax reform legislation, H.R. 1, enacted Dec. 22, 2017, and the new partnership audit regime required by the Bipartisan Budget Act of 2015 with respect to tax years beginning Jan. 1, 2018, syndicators and developers need to determine whether partnership agreements should be amended before the filing of the partnership's 2018 federal income tax return.

Deal specifics may dictate whether an amendment is required, so parties should consider each deal individually to determine the best approach. If an amendment is necessary, negotiation will be required to execute a mutually satisfactory agreement.

Business Interest Deductions

Revised Internal Revenue Code (IRC) Section 163(j) limits a taxpayer's business interest deductions for any taxable year to the sum of such year's (A) business interest income, (B) 30 percent of the adjusted taxable income, plus (C) the floor plan financing interest. Depreciation deductions are excluded from the calculation of taxable income until Jan. 1, 2022. Accordingly, after 2022, the limitation becomes more restrictive. The small-business exception to the limitation does not apply to tax shelters (which include any partnership if more than 35 percent of the losses of the partnership in a taxable year are allocable to limited partners). Thankfully, an exception to the limitation exists for electing "real property trade or businesses."

Businesses involved in the development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage of real property may deduct the full amount of business interest expense if an election is made to be treated as an "electing real property trade or business" under IRC Section 163(j)(7)(B). The price for making such an election is that the nonresidential real property, residential rental property and qualified improvement property held by an electing entity must be depreciated using the alternative depreciation system (ADS), which appears to be 40

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years for property placed in service before 2018 and 30 years for projects placed in service after 2017.

Each low-income housing tax credit (LIHTC) partnership should examine financial projections and available historical operating data to determine whether the detrimental impact of the ADS will be offset by the effects of bonus depreciation of other assets and the additional interest deductions. In tax-exempt bond transactions, the larger interest deduction will generally prove beneficial. Projects where the permanent financing bears nominal interest may benefit from remaining in the modified accelerated cost recovery system depreciation system. In 9 percent LIHTC transactions, where the buildings were placed in service before 2018, it may be beneficial to defer the election until 2022, when depreciation deductions are removed from the limitation threshold. An agreement between the parties with respect to the real property trade or business election could easily be documented through an exchange of emails rather than a formal amendment.

Depreciation

H.R. 1 reduced the recovery period under ADS for residential rental property placed in service after Dec. 31, 2017, from 40 to 30 years. Taxpayers who wish to reduce losses until after the expiration of the credit period will therefore no longer have the option to elect 40-year depreciation for residential real property under ADS. Further, residential rental projects owned in part or in whole by tax-exempt entities that are placed in service after Dec. 31, 2017, will be subject to a 30-year recovery life. With the repeal of technical terminations of partnerships and the 30-year ADS life, fewer strategies remain to address capital account issues beyond establishing a limited deficit restoration obligation. We can expect more efforts to disaffiliate debt, including deferred development fees, where capital account issues arise.

Property with a recovery period of 20 years or less (including personal property and site work) that is placed in service after Sept. 27, 2017, and before Jan. 1, 2023, may claim bonus depreciation equal to 100 percent of the adjusted basis of the property, unless the taxpayer elects out. The taxable loss computations become more complex for phased projects where some buildings and property are placed in service before 2018 and other assets are placed in service after 2017. Accordingly, whether the project has been placed in service or not, financial projections and capital account forecasts should be updated for each transaction based on the applicable new depreciation provisions and business expense deduction limitations. If a transaction has a loss- or yield-based adjuster, it may be necessary to revise the adjustment calculation.

Investors may choose to document their requirements with respect to any depreciation and business expense elections in an amendment to the partnership agreement or require that any tax elections made by a partnership be subject to investor consent in a side letter. In our view, the better approach is to amend the partnership agreement to reflect the specific obligations of the general partner and the accountants when preparing the tax returns to avoid uncertainty and misunderstanding.

Historic Tax Credits and the Transition Rules

Partnerships that own historic tax credit (HTC) property placed in service after 2017 may require an amendment to address the applicability of HTC transition rules. Unless a development qualifies under the transition rules, HTC will be claimed "ratably" over a five-year period rather than at placement in service. To qualify for the transition rule, a taxpayer must have owned the project before Jan. 1, 2018, and the measuring period must begin before June 20, 2018. We believe the better interpretation of the statute is that an investor may be admitted after Dec. 31, 2017, to a regarded partnership and qualify for the transition

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rule, but this answer is subject to change by the Joint Tax Committee "Blue Book" or IRS guidance.

Given this uncertainty, an investor may choose to base its initial capital contributions on an assumption that the credit will be claimed over a five-year period, with an upward adjuster in the event that the development qualifies under the transition rules. An investor may also price its capital contribution under the old rule and apply a downward adjuster in the event that the project does not qualify. Moreover, the adjuster provisions should take into account the uncertainty over the timing of the phased credit. It is not clear if 20 percent of the HTC is available in the initial year, or only a portion of the 20 percent that corresponds to the date on which the building is placed in service. If the building is placed in service July 1, is only 10 percent (half of 20 percent) of the HTC available with the remaining portion claimed in the sixth year? If and when federal guidance is provided, adjuster provisions may need modification.

Partnership Audit Regime

As of Jan. 1, the new partnership audit guidelines are in effect. It would be a daunting task to amend all existing agreements to incorporate the guidelines, but in circumstances where an agreement is formally amended or the partners execute a side letter or email exchange that addresses H.R. 1, it would be advantageous to include provisions that address the audit rules.

Under these guidelines, the tax matters partner (TMP) is replaced by a partner representative (PR). Unlike the TMP, which had to be a general partner or managing member, anyone, including a nonpartner, may be a PR. Each partnership must identify the PR (and a responsible individual, if the PR is an entity) for each tax year. Once provided, the identity may not be changed with respect to such tax year until the IRS sends a notice of examination or audit to the PR.

The new audit regime repeals the former limitations on the TMP's ability to bind the partnership. Any limitations on the authority of the PR will be contractual and nonbinding on the IRS. At a minimum, partnership agreements will need to be amended to provide that the PR will timely provide copies of all IRS notices received with respect to the partnership and to restrict the PR's authority to bind the partnership and its partners without the consent of the investor.

Because all limitations on the PR's authority will be contractual, if a developer affiliate is designated as the PR, investors should be comfortable with the creditworthiness of the general partner and guarantors. Because of the broad authority of the PR, removal provisions should be tailored to provide that, in the event that a general partner is removed, the investor will have the authority (coupled with any necessary powers of attorney) to replace the developer-affiliated PR with a PR of its own choosing for tax years subsequent to the removal event and with respect to prior years if an audit is commenced.

The partners should also consider whether the default rule providing that any taxes, interest or penalties assessed in an examination or audit would be paid by the partnership should apply, or if they should elect to push out any potential liability to the partners. Unless the parties agree otherwise in advance, the partnership agreement should provide that no election out of the default rule should be made without investor consent. If the parties push out the tax liability, its allocation, including whether guaranty obligations are considered in the allocation, should be articulated. We note that if a push-out election is made, the interest rate on unpaid liabilities increases by 2 percent.

Finally, in light of the default rule that taxes, interest and penalties are paid at the partnership level, partnership provisions regarding adjusters may need to be modified. They should provide that payment first

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be made to the partnership by the general partner or guarantor, and after the partnership uses the proceeds to pay the IRS, the excess be paid to the investor as a return of capital. That capital will cover its loss of future tax benefits that were included in the calculation of its capital contributions to the partnership that will not be available in later years.

Conclusion

Although uncertainty still exists, industry participants should begin reviewing their portfolios and implementing the necessary amendments and modifications with appropriate urgency. ❖

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This article first appeared in the March 2018 issue of the Novogradac Journal of Tax Credits.

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ISSN 2152-646X

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