Partnerships and the low-income housing tax credit

The low-income housing tax credit can yield significant investment returns, but the tax issues relating to the partnerships that usually operate LIHC projects can be complex. Taxpayers should review these partnership/LIHC issues to determine if they will receive the tax benefits expected.

by Michael J. Novogradac, Eric J. Fortenbach, and Donald M. Schmidt, Jr.

The Low-Income Housing Tax Credit (LIHC or credit) was enacted as part of the Tax Reform Act of 1986 and was generally effective as of January 1, 1987. An indirect federal subsidy of low-income rental housing, the credit is claimed prorata over ten years and can be used in connection with both new and existing buildings. To continue generating the credit and to avoid tax credit recapture, a LIHC building must satisfy specific low-income housing compliance rules for a full fifteen-year period.

The credit is generally designed to subsidize either 30 percent or 70 percent of the costs of the low-income units in a project.¹ The 30 percent subsidy is for new construction using additional federal subsidies and for the acquisition of existing buildings.² The 70 percent subsidy is for new construction without any additional federal subsidies.³ The term “new construction” includes the costs of rehabilitating an existing building if a minimum per unit expenditure threshold is satisfied.⁴

The LIHC was initially set to expire in 1989. As a result, the Treasury did not invest significant resources in drafting regulations for the LIHC. As a consequence, regulations are not yet available.

Most LIHC projects are operated through a partnership. The partnership vehicle is attractive because it allows the sponsor to retain an ownership interest in the project and also allows investors to receive the majority of the credit generated by the LIHC project. These partnerships can be either general or limited partnerships.

This article first addresses the general LIHC rules for partnerships.³ The article then reviews the three areas where tax issues most often arise in connection with LIHC partnerships, which are as follows:

1. The allocation of the credit among the partners;
2. The potential recapture of the credit; and
3. The application of the LIHC at-risk rules.

General rules for LIHC partnerships

In a partnership that owns a building that has been allocated the LIHC, each individual partner is generally treated as a separate taxpayer with respect to his allocable share of the LIHC

¹ I.R.C. § 42(b)(2)(B).
² I.R.C. § 42(b)(1)(B).
³ I.R.C. § 42(b)(1)(A).
⁴ I.R.C. § 42(e)(3).
⁵ For a more detailed discussion of other aspects of the LIHC, see Michael J. Novogradac and Eric J. Fortenbach, The Low-Income Housing Tax Credit Handbook (Clark Boardman, 1990).
building. In effect, the partnership is treated as a conduit for this purpose, rather than as a separate taxable entity. However, Congress intended for the Department of the Treasury to issue regulations that would treat the partnership as the taxpayer where appropriate to carry out the objectives of the LIHC. For example, calculations with respect to the determination of a building’s low-income occupancy percentage should be determined at the partnership level.

Credit allocation rules

The LIHC is allocated among partners in a manner consistent with how depreciation expense, attributable to the basis generating the credit, is allocated among the partners.

Validity of allocations. As a consequence of the allocation rule, the validity of an allocation of the credit depends on the validity of the related allocation of depreciation expense. Specific administrative guidance has not yet been issued with respect to the allocation of LIHCs that are generated at the partnership level.

The validity of an allocation of depreciation expense hinges on whether the allocation has substantial economic effect under Section 704(b) of the Internal Revenue Code. If an allocation of depreciation expense does not have substantial economic effect, the expense must be allocated in accordance with each partner’s interest in the partnership.

As a general rule, an allocation of depreciation expense will have substantial economic effect if the partnership agreement provides that:

1. The distributions on liquidation of the partnership are made in accordance with the partners’ capital accounts; and
2. Such capital accounts are adjusted for partnership-level items. The capital accounts should be decreased for partnership losses and distributions. Similarly, the capital accounts should be increased for partnership income and contributions.

However, this rule presumes that a partner’s capital account will not become negative. If a partner is allocated losses and receives sufficient distributions to have a negative capital account, then an additional requirement is necessary: The partner must generally be required by the partnership agreement to fund the negative capital account upon liquidation of the partnership. This additional rule would apply if a partner has a negative capital account at any time during the fifteen-year LIHC compliance period.

As a result, if the partnership allocations cause any partners to have negative capital accounts at any time during the fifteen-year LIHC compliance period, then the substantial economic effect test will generally only be satisfied if the partners are required to fund their negative capital accounts upon liquidation of the partnership. If the partnership does not contain such a provision and partner capital accounts become negative, then the LIHCs will generally be reallocated in accordance with the partners’ interests in the partnership.

As a practical matter, a deficit capital account makeup provision will generally be unacceptable to limited partnership investors. Individuals will generally not invest in a partnership where they will be liable for additional capital contributions if the partnership’s investment does not perform well.

Allocation planning ideas. Consequently, partnerships that are projecting negative capital account balances should consider the fol-

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7 General Explanation, p. 154, note 3. For instance, the partnership should be treated as the taxpayer for purposes of the new building determination under I.R.C. § 42(i)(4).
8 Treas. Reg. § 1.46-3(f)(2)(i).
9 For an additional discussion of this topic, see John G. Schmalz, “Compliance With New Allocation Rules: Real Estate Partnerships May Need Corrective Action,” Real Estate Accounting & Taxation (Winter 19990), p. 70.
10 I.R.C. § 704(b)(2).
11 See Treas. Reg. § 1.704-1(b). These regulations provide a complex set of rules that must be satisfied in order for partnership allocations to have substantial economic effect; these rules include certain partnership capital account maintenance requirements.
12 Id.
lowing three approaches to solving the allocation dilemma:

1. The partnership should consider ways to defer expenses (or accelerate income) to ensure that the capital accounts do not become negative during the fifteen-year LIHC compliance period. One technique that is often used to defer expenses is to adopt a forty-year (as opposed to a 27.5-year) depreciable life for the building.

2. The partnership should assess the effect of specially allocating operating losses to the general partner of the partnership. By specially allocating operating losses to the general partner, only depreciation expense will be allocated to the limited partners. This special allocation results in allocating less losses to the limited partners and, consequently, reduces the likelihood that the limited partners’ capital accounts will become negative.

3. The partnership should review the nonrecourse deduction rules. Nonrecourse deductions are deductions that are attributable to nonrecourse debt for which no partner is liable. Partnership allocations of nonrecourse deductions cannot have substantial economic effect because no partner is personally liable. If the partnership does not satisfy a nonrecourse liability, then the creditor can generally only look to the collateralized property. If the partnership has depreciated the property to an adjusted tax basis that is less than the amount of the nonrecourse debt, then the foreclosure will generally result in a taxable gain to the partnership. This taxable gain is generally equivalent to the partnership’s “minimum gain.” If the allocation of this gain differs from the original allocation of the depreciation deductions, then the partnership allocations may not have substantial economic effect.

The allocation of these nonrecourse deductions is deemed to be made in accordance with a partner’s interest in the partnership (and, as such, satisfy with substantial economic effect requirement) if the following four requirements are satisfied:

- Upon liquidation of the partnership (or any partner’s interest in the partnership), liqui-

dating distributions are required to be made in accordance with positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs. In addition, the partner capital accounts must be maintained in accordance with Treasury regulations.

- Nonrecourse deductions are allocated in a manner that is reasonably consistent with some other significant partnership item that is attributable to the property that is generating the nonrecourse deduction.

- The partnership agreement contains a minimum gain charge-back provision.

- All other material allocations and capital account adjustments are recognized.

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**The LIHC is allocated among partners in a manner consistent with how depreciation expense, attributable to the basis generating the credit, is allocated among the partners.**

A minimum gain charge-back provision requires that if there is a net decrease in minimum gain, then items of income and gain should generally be allocated to all partners with a deficit capital account balance before partners with surplus capital account balances. The allocation of these items should be in proportion to the relative deficit balances.

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15 Id.


This provision should provide for such allocation to eliminate the deficit account balances as quickly as possible.\textsuperscript{20}

**Timing of credit allocations.** The LIHC is allocated to partners based on the date that the partners are admitted to the partnership.\textsuperscript{21} The credits are not treated as accruing on the last day of the partnership’s taxable year for purposes of this rule.

For the situation in which a partner’s interest changes during a taxable year, Congress intended that each partner’s distributive share of the tax credit be determined under the general partnership allocation rules of Section 706.\textsuperscript{22} Under Section 706, allocations must be made using a method prescribed by the Department of the Treasury in regulations that take into account the varying interests of the partners in the partnership. No specific guidance exists with respect to the allocation of the low-income housing credit. As such, it should be addressed under the general rule.

**Credit recapture exception**

Recapture of the LIHC generally occurs when one of two events occurs: Either there is a reduction in the property’s qualifying basis or there is a transfer of the property. The recapture amount is generally one third of the credits that were previously claimed. In addition, there is an interest charge.\textsuperscript{23} However, during the twelfth through fifteenth years of the credit, the recapture decreases to 4/15, 3/15, 2/15, 1/15, respectively, of the amount of credits that were previously claimed. Under the general LIHC rules, these determinations typically refer to the property rather than the owner.

Generally, when a partner transfers his partnership interest, recapture of the credit will occur. This tax treatment is consistent with treating the partnership as a conduit. Recapture occurs because, as previously noted, the partner is deemed to own an interest in the property and has disposed of that interest.\textsuperscript{24} A partner should be able to avoid recapture of the credit if the partner posts a bond. Treasury has informally told taxpayers that until procedures are established to allow for posting of such a bond, an escrow account should be created and Treasury should be informed of its creation. Generally, the escrow account should be funded with twice the amount of the credit to be recaptured.

**Partnership treated as taxpayer.** A special thirty-five-or-more-partners rule allows the partnership to be treated as the taxpayer for purposes of the recapture rule.\textsuperscript{25} Under this provision, the partnership is treated as an entity for purposes of LIHC recapture. This special exception allows a partner to generally avoid recapture of the credit upon disposition of his interest in the property. For purposes of this thirty-five-or-more-partners rule, a husband and wife (and their estates) are treated as one partner.\textsuperscript{26}

A partnership can elect to have this provision not apply. By making this election, a partnership with thirty-five or more partners would be treated as a conduit for purposes of determining LIHC recapture. Taxpayers should be aware, however, that this election is irrevocable.\textsuperscript{27}

Taxpayers should also note that, according to the General Explanation to the Tax Reform Act of 1986, this thirty-five-or-more-partners exception to the recapture rule does not apply if more than 50 percent (in value) of the original ownership is transferred within a twelve-month period. This reference should probably be to 50 percent or more of capital and profits because the General Explanation was apparently referring to Section 708(b)(1)(B). For situations in which 50 percent or more of capital and profits are transferred within a twelve-

\textsuperscript{20} Treas. Reg. § 1.704-1(b)(4)(iv)(c).
\textsuperscript{21} I.R.C. § 706.
\textsuperscript{22} General Explanation, p. 154, note 3.
\textsuperscript{23} I.R.C. § 42(j).
\textsuperscript{24} It is currently unclear what effect this partner level recapture has on the partnership and future partnership level recapture events. Presumably, under the current rules, a partner can suffer tax credit recapture upon transfer of his interest, and the purchase of his interest can have similar recapture if the partnership disposes of the partnership property that generated the credit.
\textsuperscript{25} I.R.C. § 42(j)(3)(A)(i).
\textsuperscript{26} I.R.C. § 42(j)(3)(C)(ii).
\textsuperscript{27} I.R.C. § 42(j)(3)(C)(ii).
month period, a partnership is deemed to have technically terminated.

**Example: Technical termination.** Partnership A has four partners, B, C, D, and E, who have the following capital and profits interest:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>15%</td>
</tr>
<tr>
<td>C</td>
<td>20%</td>
</tr>
<tr>
<td>D</td>
<td>35%</td>
</tr>
<tr>
<td>E</td>
<td>30%</td>
</tr>
</tbody>
</table>

If any combination of two partners except B and C transfer their partnership interests in any twelve-month period, a technical termination would occur.

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**Recapture of the LIHC generally occurs when one of two events occurs: either a reduction in the property’s qualifying basis or a transfer of the property.**

Under this rule, the partnership is first deemed to have distributed all of its assets and liabilities in complete liquidation of the partnership. The partners are then deemed to have contributed such assets and liabilities to a new partnership. As such, within this conceptual framework, the partnership's building will have been disposed of by the liquidating partnership. Consequently, LIHC recapture would occur as a result of the technical termination of the partnership. Any partnership level recapture that occurs upon disposition of the property by the partnership (rather than an interest in the partnership by a partner) will be allocated in accordance with the allocation of taxable income for the year of recapture.

**At-risk rules**

When enacting the low-income housing tax credit rules, Congress wanted to ensure that taxpayers claiming the LIHC had placed some assets economically at risk. Congress, however, also wanted to allow legitimate third-party nonrecourse real estate financing. Consequently, Congress enacted the LIHC at-risk rules which differ from those that apply to the allowance of losses under Section 465. The LIHC at-risk rules generally follow the investment tax credit at-risk rules contained in Section 46(c)(8), with certain modifications.

**Specific LIHC at-risk rules**

Under the LIHC at-risk rules, tax basis that is eligible for the LIHC excludes any costs attributable to nonqualified nonrecourse financing. Costs that are attributable to qualified nonrecourse financing, however, can qualify for the credit. Qualified nonrecourse financing is generally nonrecourse financing incurred with respect to LIHC property that satisfies the following conditions:

- The property was acquired by the taxpayer from an unrelated party;
- Either:
  - The creditor is a qualified person; or
  - The loan is from, or guaranteed by, any federal, state, or local government or instrumentality thereof; and
- The financing is not convertible debt.

A qualified person is any person who is actively and regularly engaged in the business of lending money and who is not a person:

- From which the taxpayer acquired the property (or a related person to such person), or
- Who receives a fee with respect to the taxpayer’s investment in the property (or a related person to such person).

**Allocation of debt.** In a partnership context, the recourse nature of the debt is determined at the individual partner level. Therefore, nonrecourse debt that is guaranteed by

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28 I.R.C. § 46(c)(8).
29 I.R.C. § 46(c)(8)(D)(ii), as modified by I.R.C. § 42 (k)(1).
30 I.R.C. § 46(c)(8)(D)(iv).
31 I.R.C. § 46(c)(8)(E)(i).
the general partner should be nonrecourse to the limited partners.\textsuperscript{32} Congress has directed Treasury to prescribe regulations to prevent the avoidance of the rules of the LIHC.\textsuperscript{33} To date, no additional guidance has been provided in this area.

For purposes of the credit, financing is allocated among the partners based on the allocation of the credit. As previously noted, the credit is allocated among the partners based on the allocation of the associated depreciation expense. As a result, the ability to allocate depreciation expense to a given partner drives the allocation of the associated financing.

This rule for allocating financing for LIHC at-risk purposes causes an interesting result.\textsuperscript{32} Limited partners should note that debt guaranteed by the general partner must generally satisfy, at the limited partner level, the qualified financing exception to the non-recourse financing at-risk rules if such debt is to be included in eligible basis. See I.R.C. § 46(c)(8).

\textsuperscript{33} I.R.C. § 42(m)(3).

\textsuperscript{34} See I.R.C. § 752 and the Treasury regulations thereunder. See also Schmalz, "Compliance With New Allocation Rules," and Barrett and Brown, "Impact of Mandatory Allocations."

For LIHC at-risk purposes, nonrecourse financing \textit{guaranteed by the general partner} is allocated to the limited partners to the extent that the associated depreciation expense is allocated to the limited partners in accordance with Section 704(b). However, for purposes of determining partnership basis under Section 704(d), the financing is allocated to the person with the ultimate liability: the general partner.\textsuperscript{34} Therefore, it becomes vital to plan for the allocation of depreciation deductions in a partnership context because this allocation will ultimately determine which partners receive the LIHC.

\section*{Conclusion}

The low-income housing tax credit can yield substantial investment returns. LIHC projects are generally operated in partnership form to facilitate raising equity and this use of the partnership format generates unique tax issues. Taxpayers should review these partnership/LIHC tax issues to ensure that they receive the tax benefits that they are expecting.