



LIHTC Capital Accounts – How They Work, Potential Issue and Why You Should Care

Affordable Housing Investors Council

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Why Do We Care About Capital Accounts?

- When Projects starts, a budget and pro forma is created, but no capital account tax analysis.
- LIHTC is allocated as depreciation is allocated.
- Depreciation is part of tax losses that are allocated 99.99% to the Investor
- Investor Capital Account must be able to absorb depreciation and tax losses.



What Are Capital Accounts?

- Represents a partner's investment in the Partnership
- Increases in capital account:
 - Capital contributions
 - Share of Partnership income allocated to partner
- Decreases in capital account:
 - Partnership distributions
 - Share of Partnership losses allocated to partner



- Treatment of Certain Items:
 - Reasonable fees should not be treated as “distribution” that would reduce capital account
 - LIHTCs *do not* reduce Capital Accounts
 - State Credits *do not* reduce Capital Accounts
 - Federal HTC and Energy Credits do reduce Capital Accounts
 - HTC – Reduce Capital Account, depreciable and eligible basis by 100% HTC.
 - Energy Credits – 50% Capital Account and Depreciable Basis reduction, but no LIHTC basis reduction.

Acquisition Credit Projects and Capital Accounts Problems

Because the amount of credits in tax-exempt bond projects is based on a 4% rate rather than a 9% rate, **bond projects have less capital**. Due to less capital amount, bond deals often have capital account issues as compared to an allocated project that costs the same amount.

Tax-Exempt Bond vs. Allocated Project

	Tax-Exempt Bond New Construction	9% New Construction
Eligible Basis	\$30,000,000	\$30,000,000
Applicable Fraction	<u> </u> x 100%	<u> </u> x 100%
Qualified Basis	\$30,000,000	\$30,000,000
Applicable Percentage	<u> </u> x 4.00%	<u> </u> x 9.00%
Annual Acq. Credits	\$1,200,000	\$2,700,000
10 Years	<u> </u> x 10	<u> </u> x 10
Total Acq. Credits over 10 Years	\$12,000,000	\$27,000,000

9% New Construction Project more than double the equity of 4% bond acq/rehab project, even though same Total Development Cost.

Acquisition Credit Projects and Capital Accounts Problems

Acquisition credit projects commonly obtain their LIHTC by using tax-exempt bonds to finance more than 25% [50% for bonds issued prior to 2026] of land and building costs. However, because the amount of Credits is based on a 4% rate rather than a 9% rate, these projects have less capital. As a result of the reduced capital amount, acquisition credit bond deals often have capital account issues as compared to an allocated project that costs the same amount.

Investor Capital Account Hits Zero— cannot be allocated further losses or LIHTC unless:

- Deficit Restoration Obligation (“DRO”)
- Minimum Gain – a positive difference between the secured nonrecourse debt on the Project and the adjusted basis of the Project. Must be from unrelated debt to be helpful.
- Delay zero/negative capital account

Capital Accounts – Minimum Gain

LIHTC
Delivered

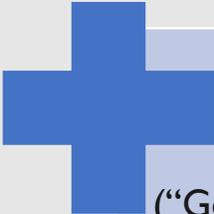
ABC DEVELOPMENT
704B ANALYSIS - FEDERAL

	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
704b Analysis:																	
First Mortgage	\$ -	\$ -	\$ 29,984,000	\$ 29,460,867	\$ 29,010,431	\$ 28,548,604	\$ 28,075,098	\$ 27,589,619	\$ 27,091,862	\$ 26,581,517	\$ 26,058,267	\$ 25,521,785	\$ 24,971,735	\$ 24,407,778	\$ 23,829,555	\$ 23,236,712	\$ 22,628,877
First Mortgage - Accrued Soft Interest	-	-	-	206,855	431,020	620,994	701,367	766,835	811,730	835,605	838,006	818,477	782,342	723,387	641,138	535,116	404,839
HOME Loan	-	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000	1,050,000
CDBG Loan	-	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000	345,000
Metro/AHP Loan	-	503,466	503,352	513,352	518,352	523,352	528,352	533,352	538,352	543,352	548,352	553,352	558,352	563,352	568,352	573,352	578,352
TOTAL NONRECOURSE DEBT	-	1,898,466	31,767,352	31,576,074	31,354,803	31,087,950	30,809,817	30,294,805	29,836,844	29,355,474	28,839,625	28,288,613	27,707,430	27,089,515	26,434,046	25,740,181	25,007,068
LESS: OUTSTANDING RESERVE BALANCES	-	-	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210	637,210
LESS: NET BOOK VALUE OF FIXED ASSETS	63,398,104	61,499,630	58,714,254	56,297,301	53,876,829	51,565,277	49,316,298	47,108,313	44,911,623	42,714,416	40,531,593	38,379,998	36,240,948	34,101,730	31,962,690	29,823,474	27,683,917
MINIMUM GAIN	(63,398,104)	(61,499,630)	(58,714,254)	(56,297,301)	(53,876,829)	(51,565,277)	(49,316,298)	(47,108,313)	(44,911,623)	(42,714,416)	(40,531,593)	(38,379,998)	(36,240,948)	(34,101,730)	(31,962,690)	(29,823,474)	(27,683,917)
LP OWNERSHIP PERCENTAGE	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%	99.99%
LP SHARE MINIMUM GAIN	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
LP CAPITAL ACCOUNT - END OF YEAR (PER BELOW)	4,768,000	2,980,932	17,353,958	17,231,878	15,118,897	13,112,334	11,206,038	9,365,211	7,567,452	5,800,375	4,078,206	2,417,060	789,056	-	-	-	-
LP SHARE OF SYNDICATION COSTS	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
CUSHION OR OVERALLOCATED LOSSES	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
(1) Excess of minimum gain over LP negative capital account less syndication costs NOTE: Prints as zero (\$0) if LP net minimum gain at the end of the year is positive (704b not an issue).																	
Analysis of LP Capital Account:																	
LP capital account - beginning of year	\$ -	\$ 4,768,000	\$ 2,980,932	\$ 17,353,958	\$ 17,231,878	\$ 15,118,897	\$ 13,112,334	\$ 11,206,038	\$ 9,365,211	\$ 7,567,452	\$ 5,800,375	\$ 4,078,206	\$ 2,417,060	\$ 789,056	\$ -	\$ -	\$ -
Capital contribution	4,768,000	-	17,047,000	2,025,000	-	-	-	-	-	-	-	-	-	-	-	-	-
Taxable income (loss)	-	(1,787,068)	(2,673,973)	(2,147,080)	(2,112,981)	(2,006,563)	(1,906,296)	(1,840,827)	(1,797,759)	(1,767,076)	(1,722,169)	(1,661,146)	(1,628,005)	(789,056)	-	-	-
Cash distribution	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
LP capital account - end of year	\$ 4,768,000	\$ 2,980,932	\$ 17,353,958	\$ 17,231,878	\$ 15,118,897	\$ 13,112,334	\$ 11,206,038	\$ 9,365,211	\$ 7,567,452	\$ 5,800,375	\$ 4,078,206	\$ 2,417,060	\$ 789,056	\$ -	\$ -	\$ -	\$ -

Capital Account is positive until after all LIHTC delivered in 2029 – Capital Account is positive until after all LIHTC delivered in 2029 (and no partner minimum gain) – Numbers Work!

Capital Accounts – Minimum Gain

Allocation of Minimum Gain – The allocation of Minimum Gain is determined by the nature of the nonrecourse debt. Note that recourse debt does not create minimum gain if it is the most junior debt.



(“Good”) Partnership Nonrecourse Debt

- If no partner bears the risk of loss, then the debt is considered “Partnership Nonrecourse Debt” and can be allocated among the partners through the partnership agreement. The partnership agreement will then allocate 99.99% to the limited partner.

(“Bad”) Partner Nonrecourse Debt

- If a partner (or a party related to a partner) bears the risk of loss on the debt, then the debt is allocated to that partner. This is called “Partner Nonrecourse Debt”.

Capital Accounts – Good Minimum Gain

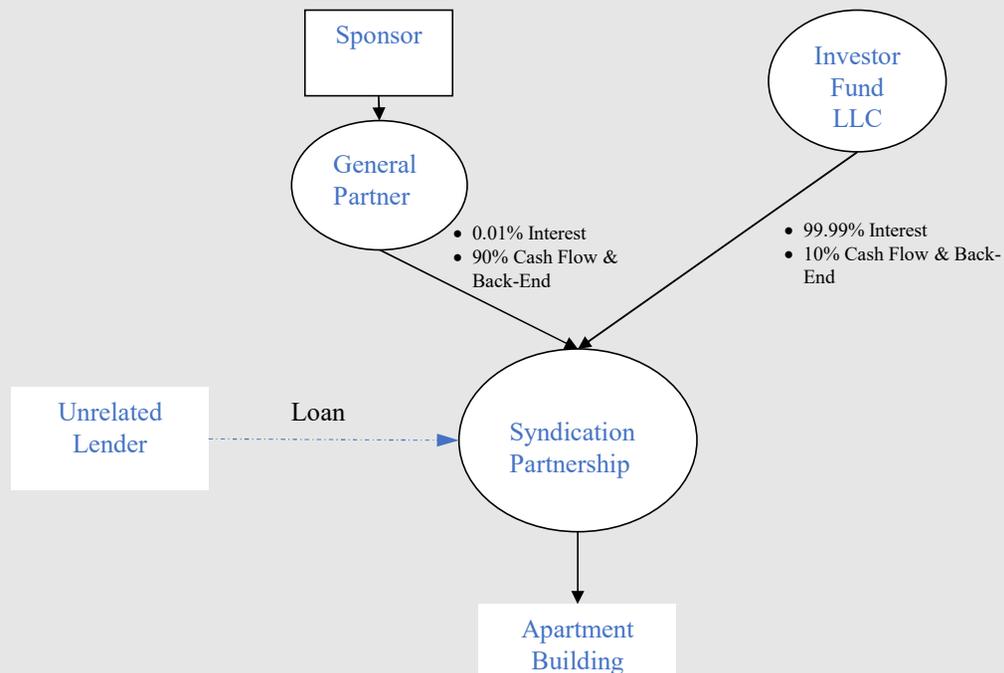
Minimum Gain Example – Third Party Debt

Nonrecourse Debt - Unrelated	\$11,000,000	Bank Loan
Net Assets (adjusted Basis)	<u>(\$10,000,000)</u>	
Partnership Minimum Gain	\$ 1,000,000	Minimum gain can be allocated to Investor.
		Investor can have a negative capital account

Capital Accounts – Good Minimum Gain

➤ Unrelated Debt Example

The below makes “Good” Partnership Minimum Gain



Capital Accounts – “Bad” Minimum Gain

Minimum Gain Example – Related Party Debt

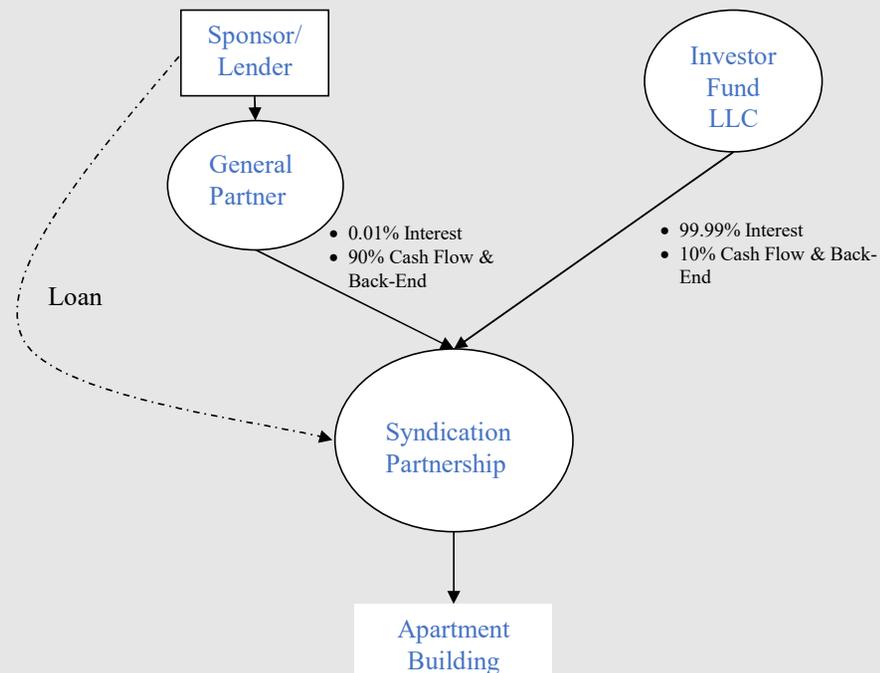
Nonrecourse Debt - Related	\$11,000,000	Loan from GP
Net Assets (adjusted Basis)	<u>(\$10,000,000)</u>	
Partner Minimum Gain	\$ 1,000,000	All minimum gain allocated to GP.

Investor cannot have a negative capital account

Capital Accounts – Minimum Gain

➤ Related Party Debt Example

The below makes “Bad” Partner Minimum Gain

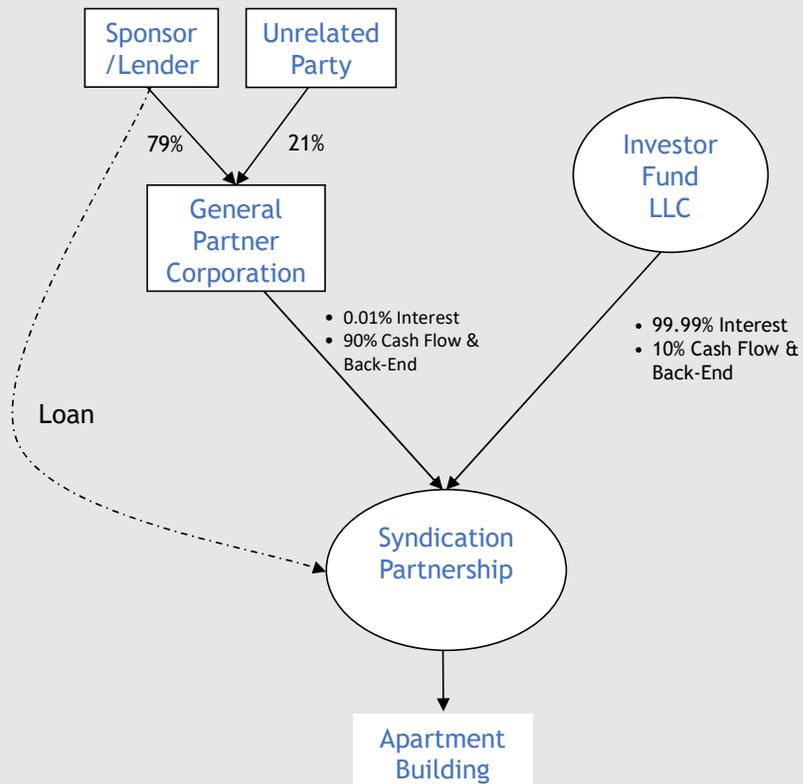


Minimum Gain - 79/21

- Minimum Gain Cure 1 – 79/21 - If the Project lender owns less than 80% of a partner in the Partnership, then it will not be considered a related party. This will allow the debt to be treated as (“Good”) Partnership Nonrecourse Debt.
 - Must Be a Corporate Partner – The entity that is a partner in the Partnership must be a corporation or an LLC that elects to be taxed as a corporation on IRS Form 8832.
 - 79% Ownership Must Be Real – Must have 79% of GP’s Vote and Value. Make everything pro rata.
 - Nonprofits and Relatedness – A nonprofit entity is deemed related to another entity if that entity controls it. This is usually measured based on a majority interest in the Board of Directors. If Developer controls 3 out of 5 Board members, then it would be deemed to control the nonprofit.

Capital Accounts – Minimum Gain – 79/21

➤ 79/21 Org Chart – Creating “Good” Partner Nonrecourse Debt

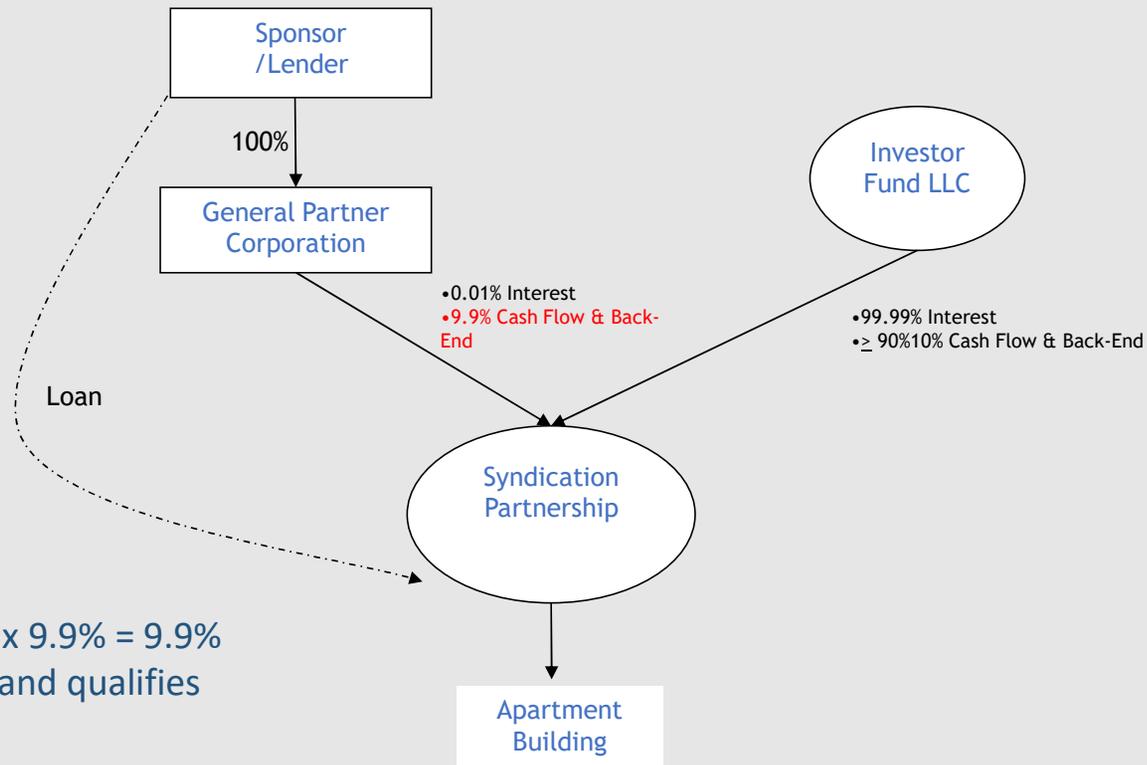


Minimum Gain – 10% De Minimis

- Minimum Gain Cure 2 – 10% De Minimis Rule - If Project lender is a governmental entity (or an entity that regularly engages in the business of lending) and the lenders direct or indirect interest in the partnership is less than 10%, then the debt will be considered unrelated debt.
 - Must limit everything below 10% - Incentive management fees and residual interests must be capped at less than 10%. General partner fees or any other distributions to partners or related parties must be closely scrutinized.
 - Two General Partners – If there are 2 General Partners, but one is not related to the lender, then the other general partner can pick up the excess cash flow above 10%.
 - Cash Flow Strategies
 - Loan Payments– Often cash flow will be absorbed for the 15-year period paying off the Deferred Developer Fee and applying 90% of cash flow to the related party debt.
 - Section 42 Right of First Refusal (“ROFR”) – If the Sponsor is a Qualified Nonprofit, then it can control the back-end with the Right of First Refusal price of debt + taxes.

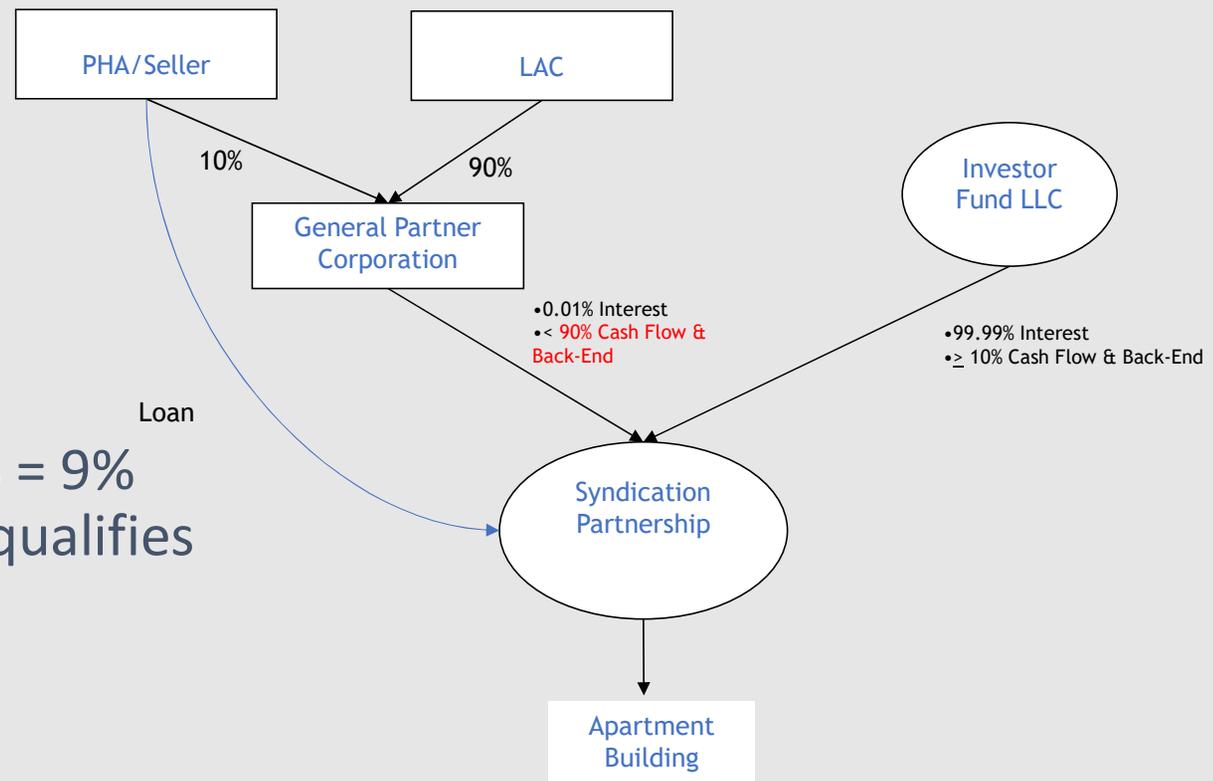
Capital Accounts – Minimum Gain – 10% De Minimis

10% De Minimis Org. Chart – Creating “Good” Partner Nonrecourse Debt



Capital Accounts – Minimum Gain – 10% De Minimis with Additional Partner

10% De Minimis Org. Chart – Creating “Good” Partner Nonrecourse Debt



PHA Interest is $10\% \times 90\% = 9\%$
This is less than 10% and qualifies
as de minimis

Minimum Gain



- Impacts of Cures 1 and 2
 - Positive Result – Investor Gets Its Credits - Investor Capital Account is allowed to go negative. This allows 99.99% of LIHTC to be allocated to the Investor
 - Positive Result – Investor Yield Maintained - Investor Yield is Maintained by receiving the losses. This maintains Credit Pricing
 - Negative Result - Exit Taxes – Because the Investor's Capital Account is negative, when it exits the Partnership, it will owe tax to the IRS.
 - Taxes Owed = 21% Corporate Tax Rate x Amount of Negative Capital Account
 - In order to exercise a GP right to call the Investor's Interest after Year 15, the GP usually has to pay the exit taxes.

Minimum Gain – Special



- Minimum Gain Cure 3 – Special Allocation of Losses to General Partner – A solution that has become more popular is to have a special allocation of non-depreciation losses to the General Partner.
 - Goal - Allocate Less Losses to Investor - so that their capital account lasts at least through the 10/11-year Credit Period –
 - Positive Result – Exit Taxes Avoided
 - Negative Result – Yield Impact – Hurts Investor Yield and may cause reduction in Credit Pricing
 - Negative Result - DRO – GP will need to have a Deficit Restoration Obligation so that it is obligated to restore its negative capital account if there is ever a liquidation.
 - Practical Result – Most GP's are comfortable with the hypothetical risk of a DRO.
 - Practice Tip – Bring Special Allocation Option up early to Investor to avoid late surprise hits to yield. Get the ability to specially allocate added to LOI.

If the Investor's **capital account is negative when it exits**, it will have to pay **exit taxes** equal to the negative capital account times its tax rate (currently 21% for corporations).

Exit Taxes

- Purchase Option - If GP exercise its option to buy out the Investor (or buy the building), that price is usually the greater of (i) FMV of the Investor's interest (or the building) or (ii) Debt + Taxes + Amounts owed the Investor
- Section 42 Right of First Refusal ("ROFR") – a 501(c)(3) or governmental entity can have a special ROFR to purchase the property for no less than (i) debt plus (ii) Taxes

Bonus Depreciation

- Bonus Depreciation is an immediate depreciation deduction for some capitalized costs.
- Available on personal property and site improvements
 - Bonus depreciation on site work can make exit taxes worse.
 - Can elect to not take bonus depreciation on personal property, site work or both.

Bonus Depreciation

- Prior to OBBBA, Bonus Depreciation was phasing out based on placement in service dates: 40% in 2025, 20% in 2026, 0% thereafter.
- 100% Bonus Depreciation is restored under OBBBA, subject to effective date rules.
 - January 19, 2025 or earlier Acquisition – eligible only for the prior 40% Bonus Depreciation
 - After January 19, 2025 Acquisition – eligible for 100% Bonus Depreciation
 - Acquisition includes signing a binding contract to acquire the property.

Bonus Depreciation

- Bonus Depreciation creates a large Year 1 loss which is valuable to Investors and increases yield and pricing.
- However, that large Year 1 loss can create capital account problems or make existing capital account problems worse.
 - Sometimes it may be best to forgo bonus depreciation on site improvements, which are 15-year property. It is unusual that forgoing bonus depreciation on personal property helps since such property would fully depreciate by Year 6 even without bonus depreciation.

Bonus Depreciation

- Technically bonus depreciation is available on used property. However, this can lead to a loss of LIHTC eligible basis.
- If a Project is acquired (land, building and personal property/site work) and some purchase price is allocated to used property personal property or site work (e.g. appliances, parking lots), but then those assets are replaced, those assets will not be counted for Eligible Basis because they won't be owned at the end of the First Year of the Credit Period.
- In contrast, if all of the acquisition price was allocated to the Projects building (and whatever is necessary to allocate to land, based on the appraisal), then, other than land costs, all of the acquisition cost will be includible in eligible basis.
- Recommendation - Avoid Appraisal/Cost Seg on Acquired Project - Just determine value of land and value of building.

PROJECT EXAMPLES



Acquire Project with a Project-based Section 8 contract with strong Section 8 rents that can support a healthy amount of permanent bonds.

Golden Goose

Have done deals where permanent sources were only:

- Construction Bonds (paid off/down with future equity)
- Permanent Bonds
- Seller Financing – see below
- Deferred Developer Fee

Rents this strong are uncommon, but sometimes possible.

Seller Financing Projects – Related Party Issues

These Projects often happen where the owner of the GP of the old owner is also the owner of the GP of the new owner. In such a case, in order to qualify for acquisition credits, the GP's interest (along with any other partners in both the old and new deal) must be less than 50%, including incentive management fee.

Overlapping Investor

If a LIHTC Investor in the new deal was also a partner in the old deal, then that Investor's interest plus the GP's interest must be under 50%.

Seller Financing Projects

- Tax-Exempt Bonds can be used with Seller Financing to create LIHTC with eligible basis costs (acquisition costs) that don't have to be paid for with current cash.
- Tax-Exempt Bonds in addition to Seller Financing
 - Note Seller Financing needs to carry AFR. Long-term, annual compounding AFR for May 2025 is 4.62%.

Seller Financing Employing Tax-Exempt Bonds

- Tax-Exempt Seller Financing – Seller gets a Tax-Exempt Note with volume cap to meet the 25% [or 50%] test.
- Some bond counsel will have a higher “true debt” standard for seller financing. Might require interest only payments.
- Some LIHTC counsel prefer this structure over the Re-Loan Structure.

Seller Financing Projects

- Re-Loan Structure
 - Tax-Exempt Bonds used to reimburse acquisition costs.
 - Seller can loan those back to the deal.
 - This helps meet the 50% test.
 - The money loaned back in should also carry AFR, since the IRS might view it as Seller financing.
 - This has been done many times, especially on redevelopment of public housing
 - Recently, one investor's LIHTC counsel did not want to do this even though bond counsel was comfortable issuing its typical "will" tax opinion.
 - Creates some extra third-party interest cost on the cash that is paid to the Seller and re-loaned in. Interest rate is usually very low since cash-collateralized.

Buy and Hold Projects

- Unlike 9% Projects, a Partnership does not need to have bonds issued in the year the acquired building is placed in service.
- LIHTC partnership purchases the building early.
- When bonds are available, the Investor can be admitted to the Partnership.
 - 18-month Time Limit.
 - Note – the Issuer would need to issue an inducement resolution within 60-days of the building being acquired.