LP Purchase Program

Customized Individual Investment Program Providing Tax Savings and Investment Opportunities for High AGI Taxpayers

Designed by:

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The following is designed to provide accurate and authoritative information with regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. The Reader should consult with his/her own tax advisors to determine the suitability of this program and whether the reader is qualified to utilize this program.

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LP Purchase Program Overview

Under the LP Purchase Program, the investor enters into an agreement with Housing & Tax Consultants, LLC (HTC) to acquire limited-partnership interests for his/her portfolio in established partnerships that own multi-family affordable housing projects subsidized by the Government. These projects operate under programs administered primarily by two Government Agencies: Housing and Urban Development (HUD) and U.S.D.A. Rural Development (RD). Projects under the RD program are the primary source of investment assets; however, we occasionally use certain types of HUD projects.

Program Benefits:
The largest benefit is tax reduction; For the qualified investor, participation in the LP Purchase Program may significantly reduce income tax. For example, a one-time investment of $150,000 would purchase a loss stream of about $100,000 per year or $1,000,000 over ten years. These reportable losses would reduce “qualified” taxable income dollar for dollar. Based on a combined state and federal tax rate of 35%, this program is designed to produce a return of at least four times the investment over the first 10 years however, there are several other areas that can add to the investor’s long-term return. Those include possible appreciation and potential cash flow. The following is a brief description of each area of return:

- **Tax Reduction:** Since the mortgages are significantly longer than the depreciation schedule, the projects tend to produce losses in the earlier years. Subsequent loans used to rehabilitate the property will increase the depreciation deductions at no cost to the investor.
- **Appreciation:** Historically, real estate tends to hold its value over time and as the mortgage is paid down, this creates equity. Another source of equity is from appreciation of the property. Neither of these should be used as a basis for investment in the LP PURCHASE program as the purpose of this program is to produce deductible losses. Appreciation should be looked at as a potential windfall.
- **Cash Flow:** Although operational cash flow is limited by government regulations, and by contract, there is a possibility of receiving some cash flow. Another source of cash flow is from re-syndication of a project. Although this may create a recapture event, the cash received can be substantial and allow the investor to replace the project for deduction purposes while receiving a cash payout.

The pricing of the limited partnership interests is based on the value of the estimated annual loss stream, as this is the most predictable element, but is also dependent on acquisition costs. Due to the inherent risks involved with long-term programs, the program is priced to produce substantial returns based only on the tax savings provided by annual project losses over the first ten years. Losses continue after the first ten years, but are not used in computing the purchase price.

The added value of appreciation and cash flow cannot be calculated easily, but can represent potential future value to the investor. Therefore, we have not included these items in the valuation or cost of the limited-partnership interests.

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Investor Qualifications:
The LP Purchase Program provides significant tax benefits to a limited scope of investors, which generally includes only two groups of taxpayers: those with large amounts of passive income and/or rental real estate professionals (see tax information section for details). To qualify as a rental real estate professional, the taxpayer must initially meet two tests: over 50% of activities in rental real estate; and more than 750 hours per year.

Projected Returns:
HTC provides calculations for the investor to share with their advisors to help determine the potential returns available. HTC reviews and analyzes the project's tax returns over the previous three years and then averages them to determine returns and the purchase price. HTC also reviews the project's annual Audits, Budgets, and Statement of Loan accounts to determine the viability of the project.

Description of Assets:
The limited-partner interests acquired typically represent 50% to 99% of the lower-tier partnership interest. This lower-tier partnership owns and operates a multi-family apartment building called a project. The following are some of the primary aspects of these projects:

- Projects are limited disbursement projects where the distributable cash flow is limited by a formula and regulated through the budgetary process.
- The average size of RD projects is 25 units – HUD projects are generally much larger.
- RD projects are located in predominantly rural areas; HUD projects are located predominantly in urban areas.
- Both HUD and RD projects generally have some form of rental assistance, and RD projects typically have interest-rate subsidies that effectively reduce the mortgage interest rate to 1%.
- Projects are professionally managed.

Program Design and Structure:
The investor forms a General Partnership or other entity to hold the limited partnership interests. The managing general partner is Affordable Housing for America, Inc. (AHFA) (see Managing General Partner) with a 1% economic interest. The investor general partner has a 99% economic interest. We use a general partnership format to avoid the problems associated with limited partnerships including tax shelters, private placement registration and the showing of active participation for tax purposes (see Acquisition Process for more detail).

Payment:
Investor makes a one-time capital contribution at the time of purchase.
If the Investor's needs change and they need more deductions, they can purchase additional projects and add them to their General Partnership.

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Managing General Partner:
Affordable Housing For America, Inc. (AHFA) is the managing general partner. AHFA is a public non-profit 501(c)(3) organization formed in 2001. Its sole mission is preservation of affordable housing. The directors of AHFA are real estate professionals and interested parties in the affordable housing industry.

Asset Management Services:
AHFA as the managing general partner is responsible for the asset management services of the LP Purchase Program. These services consist of the following:

- Gather annual financial information from the lower-tier partnerships including: complete tax returns, annual project Budget (Form RD 3560-7), annual Statement of Loan Account (Form RD 3560-54), and annual audit reports if applicable.
- Prepare Tax Returns for the upper-tier general partnership.
- Review information to isolate problem areas, create solutions, and implement remedies.
- Assist lower-tier GP in securing funds for project rehabilitation and rental assistance. This includes applying for grants, tax credits, subsequent loans, and debt restructuring.
- Determine the status of equity returns and collect funds.

As compensation for its services, AHFA receives the first $1,000 per project of equity return collected from each of the lower-tier partnerships. AHFA also receives 50% of any additional equity return collected. Since the equity return can only be received if the project is financially in compliance, it creates an economic incentive for the managing GP to help solve any problems with the projects.

Risks:

Risk is generally greater in long-term programs, like the LP Purchase Program, than in short-term programs. These risks include: default, negative capital, changes in the tax code, age of the program and estate issues & taxes, and these are discussed individually as follows:

Default:
The financial and/or physical condition of a project may deteriorate to the point that the mortgagor accelerates the note or forecloses on the property. This would have the negative effect of exposing the investor's negative capital account to taxation and may result in a debt forgiveness issue with the resulting gain taxed as ordinary income.

Negative Capital Account:
Contributions and income are additions to the partner's capital account. Conversely, losses and withdrawals are subtracted from the partner's capital account. The investor is able to take losses greater than the amount they contribute to the partnership due to the non-

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recourse financing. Over time, the investor will accumulate a significant negative capital account that will need to be reconciled at some time.

Taxation of a partner's negative capital account can be triggered by several factors including default, termination of partnership, or the sale or transfer of the partner's interest.

Phantom Income:
When depreciation is exhausted or no longer offsets the project income, the project will produce what we call "Phantom Income". This is taxable income that is not accompanied by cash flow. The primary sources of Phantom Income are: the principal portion of the mortgage payment, payments into the reserve account and interest earned on the reserve account, all of which are non-deductible and require operating income to fund.

Changes in the Tax Code:
Congress is constantly changing or adapting the Tax Code. An act of Congress limiting or eliminating the loss deductions would be a cataclysmic event. If Congress passes legislation to adopt a flat tax, the potential value of the tax losses could greatly diminish.

Changes in Investor's Tax Status:
Most investor's income tends to fluctuate from year to year and is not static. Temporary or permanent drops in the investor's taxable income may limit the effectiveness of the loss deductions rendering them worthless.

Project Age:
As mentioned earlier, the investor is acquiring LP interests in aged projects. The typical age of the project is fifteen to eighteen years. Maintenance and rehabilitation are major concerns with aged projects. Competition can also be a problem if newer competitive projects are developed nearby.

Mitigation of Risks:

A great deal of care and attention has been given to the mitigation of the risks involved in this long-term program. Our experience in the affordable housing industry since 1993 has given us insight into identifying and reducing risks. The following are some of the project elements intended to reduce risk exposure:

Project Pricing:
We have built in a very attractive return, which should offset many of the potential risk factors. This is based on the cost of acquisition and could change with increased competition.

Diversification:
To minimize default risk, we try to diversify the program in three areas: geographical location, project size (number of units) and project quality. The larger the investor need for tax deductions relates to a greater number of LP interests in the program and hence, more diversification.

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Rental Assistance:
Rental assistance is a Government program that provides financial assistance to the tenant or to the project or both. Most of the projects have some amount of rental assistance. This allows the project to achieve a higher rent rate with no increased cost to the tenant, which in turn provides additional cash flow to the project.

Non-Recourse Financing:
Most of the debt financing on projects placed in service since the late 1970s is non-recourse to the owner (lower-tier limited partnership). Financing on HUD projects is generally provided through third-party insured loans. Financing on RD projects is via direct loans from the Department of Agriculture. This eliminates the debt risk to the investor on defaults, but does not eliminate the tax ramifications.

Government Support:
The Government has been very active in working with the owners to preserve affordable housing. There are numerous programs available to the knowledgeable owners to assist them in dealing with problems such as debt restructuring or forgiveness, offer-in-compromise, grants, protective advances, etc.

Rehabilitation:
As the portfolio of affordable housing projects have aged, the Federal Government, State Agencies and the affordable housing industry have designed and implemented financial tools to assist the owners in maintaining the project. These include: establishment of reserve accounts, subsequent loans, tax credit programs, rental assistance, grants, third-party subordinated debt and low interest loans.

Qualified Disclaimer:
To counter the risk of losing the step-up in basis at the death of the investor, we suggest that the investors modify their wills or trusts to include a qualified disclaimer. This gives the heirs the ability to assess the current tax law to determine whether to accept the program or to disclaim it to a qualified non-profit organization. If disclaimed, the program and the negative capital account are transferred to the non-profit, thereby avoiding the deceased's estate.

Special Allocation Strategy:
An integral part of the LP Purchase Program provides a strategy to allocate Phantom Income to the non-profit managing general partner. This is initiated when a project begins to produce Phantom Income and can be done until the project debt is paid up to the negative capital account basis. This should allow the program to outlive an investor in their 60s or older at the time of purchase.

Offer in Compromise:
When a project defaults and the government forecloses, there is a program available to the owners to make a compromise offer. The regulations require the Government to accept an offer equal to the value of the asset or current appraisal value. In most cases, this can be substantially less than the outstanding mortgage, and the reduced debt load may allow the project to continue operations.

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Rollout Plan:
Investors under the age of 60 at the time of purchase will need to exit the program after the tax losses are used-up, as it is unlikely that the program can outlive the investor before the negative capital accounts are exposed to tax. For these investors, we have created a rollout plan that uses a combination of a part sale – part gift (Bargain Sale) strategy. The investor obtains an appraisal of the LP interests and sells them to a non-profit for a reduced amount. This should provide a charitable gift deduction to help reduce overall tax liability and some cash to pay the resulting tax.

After the fifteenth year, HTC will do an assessment of the program to determine the appropriate time to initiate the rollout plan. This will be conducted over several years to maximize the investor's use of the charitable deductions, as they are limited to a percentage of AGI.

Acquisition/Rehab:
HTC monitors the projects in each investor's portfolio for changes that may warrant participation in the acquisition/rehab program. This program utilizes tax credits and other funding sources to rehabilitate the project. An integral part of this program calls for establishing a new partnership, which then acquires the project from the current partnership. This needs approval of the LPs and allows for a significant gain on the sale of the LP interests. In most cases, a project that was purchased originally for $30,000 may bring between $100,000 to $150,000 or more. Depending on how long the project has been held, it may provide enough cash flow to pay for the resulting gain on the negative capital account as well as provide enough cash to replace the project being sold.

Prior to acceptance of an acquisition/rehab offer, HTC will compute the probable recapture tax and other costs as well as potential net cash flow.

Thank you for taking the time to inform yourself about our program.

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