What is a capital account?

•What is a capital account?

- A capital account is a kind of "ledger page" for each member which keeps track of its investment. Each member's capital account starts at zero.
- It is then INCREASED by cash and property the member contributes to the LLC plus its share of LLC profits and gains. This includes nontaxable items like bond interest
- The capital account is DECREASED by cash and property the member takes out of the LLC and its share of losses. This can also include non-deductible items like syndication expense and tax credit basis adjustments.
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77

SIMPLE Illustration

Basic capital account math –

- IM contributes $1M to an LLC; her capital account is $1M
- IM is allocated a $100,000 loss; her capital account falls to $900,000
- IM is allocated a $200,000 gain; her capital account rises to $1,100,000

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78

• When capital acct close to $0 IRS has issues,
• If falls below $0 = bad

Some Basic Rules of THE CAPITAL ACCOUNT METHOD – 1

- The IRS has some basic rules:
  - Losses can be allocated to members with positive capital accounts, and in certain other situations described below.
  - Allocations of profits and losses cannot be transitory. (not permanent)
  - RETCs are allocated the same way as "bottom line profits"
- Capital account method requires that the parties liquidate in accordance with their capital accounts

- [More basic rules on next slide]

Add up Capital Accts = Value of project

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79

Inside Basis = cost to build
Outside " = " + Debt

No such thing as Negative Basis
Neg Capital Acct, losses financed by debt

Some Basic Rules of THE CAPITAL ACCOUNT METHOD – 2

- Once capital accounts go below zero, then losses can be allocated to a member in these situations:
  - The IRS is confident that the member will be allocated gain later on to make up for the losses allocated today. ("Minimum Gain")
  - The member has agreed to "fund" the losses by putting up additional money at some point. ("Deficit Restoration Obligation" or "DRO")
  - The member bears the risk of losing actual cash or assets on account of a loan to the partnership because either he/she/it made the loan, or he/she/it guaranteed the loan

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80

Kinds of Debts

Nonrecourse debt -- Debt owed by the LLC that no member of the LLC is liable for.

Partnership/LLC Nonrecourse debt --Often nonrecourse debt is borrowed from a third party, e.g., The LLC borrowed $1M from the bank, and no one personally guaranteed the loan. But that is not always the case.

Partner/Member Nonrecourse debt – This is nonrecourse debt that is provided by one of the members of the LLC or an affiliate. E.g., The LLC owes a $1M deferred development fee to the developer, which is owned by X, who also owns the managing member of the LLC.

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81

Minimum Gain – 1

Minimum Gain – This is the "minimum gain" that a project owner would recognize if the project was foreclosed on. It is equal to the amount of nonrecourse debt on the property less the owner's basis in the property. E.g., project with a basis of $10M is subject to a nonrecourse debt of $12M. There is $2M of minimum gain. If there was a foreclosure, then even if the property went unsold at the foreclosure sale, the IRS would treat the property as sold to the lender for the amount of the debt – $12M less $10M equals $2M of minimum gain.

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82

Minimum Gain – 2

Why do we care about Minimum Gain? We care, because the IRS says: "We'll let you take losses today if we know you will recognize that much gain later on. The best that could happen is the venture will have income and you will use that money to pay off the debt. The worst that will happen is the property will be sold at foreclosure, and you will recognize the minimum gain. However, a lot depends on whether the minimum gain is allocated to the MM or the IM.

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83

Minimum gain – 3

Minimum Gain Chargeback – The allocation of minimum gain to a member that enables it take that amount of deductions. E.g., Y has a 99% interest in the LLC. His capital account is zero, but the company's loss for the year is $1M, and there is $1M of minimum gain. Y can take a $990K loss, because Y has the potential to have a $990K minimum gain chargeback:

- If things go well, the company will have $1M of income and use the income to pay off the debt; Y will be allocated 99% of that income, and the IRS is happy.
- If things go badly, the lender will foreclose, the company will have $1M of minimum gain. Y will be allocated 99% of that gain, and (again) the IRS is happy.

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84

Minimum gain – 4

Partnership Minimum Gain -- Like the preceding illustration, where the debt is attributable to partnership minimum gain, then it is usually allocated 99% to the IM, and this enables it to be allocated losses to the extent of this amount.

Partner/Member Nonrecourse Debt Minimum Gain – This is minimum gain attributable to member nonrecourse debt. E.g., a project with a basis of $2M owes a $3M development fee X, who also owns 90% of the MM. There is $1M of minimum gain, but it is all "member nonrecourse debt minimum gain" that is allocable to the managing member. As a result, losses attributable to this debt may go to the MM, and not the IM.

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85

Back Leverage and Its Impact on Transactions

- To avoid foreclosure risk, many investors prefer that the managing member put in all its cash as capital, so that there are no loans at the entity level.
- They then worry about what happens when the basis reduction and allocation of losses reduces their capital account to zero. Do the next losses go to the MM?
- Often, to assure that the losses can still be allocated to the IM, they have the IM undertake a "deficit restoration obligation" or "DRO." [see next slide]

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DROs

Deficit Restoration Obligation or DRO -- A member's agreement to contribute capital to the company when it liquidates to cover some or all of the negative amount of its capital account.

> E.g., X has a zero capital account, but it has $1M in cash that it distributes to X. As a result, X's capital account is now minus-$1M. X agrees to restore the $1M with a DRO. We ***don't*** have to specially allocate gross income to him, and he doesn't have to have a share of minimum gain.

OR

> Y has a zero capital account, and the only debt is a deferred development fee owed to the developer. The developer is owned by X, who also owns the managing member. We want to allocate $100K of losses to Y. It can agree to a $100K DRO and take the losses. Again, we ***don't*** have to specially allocate gross income to him, and he doesn't have to have a share of minimum gain.

NOTE: a DRO is ***actual cash,*** while an allocation of gross income or a minimum gain chargeback is only the tax rate (e.g., 35%) times the income allocated.

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87

Why might a DRO not be a problem?

Normally, an IM doesn't want to have an obligation to put in more money, like a DRO.

However, typically, with a DRO:

- The LLC expects to have profits in future years, so the IM will be allocated income to reduce the DRO to zero, and not have to lay out actual cash
- If the IM sells or transfers its interest, it is relieved of the DRO obligation, and this results in income (taxed at the current rate), and not a dollar-for-dollar cash obligation.

BUT: The IM can still be allocated losses with a DRO, but these get "suspended" because it doesn't have any basis in its membership interest

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88

What should the investor's share of losses be?

- If the venture sells electricity: IRS has taken the position that electricity is a "good" that has a "cost of goods sold." Note: this is not an issue if the facility is leased, and the investor is getting a share of rental income instead of electricity sales.
- Based on this analysis, depreciation is a cost, not a separate item.
- So, if investor gets 99% of the profits, this should take the cost into account, including depreciation.
- Some counsels like to see the investor get 99%/67% in during the recapture period. (67% is permitted by the regulations without causing recapture). Many counsels want the investor to get 99% of all the tax items in at least the first year, regardless of whether the entity is selling electricity or leasing the facility and collecting rent.
- Taking bonus depreciation in the first year would make the investor's capital account go wildly negative in the first year, requiring a big DRO.

Illustration of the Bonus Depreciation Problem

- $10M project generates $3M of tax credits, a $1.5m basis adjustment and $8.5M of depreciation. Assume that investor's capital contribution is $3.5M
- If bonus is used, and the investor gets 99% of everything, then its capital account is $3.5M less 99% of $1.5M basis reduction and 99% of $8.5M of bonus depreciation, all in the first year, or ($6,400,000).
- The IRS will not respect this allocation unless the deal has either (i) a DRO of $6.4M or (ii) minimum gain of $6.4M, or a combination of the two. Note that the investor cannot use the loss if the DRO method is used, because it doesn't get basis from a DRO. With minimum gain, the investor will have a taxable gain when it leaves the deal.
- If the partnership did 5-year MACRS, then the GP would be allocated a $1.5M basis adjustment and a $1.7M loss, and still have a positive capital account of $300,000

Should the Entity Take Bonus Depreciation?

- Once the IM's capital account goes to zero, is it okay for the next losses to go to the MM?
  - Compare PPAs and "costs of good sold" with leases
  - Do a DRO in the first year, or all 5 years? Reduce share of profits and losses to 67% in years 2-5?
  - Compare first year losses with and without bonus depreciation

Other things to Watch out for – 1

- Remember that we want to allocate profits to the Investor, so that it can also be allocated the tax credits.
- In general, this is easy. But there are some situations in which the allocation of profits might not go as expected:
  - We worry that if cash flow goes to the MM, the IRS might say that this is "profits," and the credits must follow. But there are other ways to analyze this.
  - We worry that if the MM has a negative capital account, a gross income allocation may be required to bring his capital account back to zero, and this means that the IM is *not* being allocated all the profits, in which case some of the RETCs should go to the MM.