FINANCIAL INSTITUTIONS REFORM AND EXPANSION PROJECT

Debt Market / Infrastructure Component

LIMITED PARTNERSHIPS
A POTENTIAL INFRASTRUCTURE SPONSOR

(Draft)

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LIMITED PARTNERSHIPS: A POTENTIAL INFRASTRUCTURE SPONSOR

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Limited Partnerships: A Potential Infrastructure Sponsor

Introduction to Limited Partnerships: Definition and Structure

A **Limited Partnership** is an unincorporated association that is a direct participation program organized as a limited partnership whose partners are one or more"general partners" and one or more "limited partners", organized in order to achieve a specific project or set of purposes over a defined period of time One or more entities, whether individuals or corporations, function as the **General Partner**. The general partner bears unlimited authority and liability, and is liable for project management, legal, or financial responsibilities. The **Limited Partner** bears limited liability and is not involved in a project's day-to-day management Sometimes called a "limited partnership investor" or more generally a "participant"

The limited partnership structure is an attractive financing vehicle for a firm or individual that seeks to develop a project for which equity resources are insufficient. Credit may not be available for a variety of reasons, or may not be accessible at the rates and terms necessary for project viability If the undertaking is a specific project, the creation of a separate public corporation--created to exist in perpetuity--may not be desirable despite the fact that a corporation can issue shares for purposes of amassing equity investment.

A limited partnership enables an individual or group to gain access to capital investment from investors, in this case limited partners, without issuing shares through normal trading venues In a limited partnership, limited partners place investments with a general partner for utilization in a specified project or purpose. The rate of return paid to limited partners may be agreed upon in the partnership agreement or determined by project cash flows. In either case, the limited partners cannot lose more than their initial investment. Neither can they participate in the project's management in an active fashion, although the agreement can include the provision of regular financial and progress reports by the managing general partner

U.S. law is well-defined in terms of the rights, responsibilities, and limitations of both general and limited partners. For example, it protects limited partners from liability resulting from lawsuits, while requiring certain financial information and reports from the general partner on the operations of the general partnership. Income to limited partners is not taxed first at the general partnership level; but, instead, is treated only as income to the individual general and limited partners, whether they are individuals or firms

Limited partnerships allow organizations, particularly nonprofits and other organizations whose resources are historically limited, to raise funds from investors and employ them in projects for the entire project life without the principal and interest payments required of most lenders For this reason, a limited partnership can be an especially appropriate vehicle for financing infrastructure, housing, and other projects that have relatively long-term lives and cash flows which do not generate substantial short-term gains. General partners are able to attract resources from limited partners due to the strength and other attributes of the project, even if their own financial position is not attractive in its own right

Investors who are attracted to limited partnership-funded projects are generally those with low short-term needs for the repayment of their investment Their cash flow requirements must be consonant with those of the project. Ideal candidates for limited partners in the US market are professionals with high incomes, such as doctors and lawyers whose working years will extend to at least until the end of the project in which they invest and who place long-term gains from investment over short-term cash flow or income.

Example:

A housing development may require a total of $1 million to develop An experienced builder wishes to undertake the project, but cannot provide the $200,000 equity investment required by financial institutions willing to lend to the project The builder decides to consider a limited partnership to raise the funds, with his own firm operating as the general partner The general partner does not have to provide any of the equity himself, but must raise it through the partnership He may contribute equity, or may provide working capital, the lease of equipment used for construction, or merely the managerial skill the project requires for initiation and later management.

Raising Capital

In this case, the builder may seek to raise all equity He creates a limited partnership with the assistance of his lawyer, who also arranges for a broker to market and sell the limited partnership shares--perhaps 20 shares at $10,000 each. Such a small partnership may readily be created within the boundaries of the state or area in which the builder resides *A limited partnership which operates within a single state need not comply with federal disclosure requirements Conversely, the sale of partnerships on an interstate basis requires the provision of legal documents which comply with federal regulations; however, these are not complex.* The attraction of limited partners generally focuses on the expected financial strength of the project, as presented in a *prospectus* or project description with *pro forma* financial statements, and the reputation of the general partner

Management of Capital

The managing general partner receives the $200,000 in limited partnership investments and uses them as the equity to leverage a loan for the project. The total funds--equity plus loan--are then managed by the general partner for purposes of project development and operation If the housing is built for sale to residents, the general partner is solely responsible for the construction, marketing, and sale of the houses. In the case of rental housing, the general partner is similarly responsible for the management of the housing and ensuring that tenant rents are collected, with payment made to the lender in a timely manner that protects the financial interests of the partnership

Partnership Agreement

The partnership agreement--the contract which governs the relationships between the general partner and the limited partners--may delineate the payments or distributions to be made to limited partners during the life of the project In some US federal housing finance programs which lend to limited partnerships, the return on equity is limited to 8% per year The partnership agreement is expected to describe the fiscal responsibility of the managing general partner The general partner can distribute profits or to reinvest them in the project, whichever has been determined to be preferable to the limited partners

If the project fails, the limited partners may lose their investment. In this example, each limited partner's financial liability is limited to his or her $10,000 share. Should losses of the project exceed the total equity investment, the general partner may be sued for damages by the lender, the tenants, or others who have legitimate grievances Limited partners are sheltered from litigation under current US law.

US Tax Law

US tax law confers special status on limited partnerships. Investment (or limited partnership shares) in certain designated activities, such as low income housing, results in access to tax "shelters" which are of considerable benefit to investors. Typically, this works as follows: The limited partners are able to subtract their partnership contribution (the $10,000 share in the above example) from income for the year in which the contribution is made. If distributions or profits are received during the project life, these are counted as income. The original investment is considered as income only when it is returned to the limited partner. If, in this example, the partnership is created for a twenty-year investment in a housing project, then the original $10,000 share becomes *income* at the end of the twentieth year. Such a scenario is ideal for a high-income individual of age 45 who wishes to pay less in tax now, and who will retire by age 65. Receipt of an additional $10,000 during retirement would likely mean that such income is received while the individual is in a lower income class or *bracket* for tax purposes. Thus, he or she pays less tax later on the $10,000 income than would have been paid during the year in which it was originally earned.

Role of Nonprofit Corporations

In the US, a number of nonprofit corporations have become involved in the formation of limited partnerships. By nature, nonprofit corporations typically do not have sufficient equity to undertake large projects, which makes it difficult for them to gain access to credit sufficient to meet project requirements Nonprofit corporations may, however, function as managing general partners in limited partnerships. In order to protect potential limited partners from spurious undertakings by general partners who lack background, any level of financial strength, or genuine commitment to the venture proposed, US securities laws require *some* level of investment by the general partner This may be an *in-kind* contribution of professional services, the provision of land for development, or other non-financial assets that can be valued fairly or objectively. Many cases involve rather nominal provisions of financial contributions by the nonprofit general partner along with the donation of professional and accounting services to the project.

Under US tax law, nonprofit general partners gain a particular advantage by developing housing and other depreciable assets through use of the limited partnership vehicle. The assets created by the project--such as housing in this example--are able to be depreciated, providing an additional category of *expenses* to be deducted from taxable income. As nonprofit corporations are not taxed, there is no advantage to be gained by them from this ability to account for depreciation Therefore, the value of depreciation can be *sold* to limited partners who *are* able to take advantage of depreciation.

With reference to the $1 million housing project example, the creation of a partnership with a nonprofit general partner means that all of the depreciation may be distributed among the limited partners. Assuming that all $1 million is depreciable, this means that each of the twenty limited partners can write 5% of the depreciation off of his or her income each year during the life of the project. If the assets are depreciated on a straight-line basis (that is, an equal amount each year), the total value of depreciation is $50,000 per year, representing a reduction in taxable income of an additional $2,500 for each limited partner.

Clearly, the value of depreciation in such a case is real and substantial to such investors In fact, it is so valuable in the US market that limited partners are typically willing to give up additional cash at the time of investment in exchange for this $2,500 reduction in taxable income each year for twenty years. It is common for nonprofit general partners to negotiate for an additional contribution early in the project in exchange for the transfer of such benefits to the limited partners. The value of the benefits may be considered equal to the present value of the stream of *tax credits* or reductions in income anticipated, discounted at a rate which reflects the investor's opportunity cost of capital. If investors or limited partners expect an 8% return on equity each year (also a fairly realistic rate of return to expect from investment in the stock market), then 8% may be considered a fair rate of discount. In this case, the present value of the benefits to *each* limited partner would be $24,545. A request for an additional contribution not exceeding this amount would be reasonable on the part of the managing general partner

Assume that each limited partner agrees to an additional contribution of $20,000 for a total of $400,000 These funds could be used for other activities of the nonprofit, such as general overhead and operations, for a special purpose project for which no other funds are available, or for the provision of subsidies to the ultimate beneficiaries of the project for which the limited partnership is created. This last option is a common choice among nonprofit general partners in housing projects in the US For instance, the $400,000 may be used as a pool to provide subsidies to permit some very low income residents the opportunity to reside in the rental housing developed, to purchase certain additional items of equipment and furniture for them, or to provide access to water and sewer services at no cost

Another Alternative

An innovative use of the limited partnership form has been made by Partners for the Common Good (*Partners*), a loan fund which borrows funds to onlend to community-based financial intermediaries who provide housing, business development opportunities, and other forms of credit generally not available at affordable rates and terms from local banks Over a five-year period from 1989 to 1994, Partners raised $3.6 million from numerous limited partners throughout the United States The managing general partner was an organization supported by a religious community, which had assets to invest and accounting and legal services to contribute. Limited partners, each of who invested between $25,000 and $250,000, were mainly other religious communities more concerned with the purposes of the fund than its potential financial gains. This experiment was self-sufficient in terms of covering all operating costs, lost less than three-tenths of one percent of the total value of the fund, and was able to pay limited partners a 3% annual distribution as well as the full value of their original investment at the close of the operation.

Based on this success, Partners created a second five-year limited partnership with a similar structure. To date, it has been successful in attracting 98 limited partners with total assets of $7.5 million. Funds are loaned out at an average rate of just under 6%, providing affordable capital to 52 community-based organizations throughout the US, Central and South America, and South Africa. In this case, most limited partners are nonprofits themselves There are no depreciable assets; however, there is no advantage to depreciation by this class of limited partners.

In some cases, funds are used to match or leverage additional resources from banks and other institutions. This not only extends the value of the principal of the fund but assists in the creation of banking relationships for organizations without prior access to commercial credit. These relationships are often able to be extended to the individual members of low-income communities served by local intermediaries, with powerful benefits to those who were not considered creditworthy by more traditional lenders in the past

Conclusion

The limited partnership form can be a viable and valuable vehicle to create projects that require substantial capital investments without having to respond to normal investor demands for short-term financial gains. Considerable planning of the project and marketing to potential investors must precede the creation of the partnership, however, the benefits can be more than adequate to warrant this input. Tax laws and their provisions of benefits and penalties to various income classes must be understood prior to proposals to initiate such ventures, and it must be understood that tax and other legal or regulatory changes could affect the ongoing viability of the partnership and the willingness of limited partners to maintain their investments.

It is equally important to assess competing opportunities for potential investors in order to project likely demand for investment partnerships. Skill in financial planning and project management on the part of the managing general partner is essential, along with a solid reputation in the sector in which project activity is planned.

A sound project--for which there is a strong demand by beneficiaries or participants, and which offers reasonable cash flows in light of investor expectations--is the other essential ingredient. While most projects for which partnerships have been created in the United States involve the development of low-income housing, loan funds are another proven use of the limited partnership structure. There is no reason not to consider the creation of limited partnerships for the development and operation of other long-term assets such as urban environmental infrastructure--if financially viable projects can be developed

Glossary

Account

An open-end, commingled separate investment account managed by professional asset managers

Direct Participation Program (DPP)

An investment vehicle which provides for "flow-through" tax consequences regardless of the structure of the legal entity or vehicle for distribution, subject to certain exclusions.

General Partner

The purchaser of an interest in a direct participation program that is a limited partnership, limited liability partnership, or master limited partnership, who bears unlimited liability and is responsible for its day-to-day management. Sometimes called an "issuer" or more generally a "participant" in the direct participation program

Leverage

The ratio of the total partners' debt to total partners' equity

Limited Partner

The purchaser of an interest in a direct participation program that is a limited partnership, limited liability partnership, or master limited partnership, who bears limited liability and is not involved in its day-to-day management. Sometimes called a "limited partnership investor" or more generally a "participant" in the direct participation program.

Limited Partnership (LP)

An unincorporated association that is a direct participation program organized as a limited partnership whose partners are one or more"general partners" and one or more "limited partners", and conforms to applicable federal or state statutes that regulate its organization

Limited Liability Company (LLC)

An unincorporated association that is a direct participation program organized as an LLC whose owners are "members", and conforms to applicable federal or state statutes that regulate its organization.

Limited Liability Partnership (LLP)

An unincorporated association that is a direct participation program organized as a limited liability partnership whose partners are one or more "general partners" and one or more "limited partners", and conforms to applicable federal or state statutes that regulate its organization

Manager Approximated Value (MAV)

The approximation of net asset value according to the manager, as reported either verbally or in the most recent financial statements

Master Limited Partnership

An unincorporated association that is a direct participation program organized as a master limited partnership whose partners are one or more "general partners" and one or more "limited partners", conforms to applicable federal or state statutes that regulate its organization, and is listed on a national stock exchange

Member

The purchaser of an interest in a direct participation program that is an limited liability company (LLC), who bears limited liability and may be responsible for its day-to-day management Also sometimes called a "LLC investor" or "participant" in the direct participation program.

Net Operating Income (NOI)

The net operating income of the security on a per unit basis after all expenses and after adding back non-cash expenses such as depreciation and amortization, based upon the most recent statement of operations published by the issuer or sponsor, multiplied by the number of reporting periods in a year

Net Operating Income/Price (NOI / Price)

The Net Operating Income divided by the Offering Price.

New Issue Market

Market in which properties or securities are sold for the first time; the issuer and its underwriters receive proceeds from the sale of shares or units. When shares or units are offered to the public, this is sometimes called an Initial Public Offering.

Number of Units Offered (No. Units)

How many interests from a given block are available for purchase (listed separately for each block)

Offering Price

An indication of the price which is currently acceptable to the sellers. This is also typically the lowest acceptable bid at auction. However, offering prices are generally subject to the results of a competitive auction process, which may result in actual purchase prices higher than those shown

Original Price

The original initial public offering price per unit.

Percentage Ownership

This is the size of the block for sale as a percentage of the total Account

Private Limited Partnerships

- **General.** Limited partnership entities that are not registered with the US Securities and Exchange Commision (SEC) and/or state regulators (i.e., exempt from registration under Regulation D of the U.S. Securities Exchange Act of 1934) and distributed in a private offering to accredited investors by broker/dealers and/or by the sponsor.

- **Number of Investors.** Many private limited partnerships are held by 50 or fewer owners who are accredited investors, and sometimes are owned by only a few individuals
- **Original Investment Size.** Many private limited partnerships have been offered with individual interests (called "units") ranging in price from $10,000 to $100,000 or more Minimum investments are commonly restricted to $50,000 or more.

Public Limited Partnerships

- **General.** Limited partnership entities that are registered with the SEC and/or state regulators (i e., not exempt from registration under Regulation D of the U.S. Securities Exchange Act of 1934) and distributed in a public offering by broker/dealers and/or by the sponsor.
- **Number of Investors.** Generally, public limited partnerships have raised capital from many hundreds or thousands of investors
- **Original Investment Size.** Many public limited partnerships have been offered with individual interests (called "units") ranging in price from $1 to $10,000, with $1,000 being a very common of unit size Minimum investments are commonly restricted to $5,000 or more, or $2,000 or more for Individual Retirement Accounts.

Real Estate Investment Trust (REIT)

An unincorporated association that is a REIT whose owners are shareholders, and conforms to applicable federal or state statutes that regulate its organization.

Secondary Market

Market in which properties or securities are bought and sold subsequent to their original issue; the original issuer does not participate in the trading or its proceeds except insofar as it also holds shares or units. Stock exchanges and over-the-counter markets are secondary markets According to various rules published by the Internal Revenue Service, transactions in limited partnership securities do not constitute the existence of secondary market, insofar as various guidelines and circumstances adhere to the trade

Shareholder

The purchaser of an interest in a REIT, who bears limited liability and may re-elect directors who are responsible for its day-to-day management Also sometimes called a "REIT investor"

Sponsor

The individual, partnership, corporation, association, or other legal entity which directly or indirectly provides management services for a limited partnership whether as general partner, pursuant to contract or otherwise

Tax Credit

The actual tax credit.

Total Credits

The dollar amount of all tax credits paid since the inception of the program