Novogradac
Journal of Tax Credits
News, Analysis and Commentary On Affordable Housing, Community Development and Renewable Energy Tax Credits

April 2013, Volume IV, Issue IV

Published by Novogradac & Company LLP

Limited Partner Exits Prior to Year 15

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On July 30, 2008, the Housing and Economic Recovery Act of 2008 (HERA) was signed into law. A number of HERA's provisions significantly affected projects financed with the proceeds of low-income housing tax credits (LIHTCs) under Internal Revenue Code (IRC) Section 42. Prior to HERA, the IRC required the seller of a building (or an ownership interest therein) in a LIHTC project post a bond to avoid recapture, if such sale was to occur prior to the end of the project's 15-year tax credit compliance period. Recapture bonds were very expensive, making them virtually cost prohibitive. As a result, there were occurrences of early limited partner buyouts in the industry.

HERA repealed the recapture bond requirement for early building dispositions occurring after July 30, 2008, as long as the seller reasonably expects that the building will continue to be operated as a qualified low-income building for the remainder of the LIHTC compliance period. In lieu of the recapture bond requirement, HERA extended by three years the statute of limitations for LIHTC previously claimed that could be recaptured. This article will examine some of the issues and challenges of early limited partner exits from the perspective of the limited partner and the general partner, and is the second in a series of articles addressing issues facing a LIHTC project as it approaches year 15.

The removal of the recapture bond requirement presented investors with an interesting exit option few had previously considered. It should be noted, however, that because of the pre-HERA recapture bond requirements, few project partnership agreements contemplated an early limited partner exit, so there are rarely provisions in partnership agreements regarding the same. As a result, a limited partner wishing to exit a partnership early (or a general partner desiring the early exit of a limited partner) should be prepared to negotiate the terms of the buyout, with the understanding that there is no contractual obligation requiring the parties to consummate the transaction.

There are a number of scenarios under which a limited partner may want to exit a partnership prior to the expiration of the tax credit compliance period. For example, the LIHTC project may have delivered its credit stream despite many less-than-desirable characteristics, or a downturn in the project's real estate market may have caused higher-than-anticipated vacancy rates or lower-than-anticipated rents, unexpected capital needs or no or limited projected residual value for the project. Under these circumstances, the limited partner may strongly consider exiting from the partnership prior to the end of the tax credit compliance period.

Additionally, assuming the project has delivered its LIHTCs, the limited partner may wish to relieve itself of its obligations to its ultimate investor, most notably its asset management and reporting obligations. These duties can be burdensome, both financially and from a man-power perspective. A limited partner may also wish to exit an LIHTC partnership prior to the end of the compliance period in order to manage its losses or exit tax liability. For example, the limited partner may be able to reduce or eliminate potential exit taxes that may arise from the occurrence of losses later in the LITHC compliance period.

If the limited partner negotiates an early exit from the partnership, it would be prudent to take measures to protect itself from recapture liability for the balance of the LIHTC compliance period. Recall that the limited partner may only dispose of its interest because it reasonably believes that

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the building will be utilized as affordable housing through the remainder of the LIHTC compliance period. As a result, the limited partner will likely require an indemnity against recapture, backed by a credit worthy entity, in the event the building is not utilized as affordable housing for the balance of the compliance period. Where the limited partner has serious concern that the general partner will not be able to maintain the building as affordable housing for the balance of the tax credit compliance period, it may go so far as to require a recapture bond, as was the statutory requirement pre-HERA. In addition to contractual protection against recapture, the limited partner will likely require that it continue to receive reports regarding the project's performance through the remainder of the tax credit compliance period.

General Partner's Perspective

The general partner may also desire that the limited partner exit prior to the end of the tax credit compliance period. For example, the general partner's financial analysis of the project may tell it that the project has value (or that it will have value in the future). Under this scenario, the general partner will likely want to retain as much of that value as possible for itself. Of course, the limited partner will likely be aware of the project's value, and will consider that when considering the general partner's proposal to exit before the end of the LIHTC compliance period. When presented with an early exit option from a potentially valuable project, the limited partner may prefer to stay in the partnership for the balance of the compliance period, allowing the existing exit provisions of the partnership agreement govern the limited partner's exit.

A general partner may also wish to relieve itself of its obligations to the limited partner (much in the way the limited partner may wish to relieve itself of its obligations to its ultimate investor, as previously discussed). Ongoing audit and tax preparation duties are expensive, and reporting requirements can be burdensome. Additionally, the general partner may intend to subject the project to the qualified contract process available under the IRC. The qualified contract process can potentially produce real value, and the general partner may not be interested in sharing it with the limited partner.

Like the limited partner, the general partner may be perfectly content to keep the limited partner in the partnership through the end of the compliance period. The limited partner's perceived risk of recapture may lead to the decision to require a higher-than-expected purchase price. In addition, as previously discussed, the limited partner will likely require a recapture indemnity that the general partner may not wish or be able to undertake.

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ISSN 2152-646X

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In summary, as the foregoing discussion illustrates, both the general partner and the limited partner have many issues to consider before undertaking an exit prior to the end of the tax credit compliance period. Therefore, both parties should be prepared for a negotiation of most, if not all, of the potential issues.

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This article first appeared in the April 2013 issue of the Novogradac Journal of Tax Credits.