

Limited Partner Exits Prior to Year 15

By Sean B. Leonard, Dentons

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HERA repealed the recapture bond requirement for early building dispositions occurring after July 30, 2008, as long as the seller reasonably expects that the building will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 LIHTC 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

continued from page 1

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.

continued on page 3

Novogradac Journal of Tax Credits Editorial Board

PUBLISHER

Michael J. Novogradac, CPA

EDITORIAL DIRECTOR

Alex Ruiz

TECHNICAL EDITORS

Robert S. Thesman, CPA
James R. Kroger, CPA
Owen P. Gray, CPA
Thomas Boccia, CPA
Daniel J. Smith, CPA

ASSOCIATE EDITOR

Jennifer Dockery

STAFF WRITERS

Teresa Garcia
Mark O'Meara

EDITORIAL ASSISTANT

Elizabeth Orfin

CONTRIBUTING WRITERS

Peter Lawrence
Jerome Breed
Corenia Riley Burlingame
Sean B. Leonard
Brandi Day
Mike Hannon
Jillian Toole

Owen Metz
Annette Stevenson
Cyle Reissig
John M. Tess
Dan Yonkin
Yuri Horwitz
Forrest Milder

CARTOGRAPHER

David R. Grubman

PRODUCTION

Alexandra Louie
Jesse Barredo
James Matuszak

Novogradac Journal of Tax Credits Information

Correspondence and editorial submissions:
Alex Ruiz / 415.356.8088

Inquiries regarding advertising opportunities:
Emil Bagalso / 415.356.8037

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding the low-income housing tax credit or any other material covered in this publication can only be obtained from your tax advisor.



**NOVOGRADAC
& COMPANY** LLP®

CERTIFIED PUBLIC ACCOUNTANTS

© Novogradac & Company LLP
2013 All rights reserved.
ISSN 2152-646X

Reproduction of this publication in whole or in part in any form without written permission from the publisher is prohibited by law.

Novogradac Journal of Tax Credits Advisory Board

LOW-INCOME HOUSING TAX CREDITS

Bud Clarke	BOSTON FINANCIAL INVESTMENT MANAGEMENT
Jana Cohen Barbe	SNR DENTON
Tom Dixon	BOSTON CAPITAL
Rick Edson	HOUSING CAPITAL ADVISORS INC.
Richard Gerwitz	CITI COMMUNITY CAPITAL
Rochelle Lento	DYKEMA GOSSETT PLLC
John Lisella	U.S. BANCORP COMMUNITY DEV. CORP.
Phillip Melton	CENTERLINE CAPITAL GROUP
Thomas Morton	PILLSBURY WINTHROP SHAW PITTMAN LLP
Mary Tingerthal	MINNESOTA HOUSING FINANCE AGENCY
Rob Wasserman	U.S. BANCORP COMMUNITY DEV. CORP.

PROPERTY COMPLIANCE

Michael Kotin	KAY KAY REALTY
Michael Snowdon	MCA HOUSING PARTNERS\
Kimberly Taylor	HOUSING DEVELOPMENT CENTER

HOUSING AND URBAN DEVELOPMENT

Flynnan Janice	RAINBOW HOUSING
Ray Landry	DAVIS-PENN MORTGAGE CO.
Denise Muha	NATIONAL LEASED HOUSING ASSOCIATION
Monica Sussman	NIXON PEABODY LLP

NEW MARKETS TAX CREDITS

Frank Altman	COMMUNITY REINVESTMENT FUND
Merrill Hoopengardner	ADVANTAGE CAPITAL
Scott Lindquist	SNR DENTON
Matthew Philpott	U.S. BANCORP COMMUNITY DEV. CORP.
Matthew Reilein	JPMORGAN CHASE BANK NA
Ruth Sparrow	FUTURES UNLIMITED LAW PC
Elaine DiPietro	ENTERPRISE COMMUNITY INVESTMENT INC.

HISTORIC TAX CREDITS

Jason Korb	CAPSTONE COMMUNITIES
John Leith-Tetrault	NATIONAL TRUST COMM. INVESTMENT CORP.
Bill MacRostie	MACROSTIE HISTORIC ADVISORS LLC
John Tess	HERITAGE CONSULTING GROUP

RENEWABLE ENERGY TAX CREDITS

Bill Bush	BORREGO SOLAR
Ben Cook	SOLARCITY CORPORATION
Jim Howard	DUDLEY VENTURES
Forrest Milder	NIXON PEABODY LLP
John Pimentel	FOUNDATION WINDPOWER

continued from page 2

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. ❖

Sean Leonard is a partner in Dentons' real estate practice, concentrating on the representation of various participants in the equity financing of tax-advantaged transactions, focusing primarily on those generating federal and state low-income housing tax credits, new markets tax credits, historic rehabilitation tax credits and renewable energy tax credits. He can be reached at (617) 235- 6805 or sean.leonard@dentons.com.

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

© Novogradac & Company LLP 2013 - All Rights Reserved

Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking a transaction should seek advice based on their particular circumstances.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.novoco.com.