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Options for the End: Typical Partnership Agreement Exit Provisions

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The parties to low-income housing tax credit (LIHTC) developments negotiate various agreements governing their relationship. Most notably, the partnership agreement sets forth key agreements between the general partner and investor. For example, the parties negotiate funding conditions, credit adjusters, guaranties (completion, deficit funding, etc.), reserves, repurchase, transfer restrictions, and exit strategies, to name a few. This article, in which we review typical exit provisions in partnership agreements, is the third in a series examining issues and challenges facing participants as the project approaches the end of its tax credit compliance period.

It should be noted that in addition to the exit provisions set forth in the partnership agreement, other documents may contain provisions affecting the available exit strategies such as loan documents (especially documents governing "soft loans"), any U.S. Department of Housing and Urban Development (HUD) documents governing the development, and LIHTC documents (especially the extended use agreement). Therefore, it's important to look at the transaction documents in the totality.

Nonprofit Right of First Refusal

Internal Revenue Code (IRC) Section 42(i)(7) affords qualified nonprofit entities a right of first refusal to purchase a LIHTC project at a price equal to all outstanding indebtedness secured by the project plus associated exit taxes. It is common to add to that price amounts owed to the investor by the partnership. A typical provision may look like this:

> *Commencing on the 15th anniversary of the first day of the first taxable year of the Compliance Period and ending one year thereafter, a qualified 501(c)(3) Affiliate of the General Partner shall have a right of first refusal to purchase the Project at a price (the "Purchase Price") equal to (i) the amount of outstanding indebtedness secured by the Project, (ii) the amount of federal, state and local tax liability projected to be imposed on the Partners as a result of the sale pursuant to the right of first refusal, including federal income tax liability incurred due to the payment of amounts pursuant to this clause (ii), (iii) the amount of any unreimbursed deficiency in Credits recognized by the Investment Partner as compared to the Projected Credits, and (iv) amounts owed to the Special Limited Partner and the Investment Partner pursuant to this Agreement.*

There are a couple of things to think about with this option. First, requirements may vary by state. For example, the Texas Department of Housing and Community Affairs requires for-profit general partners to identify a nonprofit entity to receive the benefit of the right of first refusal, even if there is not a nonprofit in the transaction at closing. Typically, the nonprofit that is ultimately granted the right of first refusal is not identified at closing. It should be noted that, under IRC Section 42(h)(5)(C)(ii), the LIHTC allocating agency must make a determination that the nonprofit entity is not affiliated with or controlled by a for-profit organization.

Additionally, at closing or at the time a nonprofit enters the transaction, the nonprofit status of the entity should be

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verified by reviewing its organizational documents, exemption letters and the Internal Revenue Service (IRS) list of exempt organizations. The parties should also verify that the entity is not affiliated with or controlled by a for-profit entity (as noted above). Note that the actual requirement in the IRC is that the credit agency makes determination of non-affiliation, not just that there be non-affiliation.

General Partner Purchase Option

This common provision gives the general partner an option to purchase the project or the investor's interest in the partnership for fair market value. The price is often set at the greater of fair market value or debt plus taxes. A sample provision:

> *Commencing on the 15th anniversary of the first day of the first taxable year of the applicable Compliance Period and ending one year thereafter, the General Partner shall have the option to purchase the Project at a price (the "Purchase Price") equal to the greater of (i) fair market value of the Project based on an appraisal conducted by an appraiser approved by the Special Limited Partner, which appraisal shall assume the Project will remain subject to the Extended Use Agreement or (ii) the minimum price under Code Section 42(i)(7), plus any amounts owed to the Special Limited Partner and the Investment Partner including any federal income tax liability incurred by the Limited Partners as a result of the payment of amounts pursuant to this clause.*

The importance of this provision to the general partner is resulting in some common negotiation points between the parties leading up to exit. A strong emphasis is being placed on the appraisal, and the parties need to ensure the assumptions therein are consistent with the market and the assumptions used up front to justify the initial projections and residual analysis.

As one would expect, the tax liability provision is particularly important to general partners. Therefore, general partners are requesting that profits and losses be reallocated from the limited partner after the end of the credit period in an effort to minimize exit taxes. In cases where the investor's capital account is projected to go negative prior to the end of the compliance period, reducing its share of losses can avoid or delay a negative capital account, thereby reducing or eliminating any gain that would be triggered by the existence of a negative capital account upon the investor's exit.

Continued Compliance Sale/Compliance Termination Sale

Under a so-called "continued compliance sale" exit, the investor requests the partnership sell the project subject to the extended use agreement. As a result, an owner of the property would be subject

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to the restrictions and set-asides set forth therein. In a so-called "compliance termination sale," IRC Section 42(h)(6) permits the investor to ask the partnership to request the LIHTC allocating agency arrange for the sale of the project after submission of a qualified contract. If a sale cannot be effectuated, the IRC permits termination of the extended use agreement. A typical provision may look like this:

> *Notwithstanding the foregoing, at any time after the 16th anniversary of the first day of the first taxable year of the Compliance Period, the Special Limited Partner may request that the Partnership request that the Agency arrange for the sale of the Project after submission of a "Qualified Contract" (as defined in Code Section 42(h)(6)(F)) (a "Compliance Termination Sale").*
>
> *After receipt of a request for a Compliance Termination Sale, the General Partner shall make a request to the Agency to obtain a buyer willing to operate the low-income units of the Project as a qualified low-income building and who will submit a Qualified Contract for the Project, and if no Qualified Contract is submitted within one year of the date of the General Partner's request, the General Partner shall use best efforts to find a third party purchaser and to cause the Partnership to sell the Project to such purchaser on terms Consented to by the Special Limited Partner, which terms shall include a purchase price at least equal to the minimum price established in accordance with Code Section 42(i)(7) plus any amounts owed to the Special Limited Partner and the Investment Partner pursuant to this Agreement, and free of the restrictions imposed by the Extended Use Agreement. If such efforts are unsuccessful on terms reasonably satisfactory to the Special Limited Partner within six months, the Special Limited Partner shall have the right thereafter to locate a purchaser for the Project. If the Special Limited Partner locates such a purchaser, the General Partner shall be given a right of first refusal to purchase the Project on the same terms and conditions as would be applicable to such purchaser; if such right of first refusal is not exercised by the General Partner within 30 days, then the General Partner shall be obligated to consent to the sale to such purchaser so long as the purchase price and other terms offered by such purchaser are at least as favorable to the Partnership as the best offer, if any, located by the General Partner.*

Despite its presence, various hurdles have prevented most parties from using the qualified contract process. For example, many states require applicants to waive the right to pursue a qualified contract in order to receive an LIHTC allocation. In addition, many qualified allocation plans (QAPs) give applicants additional points for agreeing to extended affordability restrictions beyond the 15-year compliance period. The IRS issued new rules in May

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2012 explaining how the process works (including the calculation of the purchase price) and the requirements owners and credit agencies must follow.

Investor Put Right

Many partnership agreements provide the investor with the right to put its interest to the partnership or to the general partner for a nominal amount (e.g., $1,000) or for fair market value. The put for fair market value is not often obtained. A sample provision may look like this:

> *At all times after the end of the Compliance Period, the Limited Partner, shall have the right, in its sole and absolute discretion, to put its entire Interest to the General Partner (or its designee) for a price equal to the sum of the following: (i) $100.00 and (ii) all amounts due and owing to the Limited Partner under this Agreement.*

Unlike a right of first refusal described above, care needs to be taken in considering amounts that are added to the put price. Such amounts may be viewed as a backdoor guaranty of cash payments that are not otherwise guaranteed, thereby making it more difficult to demonstrate that the investor is not economically compelled to exercise the put option.

Variations on these provisions and agreements abound. Parties should be cautious when attempting to exercise an exit option and parties should consult their tax and legal consultants early in the process.

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