LEGAL MATTERS:

Year 15 Disputes Continue

Developers Defend Their Rights

By David A. Davenport

Litigation surrounding Year 15 exit issues continues to be on the rise and Low Income Housing Tax Credit (LIHTC) developers must take care to fully understand their rights. Two important Treasury regulations provide information about recent cases in which aggregators attempted to monetize positive capital account balances in violation of agreements governing LIHTC partnerships.[1] To support their initiatives, arguments were offered to suggest that Treasury Regulation 1.704-1 mandates such an outcome by requiring partnership dissolution and liquidation assumptions, regardless of the parties' written agreements. In each instance, the courts determined that the terms and conditions of the parties' partnership agreements prevailed, hypothetical dissolutions and liquidations were *not* proper, and capital accounts had *no* bearing on the applicable fair market value determinations necessary to consummate the Year 15 transfers.

Treasury Regulation 1.704-1 addresses the substantial economic effect of how partners agree amongst themselves to allocate, for tax purposes, items of income, gain, loss, deduction and tax credits, as such allocations, which are effectively bookkeeping entries for tax accounting purposes, directly impact the tax revenues received by the federal government. The regulation does not have the power to amend the plain and unambiguous distribution agreements reached between parties to a LIHTC partnership. How partners agree to distribute dollars received

amongst themselves is subject to their own, private agreements. As a result, the regulation does *not* serve to negate agreed upon sharing arrangements in LIHTC partnerships. Additionally, Treasury Regulation § 1.704-1(b)(2)(ii)(b)(5) provides that, so long as a partnership agreement provides for the determination and maintenance of capital accounts, the substantial economic test is *not* violated if all or part of the partnership interest of one or more partners is purchased by one or more partners pursuant to a negotiated, arm's length agreement.[2] These are two important regulations to keep in mind when considering Year 15 transactions, and they may serve a general partner well if faced with arguments like those offered in recent court cases.

Recent Florida Ruling

For context, in February 2018, the general partner of Berkshire Club Partners, Ltd., who developed a 288-unit affordable housing complex in the Orlando area more than 15 years ago, exercised its option to purchase the limited partner interests in a LIHTC partnership pursuant to a contractually mandated process providing for a formulaic option price at fair market value. At the time, ownership and control of the limited partner interests had changed from what it was initially when the project was financed, thus the general partner was dealing

[1] An Aggregator has acquired limited partner interests in the LIHTC partnership, or may have obtained management control of those interests or an Upper Tier LIHTC partnership. Thus, the Aggregator is someone new to the general partner, who was not part of the initial transaction that led to the partnership. See *Year 15: Facing Off with the Aggregator, Tax Credit Advisor* (May 2019) and *Beware the Aggregator, Tax Credit Advisor* (April 2018). Aggregators often use economies of scale and litigation, or the threat of it, in hopes of leveraging windfall financial outcomes at year-15. *Nonprofit Transfer Disputes in the Low Income Housing Tax Credit Program: An Emerging Threat to Affordable Housing*, Washington State Housing Finance Commission (September 2019), http://www.wshfc.org/admin/Reporton-15YearTransferDisputes.pdf.

[2] Treasury Regulation 1.704-1(b)(2)(iv)(l) provides that the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner upon the transfer of transferor partner's interests, allowing for this. With this transfer, economic effect is maintained in such a manner that there is no avoiding of the transferee receiving the economic benefit or bearing the economic burden of allocations from the partnership.

with someone whom they had not worked with when the agreements were negotiated and finalized (i.e., an aggregator). Despite the general partner's full compliance with the partnership agreement and option process, the limited partner refused to accept the tendered proceeds, claimed that a positive capital account balance of more than $5.3 million must be included in the purchase price, and later declared alleged defaults under the partnership agreement to support an initiative to remove the general partner from the partnership in order to prevent the acquisition of the limited partner interests. Prior to this time, the general partner had never been accused to be in default of its obligations, never had any performance issues raised, and had diligently served as general partner for more than 15 years, delivering the anticipated tax and other benefits to the preceding limited partner. To support its efforts to increase the purchase price by more than $5.3 million, the limited partner argued that "industry standards," as well as certain Treasury regulations, mandated such an outcome.

On summary judgment, the Florida Circuit Court held otherwise, finding that the parties' agreed upon option process and formulaic fair market value option price would be enforced, as written and agreed upon more than 15 years ago by the original participants in the LIHTC partnership. The court also held that there were no grounds to remove the general partner from the partnership and that the option purchase price is determined "as if there were a hypothetical sale of the Project, not as if the Partnership were being dissolved or liquidated" as the limited partner argued.[3] As a result, the court rejected the limited partner's arguments that the price must include credit for a capital account balance because there was no need to consider capital account balances in the hypothetical sale used to determine the purchase price since the option agreement did not involve a dissolution of the partnership or liquidation of its assets. The limited partner's alleged defaults, lodged to remove the general partner and prevent the option, were also found to be "baseless and intended to deprive" the general partner of its rights; and the court ordered the immediate transfer of the limited partner interests to the general partner, reserving jurisdiction to later enter a damages order and an award of attorney's fees.

Two Similar Decisions

This decision came after two other cases reached similar outcomes in recent months. Earlier this year, in the case of *Centerline/Fleet Housing Partnership, L.P. et. al v. Hopkins Court Apartments, L.L.C. et. al*, Hopkins Court Apartments secured a summary judgment decision in Buffalo, NY, which provides that the exercise of a general partner's option to acquire a limited partner's interests in a LIHTC partnership does *not* trigger a dissolution or liquidation of the partnership; and, thus does not require consideration of positive capital account balances in the hypothetical sale used to determine the fair market value option price.[4] And, in the matter of *Centennial Partners, LLC v. ORC Tax Credit Fund 10, LLC and SCDC, LLC*, a summary judgment decision in Milwaukee, WI, confirmed that the purchase of the investor limited member's interests in the LIHTC company was not a capital transaction and did not require consideration of a positive capital account balance when determining a fair market value purchase price. Following this decision and the subsequent jury trial, Centennial Partners was awarded damages and ultimately acquired the limited member interests for less than $6,000, rather than the more than $1.7 million sought by the aggregator. Like in the Florida case, the limited partners in these cases relied on Treasury Regulations to advance arguments contrary to the parties' agreements but failed.

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[3] 2020 WL 1856259 (Fla.Cir.Ct. 2020).

[4] 2020 WL 201150 (N.Y.Sup 2020).