ARTICLES

Preserving the Low-Income Housing Tax Credit Public-Private Partnership: Investor Perspectives on Year-15 Exit Disputes

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Introduction 35
I. Background 37
A. Overview of the LIHTC Program 39
B. Investors and the Role of Private Capital 40
C. The Role of Nonprofits 42
II. Year 15 Issues Affecting Investors 44
A. Property Valuations 45
B. The Treatment of Positive Capital Accounts 47
C. The Nonprofit Right of First Refusal 49
1. Survey of Relevant Case Law 51
2. Recent Policy Measures 53
III. Implications for Combating the Affordable Housing Shortage 56
Conclusion 58

Introduction

Last year marked the thirty-fifth anniversary of the Low-Income Housing Tax Credit (LIHTC). Established by the Tax Reform Act of 1986 and codified in Section 42 of the Internal Revenue Code,[1] the LIHTC program is the federal government's largest program aimed at funding the development and rehabilitation of affordable rental housing for low-income families.[2]

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1. 26 U.S.C. § 42; I.R.C. § 42.

2. *See, e.g.*, Mark P. Keightley, Cong. Rsch. Serv., RS22389, An Introduction to the Low-Income Housing Tax Credit (Jan. 26, 2021); *see also, e.g.*, Joint Center for Housing Studies of Harvard University, America's Rental Housing

AffordableHousing_V31No1.indd 35 4/8/22 9:17 AM

It is also a political anomaly, enjoying bipartisan support for virtually the entirety of its existence and aligning the interests of groups—affordable housing advocates, corporations, and other for-profit and nonprofit organizations—that might otherwise find themselves at odds.[3] By all accounts, the LIHTC has been, and remains, a remarkable success. And it is distinctly market-based.

An outgrowth of the free-market ideology of Ronald Reagan's administration and the policy shifts of the 1980s,[4] the LIHTC is a supply-side tax subsidy in the form of a non-refundable credit that provides or allocates dollar-for-dollar credits to qualified developers for the production and operation of qualified affordable housing projects.[5] A key feature of the program is the developer's ability to sell those credits to private investors in exchange for equity financing for qualified projects, which allows the developer to reduce construction costs and a property's debt burden while providing newly constructed or rehabilitated units at reduced rental prices.[6] In turn, a key factor contributing to the rise and success of the LIHTC has been the emergence and role of intermediaries—or syndicators—in underwriting, bundling, and then brokering portfolios or "funds" of credits across multiple projects and developers to a secondary market of typically corporate or large institutional investors. The demand for credits within that syndication market—and in turn the market price for those credits—has become the engine that propels the entire LIHTC program.[7]

There is debate over whether Congress intended the results of the LIHTC program that we are seeing today, including even the funneling of

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2020, at 33 (2020), https://www.jchs.harvard.edu/sites/default/files/reports/files/Harvard_JCHS_Americas_Rental_Housing_2020.pdf; Fact Sheet: Biden-Harris Administration Announces Immediate Steps to Increase Affordable Housing Supply, https://www.whitehouse.gov/briefing-room/statements-releases/2021/09/01/fact-sheet-biden-harris-administration-announces-immediate-steps-to-increase-affordable-housing-supply ("LIHTC is the nation's largest federal program for the construction and rehabilitation of affordable rental housing.").

3. *See, e.g.*, Mihir Desai et al., *Investable Tax Credits: The Case of the Low Income Housing Tax Credit* 5, 18 (NBER Working Paper No. 14149, June 2008), https://www.hbs.edu/faculty/Pages/item.aspx?num=33531; Jt. Ctr. for Hous. Stud. Harv. Univ., What Works Collaborative, The Disruption of the Low-Income Housing Tax Credit Program: Causes, Consequences, Responses, and Proposed Correctives 13 (2009), https://www.jchs.harvard.edu/sites/default/files/disruption_of_the_lihtc_program_2009_0.pdf; *see also, e.g.*, William R. Mitchell, *Sheltering the Rich or Housing the Poor? The Story of the Low Income Housing Tax Credit*, 4 Strathclyde L. Rev. 5, 17–18 (2008).

4. *See, e.g.*, Charles H. Stewart III, *The Politics of Tax Reform in the 1980s*, *in* Politics and Economics in the Eighties 143, 144 (Alberto Alesina & Geoffrey Carliner eds., 1991); Gregg Ip & Mark Whitehouse, *How Milton Friedman Changed Economics, Policy, and Markets*, Wall St. J. (Nov. 17, 2006), http://www.wsj.com/articles/SB116369744597625238.

5. 26 U.S.C. § 42.

6. Keightley, *supra* note 2; *see also* Desai et al., *supra* note 3, at 3.

7. *See generally* What Works Collaborative, *supra* note 3.

private capital into low-income housing developments, or whether it fully grasped the scope of the program in that regard.[8] But it is undeniable that, as it stands today, the continued viability and success of the government's largest—and many would argue most successful—affordable housing program is dependent on the continued engagement and incentivizing of its investor base.

This article examines investor considerations with respect to a critical juncture within the lifecycle of a LIHTC deal—Year 15—and the potential consequences for continued investor engagement and participation, and even the preservation of affordable housing itself, posed by current disputes among program participants over Year 15 exit issues. More specifically, this article examines attempts by non-investor participants to acquire control of LIHTC projects at or around Year 15 and, in certain instances, exclude investor participants from sharing in an asset's fair market, and at times much-appreciated, value. As this article discusses, such attempts not only erode an investor's expected return on investment but threaten basic tax principles underlying the program and investor participation. Ultimately, this article proposes that decisionmakers navigating these disputes must account for investor considerations, expectations, and well-established legal and tax principles if they are to best incentivize new and return investors and ensure the continued powering of the engine that drives the LIHTC program.

Part I of this article discusses the mechanics of the LIHTC and the role of private capital within the program, as well as the role of nonprofit entities, as a backdrop to understanding the emergence of certain issues at Year 15. Part II examines certain of those "Year 15 Issues," as well as recent case law surrounding these issues and the potential consequences of these and other trends for investor participation and the long-term health of the LIHTC program. Finally, Part III surveys recent developments in the affordable housing sector and the role of the LIHTC in addressing the country's continued affordable housing shortage.

I. Background

Issues surrounding affordable housing—and specifically the relative lack of affordable housing—have been the subject of vigorous debate for almost 100 years.[9] In the 1980s, the perennial effort to address the country's affordable housing needs collided with Friedman-influenced free-market ideology and a fundamental shift in how leaders and the public viewed the

8. *See generally* Mitchell, *supra* note 3.

9. *See* United States Housing Act of 1937 (Wagner-Steagall Act), Pub. L. No. 93-383, 88 Stat. 653, 42 U.S.C. § 1437, which provided the statutory structure for public housing and funding for public housing through direct assistance to local housing agencies; *see also* Charles L. Edson, *Affordable Housing—An Intimate History,* 20 J. Affordable Hous. 194 (2011).

AffordableHousing_V31No1.indd 37 4/8/22 9:17 AM

government's role in society.[10] The LIHTC reflects that ideology and shift. Enacted as part of the Tax Reform Act of 1986,[11] the LIHTC initially was set to sunset in 1989. Congress extended the program on an annual basis until making the LIHTC permanent in 1993.[12]

The LIHTC operates as a mechanism for funneling private capital and investment into low-income housing developments. It does so by way of tax credits provided to developers of low-income housing units following an application process who then agree to comply with certain affordability and other restrictions for a specified period of time, and who can in turn sell those credits in exchange for equity financing.[13] The proceeds from that investment, in turn, enable lower-cost development, reduces the debt burden on a property, and makes it "financially feasible to offer lower, more affordable rents."[14] In exchange, the investor providing the equity financing receives an ownership interest allowing it to claim the lion's share of the LIHTCs allocated to and claimed by a project as well as the other benefits typical of a real-estate investment, including depreciation and tax losses flowing from the property, cash from operations, and a share of the residual value of the property.[15]

In short, a LIHTC asset is a real-estate investment that happens to also provide affordable housing. The program generates billions of dollars in private investments annually,[16] and it serves the extremely low-income and most vulnerable of households.[17] Since its inception in 1986, the program has funded the construction or rehabilitation of more than 3.6 million

10. *See, e.g.*, Report of the President's Commission of Housing xvii (1982) ("The genius of a market economy, freed of the distortions forced by government housing policies and regulations that swung erratically from loving to hostile, can provide housing far better than Federal programs.").

11. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; *see also* Edson, *supra* note 9, at 206.

12. Revenue Reconciliation Act of 1993, Pub. L. 103-66, Aug. 10, 1993, 107 Stat. 416, 26 U.S.C. § 1; *see also* Edson, *supra* note 9, at 206.

13. *E.g.,* Keightley, *supra* note 2.

14. Office of the Comptroller of the Currency, *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks* at 2 (Mar. 2014), https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-insights/ca-insights-mar-2014.html [hereinafter OCC Report]; *see also* Keightley, *supra* note 2.

15. *E.g.*, Keightley, *supra* note 2.

16. *See* Jeffrey R. Pankratz & Craig A. Emden, *Section 704(b) Regulations and Tax Credit Transactions: Structuring Low-Income Housing Tax Credit Transactions to Avoid Reallocation of Tax Credits and Losses*, 11 J. Affordable Hous. & Cmty. Dev. L. 339 (2002).

17. Nearly half of the American households utilizing LIHTC housing are extremely low-income. *See* Lauren Loney & Heather Way, *Strategies and Tools for Preserving Low Income Housing Tax Credit Properties*, 28 J. Affordable Hous. & Cmty. Dev. L. 255, 256 (2019). It shoudl be noted that extremely low-income (ELI) households include those households with an income at or thirty percent of the particular area's median income.

affordable units.[18] In that same timeframe, it has funded the construction, redevelopment, or preservation of over 2.5 million units affordable to households at fifty to sixty percent of the Area Median Income (AMI).[19]

A. Overview of the LIHTC Program

The LIHTC is an indirect federal subsidy that offsets the credit holder's federal tax liability dollar-for-dollar. The LIHTC is codified in Section 42 of the Internal Revenue Code,[20] and the program is administered at the federal level by the Internal Revenue Service (IRS).

The process of allocating, awarding, and ultimately claiming LIHTCs is relatively complex.[21] The process begins with the IRS making an annual LIHTC allocation to each state based on the state's population.[22] Each state—typically acting through the state's housing finance agency (HFA)—then allocates credits to developers of "qualified low-income housing projects" according to state-specific qualified allocation plans (QAPs).[23] Federal law requires that states give priority in allocating credits to projects that serve the lowest-income households and remain affordable for the longest period of time, but QAPs may also incorporate state-specific policy considerations and objectives or impose additional requirements on developers.[24]

Once credits are allocated to a developer, the developer typically has two years to place a project in service so that the tax credits may be claimed.[25] Credits may not be claimed until a project is placed in service, and an allocation of credits to a developer does not necessarily mean that all allocated credits will be claimed.

Once a project is placed in service, the LIHTCs allocated to the project are claimed over a ten-year "Credit Period"[26] but earned over an initial fifteen-year "Compliance Period"[27] during which the project must comply with affordability restrictions and other program requirements. Among other things, the project must meet certain tests that restrict both the income of eligible tenants (typically limited to fifty to sixty percent of AMI)[28] and the rent charged to those tenants (limited to thirty percent of the AMI applicable to the unit).[29]

For projects developed after 1990, in addition to the fifteen-year initial Compliance Period, the IRS requires that LIHTC properties have an

18. State HFA Factbook, 2020 NCSHA Annual Survey Results 95 (2020).

19. America's Rental Housing 2020, *supra* note 2, at 33.

20. 26 U.S.C. § 42.

21. Keightley, *supra* note 2.

22. *See id.; see also* 26 U.S.C. § 42.

23. Keightley, *supra* note 2; Desai et al., *supra* note 3, at 3.

24. *See* 26 U.S.C. § 42(g)(1), (h)(3); *see also* Keightley, *supra* note 2; Desai et al., *supra* note 3, at 3.

25. Keightley, *supra* note 2.

26. *See* 26 U.S.C. § 42 (f)(1).

27. *See id.* § 42 (i)(1).

28. *Id*.

29. Keightley, *supra* note 2.

"extended use agreement" with the state housing agency that extends the project's affordability for at least an additional fifteen years, ensuring affordability for a minimum of thirty years.[30] States may require even longer affordability or extended use periods,[31] though housing advocates have cautioned against such longer periods given the physical toll on properties and the increased cost and burden of physical maintenance for older properties.[32] Extended use periods ensure continued affordability beyond the Compliance Period regardless of who owns the property after Year 15.

B. Investors and the Role of Private Capital

Many developers lack the upfront capital or financing necessary to complete construction. As a result, developers often sell or exchange their allocated credits to investors or syndicators in exchange for equity financing, in a process known as syndication.[33] This equity financing reduces the debt burden on the project, lowers the cost of development, and allows the project to offer more affordable rents.[34]

The "sale" of credits in exchange for equity financing typically occurs within a partnership formed between the developer (as general partner and manager of the property)[35] and the investor entity (as limited partner).[36] The partnership exists for the sole purpose of constructing, owning, and operating the LIHTC property. In this arrangement, the investor entity receives 99% or more (typically 99.99%) of the tax credits allocated to the project, as well as an equal share of the project's taxable income and losses,[37] certain fees and cash flow, and a share of the property's residual value. A limited partnership agreement is negotiated and executed to govern the rights and obligations of the parties within this construct.

LIHTC deals typically utilize the partnership structure because of its ability to legally bind the parties and satisfy federal tax requirements that the tax credit claimant have an ownership interest in the underlying property.[38]

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30. 26 U.S.C. § 42(h)(6).

31. *See, e.g.*, A.B. 1584, Reg. Sess. (Cal. 2021) (proposing extended use period of fifty-five years).

32. *See, e.g.,* Most LIHTC Properties Stay Affordable, But Concerns Remain, available at https://www.housingfinance.com/news/most-lihtc-properties-stay-affordable-but-concerns-remain_o.

33. *See* Desai et al., *supra* note 3, at 4–5.

34. *See* Keightley, *supra* note 2; Pankratz & Emden, *supra* note 16, at 339–40; *see also* Office of the Comptroller of the Currency, Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks at 2 (Mar. 2014), https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-insights/ca-insights-mar-2014.html [hereinafter OCC Report].

35. The authors use the term "partnership and partner," which has been the most common type of ownership structure for LIHTC properties, but LIHTC deals may also be structured as limited liability companies.

36. Keightley, *supra* note 2.

37. Pankratz & Emden, *supra* note 16, at 339–41.

38. Keightley, *supra* note 2; *see also* Pankratz & Emden, *supra* note 16, at 339–40.

AffordableHousing_V31No1.indd 40 4/8/22 9:17 AM

Hence, the share of credits distributed to the investor partner will match that partner's equity ownership in the partnership: a limited partner that receives 99.99% of the tax credits will own 99.99% of the equity in the partnership. And, because of the "economic substance doctrine," in order to support the distribution of credits between the partners (for which the investor partner provided upfront capital), and the deal not be deemed a sham, it is critical that the investor partner be and remain the true owner of the underlying property.[39]

The economic substance doctrine is a common law judicial doctrine designed to prevent taxpayers from entering transactions lacking economic reality for the sole purpose of reaping a particular tax benefit.[40] Although codified in Section 7701(o) of the Internal Revenue Code in 2010,[41] the doctrine has been used by the IRS and courts for years to evaluate and disregard non-compliant transactions.

In short, the economic substance doctrine disallows tax benefits of a transaction if the transaction lacks "economic substance" or a business purpose. "Under the economic substance doctrine, 'the objective economic realities of a transaction,' rather than its legal form, determine who is an owner for tax purposes."[42] To demonstrate true ownership, Section 7701(o) requires a party to establish that

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[43]

Relatedly, Section 704 of the Internal Revenue Code governs partnership allocations and is intended to ensure that allocations "follow the 'economics of the deal.'"[44] Pursuant to Section 704(a), "a partner's distributive share of income, gain, loss, deduction, or credit shall . . . be determined by the partnership agreement."[45] However, pursuant to Section 704(b), a "partner's distributive share of income, gain, loss, deduction, or credit shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if the allocation to a partner under the agreement does not have substantial economic effect."[46] Section 704(b) and corresponding regulations are

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39. 26 C.F.R. § 1.42-4 specifies that the economic substance doctrine applies to LIHTCs.

40. *See, e.g.*, Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 Fla. Tax Rev. 411, 412 (2010).

41. 26 U.S.C. § 7701(o).

42. Homeowner's Rehab, Inc. v. Related Corp. V SLP, L.P., 99 N.E.3d 744, 755 (Mass. 2018) (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 572–53 (1978)).

43. 26 U.S.C. § 7701.

44. Pankratz & Emden, *supra* note 16, at 340.

45. I.R.C. § 704(a).

46. *Id.* § 704(b).

designed to guard against potential abuses related to the flexibility inherent in the Code's treatment of the partnership structure.[47]

Section 42 specifies that the "losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law."[48] It goes on to mention the economic substance doctrine and sham analysis specifically,[49] demonstrating clear legislative intent to apply these enduring tax law principles to the LIHTC program.

Congress intended—and Section 42 requires—that the investor owner have and maintain a true property ownership in the LIHTC property. To this end, the investor partner must sustain the economic realities of property ownership, and the parties to a LIHTC transaction must comply with the Section 704(b) regulations, including at exit. Failure to do so may have "adverse consequences for the investor, namely, a reallocation [or loss] of [claimed] losses and credits and a corresponding failure to achieve its expected economic return."[50] For this reason, before an investor will invest the private capital necessary to build a LIHTC project, it typically requires an opinion letter from experienced tax counsel attesting that the project and the project's partnership agreement comply with applicable tax regulations and Section 42's provisions regarding economic substance.

C. The Role of Nonprofits

The creation of the LIHTC and its thirty-five-year survival attests to lawmakers' faith and confidence in the market and for-profit entities' ability to effectively and efficiency direct government resources and address the country's affordable housing needs. But nonprofits have also played a role in the history of the program, for a very specific reason: the idea that a nonprofit will be less motivated by profit and more likely to maintain the affordability of properties beyond the statutorily required time period. One product of such thinking is the nonprofit right of first refusal (ROFR). While extended-use periods largely negate concerns over continued affordability, the ROFR remains at the center of new legislative proposals as well as much of the litigation surrounding Year 15 Issues.

Since the inception of the LIHTC program, lawmakers have sought out ways to discourage the market-rate conversion of LITHC properties. In

47. Pankratz & Emden, *supra* note 16, at 340.

48. 26 C.F.R. § 1.42-4(b).

49. *Id*. ("Notwithstanding paragraph (a) of this section, losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law." (citing sections 38(c), 163(d), 465, 469; Knetsch v. United States, 364 U.S. 361 (1960), 1961–1 C.B. 34 ("sham" or "economic substance" analysis); and *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978), 1978–1 C.B. 46 ("ownership" analysis)).

50. Pankratz & Emden, *supra* note 16, at 340.

1988, Senators George Mitchell (D-ME) and John Danforth (R-MO) created a task force to review the LIHTC program and propose improvements.[51] The result of those efforts was a report identifying potential modifications and measures to encourage the continued affordability of LIHTC units beyond the initial Compliance Period.

Among other things, the Mitchell-Danforth Report identified specific concerns associated with the sale of LIHTC properties to for-profit entities following the Compliance Period,[52] including what the task force believed to be the greater likelihood of for-profit entities converting properties to market rate.[53] Aimed at maintaining the supply of affordable housing, the Mitchell-Danforth Report urged Congress to identify a mechanism to position nonprofit groups as the owners and managers of affordable housing projects.[54] It specifically urged Congress to create a unique nonprofit option allowing nonprofits to purchase LIHTC properties at below-market prices following the end of the Compliance Period.[55]

Congress rejected the Mitchell-Danforth Report's proposal for a below-market purchase option. Instead, Congress enacted the Omnibus Budget Reconciliation Act of 1989[56] and the Omnibus Budget Reconciliation Act of 1990,[57] which, in part, created a nonprofit right of first refusal that permitted nonprofit participants to purchase a LIHTC property for a statutorily prescribed minimum price equivalent to the remaining debt on the property and any taxes attributable to the sale.[58] The legislation further modified Section 42 to mandate that each state reserve ten percent of its allocable tax credits for LIHTC projects developed by qualified nonprofit organizations.[59] Such provisions are intended to encourage nonprofits' control of LIHTC properties based on the assumption and objective that the nonprofits will maintain the properties as affordable housing.[60]

The nonprofit ROFR provides nonprofit entities an opportunity to purchase LIHTC properties for a below-market price, but only where the

51. *See* Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Tax Credit*, 38 Vill. L. Rev. 871, 883 (1993).

52. Report of the Mitchell-Danforth Task Force on the Low-Income Housing Tax Credit (1989)).

53. *Id*. at 4.

54. *Id.* at 4, 19.

55. *Id.* 19.

56. Pub. L. No. 101-239, 103 Stat. 2106, 2306–22.

57. Pub. L. No. 101-508, 104 Stat. 1388, 1388–475.

58. Pub. L. No. 101–239, tit. VII, subtit. A, § 7108(q), 103 Stat. 2321 (1989).

59. 26 U.S.C. § 42(h)(5).

60. Homeowner's Rehab, Inc. v. Related Corp. V SLP, L.P., 99 N.E.3d 744, 755 (Mass. 2018) ("By creating this safe harbor, § 42(i)(7) also furthers one of the key policy goals of the LIHTC program, which is to ensure that affordable housing remains affordable in the long term. Nonprofit organizations are more likely to continue to operate properties as affordable housing, even after the affordability restrictions are lifted, because it is their mission to do so."*).*

AffordableHousing_V31No1.indd 43 4/8/22 9:17 AM

owner chooses to sell the property at the end of the Compliance Period.[61] Nonprofit entities, solely by virtue of the statutory revision, have no right to compel a sale of the property.

Even so, developers (both for-profit and nonprofit) have attempted to use the nonprofit ROFR to force sales of LIHTC projects from unwilling owners and investors, giving rise to one of the several Year 15 Issues currently facing investors. Recent legislative proposals have also sought to retroactively convert these ROFRs into purchase options, attempting to do what Congress twice before rejected.[62] From the investor's perspective, such measures would unfairly change the rules the program has lived by for thirty-five years, as well as undermine certain of its core tax foundations.

II. Year 15 Issues Affecting Investors

Although not always the case, because of the timing of LIHTC delivery and compliance and the delivery of losses versus gains, the end of the initial Compliance Period at Year 15 is often a point at which the developer or general partner and its investor partner decide to part ways. As a consequence, the partnership agreements governing LIHTC partnerships typically spell out what happens—or can happen—at and after Year 15, including with respect to the investor's exit from the deal. From the investor's perspective, such provisions exist not merely to advise the partners of their contractual rights: they exist to ensure that the tax foundations and assumptions on which the partnership was conceived and according to which the partners have been operating for fifteen or more years remain true and intact.

Various factors have contributed to a recent uptick in disputes surrounding Year 15 and specifically investor exit at or around Year 15. Projects are increasingly reaching Year 15. In addition, property values in many regions have appreciated more than initially anticipated, while capitalization rates have fallen dramatically, resulting in asset value that participants may not have anticipated when they first struck their deal. At the same time, where a property does not deliver the losses or return originally projected for the investor partner, the investor may have an unexpectedly large capital account for which it expects to be accounted and compensated at exit.

61. The relevant House committee report clarifies the legislative intent behind the § 42 nonprofit ROFR, defining ROFR as "the right of first refusal (with one year's notice) to purchase the building, for a minimum purchase price, *should the owner decide to sell* (at the end of the compliance period)" (emphasis added); *see also* H.R. Rep. 101-247, 1195, 1989 U.S.C. 1906, 2665.

62. S. 1703 § 303(30(i)-(ii) (purposing a "clarification" to § 42: "(i) such option or right of first refusal may be exercised with or without the approval of the taxpayer, and "(ii) a right of first refusal may be exercised in response to any offer to purchase the property, including an offer by a related party.").

This section discusses three particular Year 15 Issues and areas of dispute: property valuations, the treatment of positive capital accounts, and the nonprofit ROFR.

A. Property Valuations

While not always present, the general partner's option to purchase the limited partner's ownership interest or the LIHTC property itself following Year 15 is the most prevalent mechanism for investor exit.[63] If an option is provided, the partnership agreement or a separate option agreement will typically provide for a process by which the parties are to value the property (or limited partner interest) using a specified valuation method and one or more qualified appraisers. Assuming that the property has sufficient value to trigger what is typically provided for as a fair market value valuation, the interests of the partners in this context are at odds: whereas the general partner wishes to acquire the partnership or the limited partner interest for a bargain, at the lowest price possible, the investor or limited partner understandably wants top dollar or the true fair market value of its interest.

Appraisals are opinions of value and, by their nature, are subject to some (key word being "some") variation and difference of opinion across different appraisers. However, the appraisal process is also one in which partners—and general partners specifically, in their role as managers of the partnership—can influence the valuation of a property or interest to suit their own interests. For example, the appraiser might be persuaded not to include certain categories of income, such as additional income provided by vouchers, in calculating the property's net operating income (NOI), resulting in a decreased valuation. The appraiser might decide to make downward adjustments to income for vacancy and other factors, or upward adjustments to costs, based on surrounding market data but contrary to the actual historical experience at the property. The general partner or manager might not even provide the appraiser with all requested or desired data for a property. Small variations in the assigned capitalization rate can have relatively large consequences for the overall valuation. Multiple points in an appraisal provide an opening for the general partner to potentially influence the valuation. There also have been more overt attempts to subvert the appraisal process.

In *Multi-Housing Tax Credit Partners XXX v. Alexander Dairy Associates, LLC*,[64] for instance, the United States District Court for Eastern District of Virginia considered claims surrounding a general partner's alleged improper exercise of its option to buy a limited partner's interest in an LIHTC partnership and looked specifically at a provision in the

63. Kenneth N. Alford, MAI, & David C. Wellsandt, *Appraising Low-Income Housing Tax Credit Real Estate*, Appraisal J., Fall 2010, at 15.

64. Multi-Housing Tax Credit Partners XXX v. Alexander Dairy Assocs., LLC, No. 3:20CV612, 2021 WL 2711468, at *1 (E.D. Va. July 1, 2021).

partnership agreement mandating that the partners "agree on an appraiser whose appraisal sets the purchase price for [the Limited Partner's] interest in the partnership."[65] The court observed that the general partner, "believing that it '[was its] time to get paid,' notified [the limited partner] that it intended to exercise the Purchase Option" and proposed an appraiser to provide a valuation of the limited partner's interest.[66]

The limited partner rejected the general partner's appraiser but suggested three alternatives.[67] The general partner then provided a proposed engagement letter purporting to provide an appraisal of the limited partner's interest (the "valuation analysis") and an appraisal of the partnership property's fair market value.[68] The limited partner objected to the appraisal and advised that it would agree only to "an appraisal of the Partnership's improved real property [as opposed to a valuation analysis], in accordance with the Partnership Agreement" conducted solely by an appraiser holding the requisite qualifications. [69] The limited partner offered to work towards an agreement as to the appropriate valuation instructions, cautioning that moving forward unilaterally would violate "the Partnership Agreement, which requires that the partners agree on the selected appraiser."[70]

The general partner responded with a revised engagement letter providing the same valuation analysis.[71] The limited partner refused to sign the revised engagement letter containing terms and conditions identical to those to which it previously objected.[72] Despite the limited partner's objections, the general partner unilaterally proceeded with the appraisal[73] and, the following month, advised it was prepared to close on the sale of the limited partner interest for a purchase price of $675,000.[74] The limited partner refused to cooperate with the closing or accept any funds.[75]

Notwithstanding, the general partner "believing that he had acquired [the] interest in the Limited Partnership" began acting as if he "could do whatever we wanted to do with" the Partnership,[76] refusing to deliver required financial documents and contemplating a refinancing of the debt on the property.[77] The limited partner filed suit based on the general

65. *Id.* at *1.
66. *Id.*
67. *Id.*
68. *Id.* at *3.
69. *Id.* at *2.
70. *Id*, at *3.
71. *Id*.
72. *Id*.
73. *Id*.
74. *Id*.
75. *Id*.
76. *Id.*
77. *Id*.

partner's failure to comply with the limited partnership agreement and improper exercise of ownership over the limited partner's interest.[78]

The federal court found that "the parties *did not* agree on an appraiser to set the purchase price for [the Limited Partner's] interest in the partnership" and, therefore, the general partner improperly claimed to own the limited partner's interest.[79] The court further concluded that the general partner breached the partnership agreement by purporting to exercise the purchase option despite the limited partner's refusal to consent to the appraisal and found that the general partner's behavior "amount[ed] to nothing more than manifest opportunism."[80] The "manifest opportunism" recognized in the *Dairy* case demonstrates the tactics taken by certain general partners with respect to option rights, which potentially operate to transfer value away from the investor to the general partner in violation of both the tax underpinnings of the program and the partnership agreements between the parties.

B. The Treatment of Positive Capital Accounts

A further issue often attendant to a general partner's purchase of a LIHTC property or the limited partner's interest is the treatment of the partners' respective capital accounts at exit. Capital accounts are a measure of each partner's economic interests in a transaction or arrangement.[81] For this reason, the law requires that capital accounts be considered as part of a buyout or exit, and the parties' agreements include provisions confirming it.

Guided by the overarching principle that allocations must "follow the "'economics of the deal,'"[82] Section 704(b) of the Internal Revenue Code provides the rules for measuring partners' respective equity stakes and the economic relationship among partners.[83] It also provides a safe harbor whereby partnerships that maintain their capital accounts in compliance with Section 704(b) and follow specific requirements for liquidation will be deemed to have their allocations possessing the "substantial economic effect" required by the Regulations.[84]

Capital accounts track partners' respective economic investment in a partnership. A partner's capital account initially consists of their initial capital contributions (cash plus fair market of any property contributed, net of any liabilities associated with the property) and then is adjusted upward or downward each year depending on the transactions occurring within the partnership during that year. Generally speaking, a partner's capital account is increased by (1) additional contributions (cash or the fair

78. *Id*.
79. *Id*.
80. *Id*.
81. Pankratz & Emden, *supra* note 16, at 341.
82. *Id*. at 340.
83. *Id.* at 342.
84. *See* Treas. Reg. 1.704-1(b)(2)(ii).

market of contributed property, net associated liabilities) by the partner to the partnership, and (2) any allocations of partnership gain or income allocated to the partner.[85] A partner's capital account is generally decreased by (1) distributions (cash or the fair market value of distributed property, net any attendant liabilities) to the partner, and (2) the amount of any partnership losses or deductions allocated to the partner.[86] Positive or negative 704(b) reevaluations may also take place but are less common.

Several basic tenets are inherent and reflected in this framework. First, partnership assets must be recorded at fair market value, as opposed to cost basis at the time of liquidation or sale. Second, partners' capital accounts determine distribution rights. Therefore, upon liquidation, the partnership must make liquidating distributions in accordance with the partners' positive capital account balances, and a partner is unconditionally obligated to restore a deficit capital account balance following a liquidation of the partner's partnership interest.[87]

With respect to Year 15 Issues, disputes over capital accounts have generally arisen where the investor or limited partner has a significant positive capital account at the time that the general partner seeks to exercise an option right or the parties otherwise seek to sell the property to a third party. For the limited partner or investor, a significant positive capital account in this context typically reflects investments by the investor at the beginning of the partnership that are not returned through operations (i.e., distributions and loss allocations).[88] For the general partner, it can pose a significant (and often unexpected) financial hurdle to acquiring 100% of a LIHTC partnership or result in the limited partner receiving more sale proceeds than the general partner might have anticipated. As such, general partners may attempt to avoid paying the limited partner for its positive capital account in an actual or hypothetical liquidation as required by Section 704(b).

While courts have started to address disputes over positive capital accounts, the case law on this issue is emerging and mixed.[89] From the investor's perspective, however, the partnership agreements and the Internal Revenue Code and associated Regulations require that the limited partner's positive capital be accounted for at exit.

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85. *Id.* § 1.704-1(b)(2)(iii).

86. *Id.*

87. *Id.*; *see also* Pankratz & Emden, *supra* note 16, at 340–41.

88. *See* Bradley Myers, *The Low-Income Housing Tax Credit: A Proposal to Address IRS Concerns Regarding Partnerships Between Non-Profit and For-Profit Entities*, 60 Tax Law. 415, 443 (2007).

89. *Compare, e.g.*, Saugatuck, LLC v. St. Mary's Commons Assocs., L.L.C., No.19-cv-0217 (SJF)(SIL), 2021 WL 4813170, *4 (E.D.N.Y. May 19, 2020), *with* Centerline/Fleet Hous. P'ship, L.P. - Series B v. Hopkins Ct. Apartments, L.L.C., 195 A.D.3d 1375 (N.Y. App. Div. 2021); CED Capital Holdings 2000 EB, L.L.C v. CTCW-Berkshire Club, LLC, No. 2018-CA-013886-O, 2020 WL 1856259, at *1 (Fla. Cir. Ct. Apr. 08, 2020).

In *Saugatuck, LLC v. St. Mary's Commons Associates, L.L.C.*, the United States District Court for the Eastern District of New York examined the price owed for a general partner's option to purchase a LIHTC property, which comprised substantially all of the partnership's assets, or the limited partner's interest in the partnership at the end of the Compliance Period.[90] The partnership agreement between the parties specified the amounts owed to each partner in the event of liquidation or, specifically, the "disposition of all or substantially all of the assets of the Partnership."[91] The agreement also included a section governing the "Distribution and Application of Cash Flow and Proceeds from Sale or Refinancing Transactions," which provided a calculation for the proceeds owed to each partner in the event of a sale of a portion of the project to a third party or a refinancing of the debt.[92] Notably, the liquidation waterfall accounted for the limited partner's positive capital account balance, while the sale or refinancing proceeds waterfall did not.

The general partner argued that the partnership agreement required only a $242,064.39 purchase price for the option, contending the option constituted merely a sale rather than a liquidation.[93] In contrast, the limited partner claimed the purchase price for the option should be calculated as a liquidation, because the sale of the property—the partnership's only asset—was a liquidation event. The liquidation calculation accounted for the limited partners' positive capital account balance of $3,927,499.[94]

The federal court found no dispute that the "Property comprises 'substantially all of the assets of the Partnership'" and, further, concluded that the Partnership Agreement specified "'[t]he sale of other disposition of all or substantially all of the assets of the Partnership' as an event that immediately causes a dissolution of the Partnership." On that basis, the court held that the liquidation provision controlled the calculation of the option price, and, therefore, the price owed for the option must reflect the limited partner's positive capital account balance.

The federal court's decision in *St. Mary's* is not only consistent with the partnership agreement between those parties: it is consistent with and adheres to the tax principles underlying the LIHTC program and partnership tax law generally.

C. The Nonprofit Right of First Refusal

Nonprofit organizations serve a well-intended goal within the LIHTC program: to ensure continued affordability of properties beyond Year 15. As also noted earlier, however, extended use agreements ensure affordability for at least thirty years regardless of the owner, mitigating concerns in this

90. *Saugatuck*, 2021 WL 4813170, at *4.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*

regard. Moreover, as a property ages, it requires more maintenance and, ultimately, rehabilitation. Nonprofit entities may lack sufficient resources to meet these needs, meaning that a property will need to re-enter the LIHTC program at the end of the Extended Use Period to fund the costs of rehabilitation if it is to remain both attractive to tenants and affordable. Disputes surrounding the ROFR must be viewed against this backdrop, with a healthy appreciation for both the role of nonprofit owners and the potential challenges that they face.

Case law surrounding the nonprofit ROFR is relatively more developed and has been far more uniform than that surrounding disputes over capital accounts. However, recent proposals in Congress have threatened to fundamentally change the ROFR, demonstrating a desire and willingness to enact a regime specifically rejected by prior Congresses and the courts. These proposals also threaten the continued engagement and participation of investors who potentially stand to see basic terms and principles to which they have long adhered summarily undone. Finally, this area is not immune to abuse by for-profit general partners seeking to seize value belonging to the investor or limited partner.

As noted above, the origin of the nonprofit ROFR lies in lawmakers' efforts to discourage market-rate conversions of LIHTC properties, the notion being that a nonprofit entity is less likely (or should be less likely) to convert a property to market rate following the statutorily prescribed period for affordability. On that basis, Section 42 was modified to include a statutory "right of 1st refusal" for qualified nonprofit organizations.[95]

A ROFR is a defensive right that "limits the right of the owner to dispose freely of its property by compelling the owner to offer it first to the party who has the first right to buy."[96] It guarantees the holder an initial opportunity to purchase a property in the event that an owner decides to sell. Unlike a purchase option, a ROFR does not entitle the holder to compel a sale from an unwilling owner.[97] In short, "[a] right of first refusal does not become an option to purchase until the owner of the property voluntarily decides to sell the property and receives a bona fide offer to purchase from a third party."[98] Furthermore, unlike a purchase option, a ROFR cannot be exercised unilaterally by the holder.

It is clear from the legislative record that Congress intended Section 42's nonprofit ROFR to operate as a common-law ROFR, not a purchase option.

95. 26 U.S.C. § 42(i)(7)(A).

96. 25 R. Lord, Williston on Contracts § 67:85, at 502 (4th ed. 2002).

97. *Id*. ("[A] right of first refusal has no binding effect unless the offeror decides to sell.").

98. Senior Hous. Assistance Grp. v. AMTAX Holdings 260, LLC, No. C17-1115RSM, 2019 WL 687837, at *6 (W.D. Wash. Feb. 19, 2019), *clarified on denial of reconsideration*, No. C17-1115 RSM, 2019 WL 827232 (W.D. Wash. Feb. 21, 2019) (citing Kelly v. Ammex Tax & Duty Free Shops W., Inc., 162 Wash. App. 825, 830–32 (2011)) *see also* SunAmerica Hous. Fund 1050 v. Pathway of Pontiac, Inc., No. 19-11783, 2021 WL 391420, at *4–7 (E.D. Mich. Feb. 4, 2021).

For instance, the House committee report described the nonprofit ROFR as "the right of first refusal (with one year's notice) to purchase the building, for a minimum purchase price, *should the owner decide to sell* (at the end of the compliance period)."[99]

Interpreting the below-market ROFR to apply as a below-market option would further violate the economic substance doctrine's requirement that "'the objective economic realities of a transaction,' rather than its legal form, determine who is an owner for tax purposes."[100] The right to receive the profit associated with a property's appreciation is customarily recognized as a right fundamental to property ownership.[101] A purchase option that permits the holder to compel the purchase of a property at a below-market price effectively shifts that right of ownership from the owner to the option holder and, thus, severs property ownership from the tax benefits and burdens assigned to it. The risk here is creating a sham entity for tax purposes,[102] disqualifying the owner from the receipt of the tax credits and undoing fifteen or more years of tax treatment between the parties.[103] It is precisely to avoid this risk that investors and developers include provisions in their agreements requiring that the exit provisions (and all provisions) of those agreements be read in a manner that ensures adherence to the economic substance doctrine.

1. Survey of Relevant Case Law

Nonprofit (and even for-profit) entities nonetheless have pursued litigation claiming that the ROFR or other provisions of the partnership agreement permit them to compel the sale of an LIHTC property at a below-market price from an unwilling owner.

For instance, in *Senior Housing Assistance Group v. AMTAX Holdings 260, LLC*,[104] the United States District Court for the Western District of Washington concluded that the nonprofit ROFR provided in the LIHTC partnership agreement before it did not allow the holder to purchase the property unless the owner received a bona fide, third-party offer that the owner was willing to accept. In *SunAmerica Housing Fund 1050 v. Pathway of Pontiac*,

99. H.R. Rep. 101-247, 1195, 1989 U.S.C. 1906, 2665 (emphasis added)

100. Homeowner's Rehab, Inc. v. Related Corp. V SLP, L.P., 99 N.E.3d 744, 755 (Mass. 2018) (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

101. *Homeowner's Rehab*, 99 N.E.3d at 755 (citing Dunlap v. Commissioner of Internal Revenue, 74 T.C. 1377, 1436–1437 (1980), *rev'd and remanded on other grounds*, 670 F.2d 785 (8th Cir. 1982).

102. Since the LIHTC program's inception, Congress has intended the true ownership tax-law principle to apply in the LIHTC context. *See supra* text accompanying notes 40–43.

103. *Homeowner's Rehab*, 99 N.E.3d at 755. (citing Dunlap v. Commissioner of Internal Revenue, 74 T.C. 1377, 1436–37 (1980), *rev'd and remanded on other grounds*, 670 F.2d 785 (8th Cir. 1982) (citing Rev. Rul. 55–540, 1955–2 C.B. 39, § 4.01(e)).

104. Senior Housing Assistance Group v. AMTAX Holdings 260, LLC, No. C17-1115RSM, 2019 WL 687837, at *8 (W.D. Wash. Feb. 19, 2019), *clarified on denial of reconsideration*, No. C17-1115 RSM, 2019 WL 827232 (W.D. Wash. Feb. 21, 2019).

Inc.,[105] the Eastern District of Michigan, considering an illusory third-party offer solicited by the general partner for the sole purpose of triggering its ROFR, determined that an offer made without an intent to execute a sale did not suffice as a bona fide offer triggering the ROFR.[106]

In *Riseboro Community Partnership Inc. v. SunAmerica Housing Fund* 682,[107] the United States District Court for the Eastern District of New York considered a nonprofit entity's challenge to the term "right of first refusal" and claim that the ROFR provided in Section 42 gave the nonprofit designee an unconditional right to purchase an LIHTC project at any point following the Compliance Period.[108] The plaintiff, Riseboro Community Partnership, Inc. (Riseboro), a nonprofit entity, was not a partner to the LIHTC partnership in question but rather a designee of the general partner and brought the action based on provisions of the partnership agreement providing a nonprofit ROFR, claiming further that the provision permitted Riseboro's unilateral purchase of the LIHTC property at any point after the Compliance Period.[109] The federal court disagreed, finding that the Section 42 ROFR did not operate differently than common law ROFRs and, therefore, did not provide an unconditional option to purchase the project.[110]

The recent case of *Centerline Housing Partnership v. Palm Communities*[111] involved a still further, more troubling phenomenon: an attempt by a for-profit general partner to manipulate and abuse the nonprofit ROFR. In *Palm Communities,* the United States District Court for the Central District of California considered a partnership agreement that provided both a purchase option and a ROFR. The court distinguished between the two: whereas the ROFR "to purchase the Property at a below-market price permitted by Section 42(i)(7) of the Internal Revenue Code following the end of the Compliance Period, but only if the Partnership 'shall desire to accept a bona fide offer from an unrelated third party to purchase the Property' from the Partnership,"[112] the purchase option provided the general partner a right to unilaterally compel the sale of the property, though the purchase price could not be less than the property's fair market value.[113]

In the case, the for-profit general partner executed an "Agreement of General Partners" (AGP) with its nonprofit general partner that transferred the nonprofit's below-market Section 42(i)(7) ROFR to the for-profit

105. SunAmerica Hous. Fund 1050 v. Pathway of Pontiac, Inc., No. 19-11783, 2021 WL 391420, at *4 (E.D. Mich. Feb. 4, 2021).

106. *Id.* at *4.

107. Riseboro Cmty. P'ship Inc. v. SunAmerica Hous. Fund 682, 482 F. Supp. 3d 31, 36 (E.D.N.Y. 2020), *as corrected* (Aug. 31, 2020).

108. *Id*.

109. *Id*.

110. *Id.* at 39.

111. *Centerline Hous. P'ship v. Palm Cmtys.*, No. 8:21-cv-00107-JVS-JDE, at *1 (C.D. Cal. Jan. 12, 2022).

112. *Id.* at *3.

113. *See id.* at *1.

general partner.[114] Once it secured the ROFR, the for-profit general partner sought to trigger the ROFR to acquire the property for millions below the fair-market price by claiming that it "'desired to accept' a third-party offer to purchase the Property" before receiving any third-party offer.[115] The for-profit general partner then refused to negotiate with the offeror and refused to conduct any due diligence on the third-party offer.[116] The court found that the for-profit general partner "devised a scheme to acquire the Property for 'millions of dollars' less than the price it was entitled to under the LPA and ROFR Agreement" in an effort to "enrich itself at the Limited Partners' expense."[117] Accordingly, the court ruled that the for-profit general partner breached its fiduciary duty to the limited partner when attempting to subvert the limited partner's profits through manipulating the nonprofit ROFR.[118]

As recognized by the court in *Palm Communities*, AGPs like the one at issue in that case permit for-profit entities to obtain the investor limited partner's asset at a below-market price. Their incentive in doing so is not to maintain a property's affordability but rather to seize value that would otherwise flow to the investor partner. Meanwhile, the investor loses money that may have otherwise funded new LIHTC or rehabilitated affordable developments.

2. Recent Policy Measures

Courts addressing disputes over the nonprofit ROFR generally have come to the same conclusion: the LIHTC ROFR is a common law ROFR and must be respected as such. At the same time, however, members of more recent Congresses and some state housing authorities have indicated a desire to fundamentally change the ROFR.

For instance, in March 2017, Senators Maria Cantwell (D- Washington) and Orrin Hatch (R-Utah) introduced the Affordable Housing Improvement Act of 2017. That legislation would have operated to convert Section 42(i)(7)'s nonprofit ROFR into a below-market purchase option.[119] Notably, the 2017 bill would have applied only proactively to LIHTC projects initiated after the bill's passing. As such, the 2017 legislation had no effect on existing LIHTC projects. The bill failed to become law.

In 2019, however, in the months following the court's ruling in *Senior Housing Assistance Group v. AMTAX Holdings 260, LLC*,[120] members of Congress introduced a new version of the 2017 bill, the Affordable Housing

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *See* S. 548 (modifying I.R.C. § 42(i)(7)(A)(1) by striking "a right of 1st refusal" and inserting "an option").

120. *See supra* text accompanying note 99.

Improvement Act of 2019,[121] which on the whole purported to "expand and strengthen the Affordable Housing Tax Credit (also known as the Low-Income Housing Tax Credit) to produce more units of affordable housing and better serve a number of at-risk and underserved communities."[122] In part, the proposed legislation addressed the nonprofit ROFR. More specifically, the proposed legislation would have replaced the words "a right of 1st refusal" in Section 42(i)(7) with "an option," for purposes of agreements on a going forward basis. But the 2019 bill also included a "clarification with respect to the right of first refusal and purchase options" in *existing* agreements, potentially—*retroactively*—converting all existing nonprofit ROFRs to below-market purchase options.[123] The 2019 proposal failed to pass. A similar version of the Affordable Housing Improvement Act was reintroduced in 2021[124] but also failed to pass.

On November 19, 2021, the U.S. House of Representatives passed the Build Back Better Act (H.R. 5376), which, among other spending and tax measures, includes a significant expansion of the LIHTC program, through measures such as increasing state credit allocations, reducing the threshold for 4% tax-exempt bond-financed projects, and increasing the eligible basis of buildings designated to serve extremely low-income households.[125] But the Act also seeks to replace Section 42(i)(7)'s nonprofit ROFR with a below-market option, and it would even go further than prior proposals in making the "option" an option to purchase the LIHTC property or the partnership interests and reducing the statutory price by excluding exit taxes from the price formula.[126]

121. The Affordable Housing Credit Improvement Act of 2019 was introduced in both the House (H.R. 3077) and the Senate (S. 1703).

122. Press Release, Sen. Maria Cantwell, Cantwell, DelBene, Bipartisan Colleagues Introduce New Legislation to Combat Affordable Housing Crisis (June 4, 2019), https://www.cantwell.senate.gov/news/press-releases/cantwell-delbene-bipartisan-colleagues-introduce-new-legislation-to-combat-affordable-housing-crisis.

123. S. 1703 § 303(30)(i)–(ii).

124. The Affordable Housing Credit Improvement Act of 2021 was introduced April 15, 2021, in the 117th Congress as H.R. 2573.

125. *See* H.R. 5376, 117th Cong. (2021): Build Back Better Act, H.R. 5376, 117th Cong. (2021); *see also, e.g.,* Build Back Better Includes Historic Expansion of the Low-Income Housing Tax Credit Program (Dec. 10, 2021), *available at* https://www.jdsupra.com/legalnews/build-back-better-includes-historic-9028137.

126. *See* H.R. 5376, § 1235506.

SEC. 135506. MODIFICATION AND CLARIFICATION OF RIGHTS RELATING TO BUILDING PURCHASE.

(a) MODIFICATION OF RIGHT OF FIRST REFUSAL.—

(1) IN GENERAL.—Subparagraph (A) of section 42(i)(7) is amended by striking ''a right of 1st refusal'' and inserting ''an option''.

(2) CONFORMING AMENDMENT.—The heading of paragraph (7) of section 42(i) is amended by striking ''RIGHT OF 1ST REFUSAL'' and inserting ''OPTION''.

(b) CLARIFICATION WITH RESPECT TO RIGHT OF FIRST REFUSAL AND PURCHASE OPTIONS.—

(1) PURCHASE OF PARTNERSHIP INTEREST. —Subparagraph (A) of section 42(i)(7), as amended by subsection (a), is amended by striking ''the property'' and inserting ''the property or all of the partnership interests (other than interests of the person exercising such option or a related party thereto (within the meaning of section 267(b) or 707(b)(1))) relating to the property''.

(2) PROPERTY INCLUDES ASSETS RELATING TO THE BUILDING.—Paragraph (7) of section 42(i) is amended by adding at the end the following new subparagraph:

''(C) PROPERTY.—For purposes of sub23 paragraph (A), the term 'property' may include all or any of the assets held for the development, operation, or maintenance of a building.''

(3) EXERCISE OF RIGHT OF FIRST REFUSAL AND PURCHASE OPTIONS.—Subparagraph (A) of section 42(i)(7), as amended by subsection (a) and paragraph (1)(A), is amended by adding at the end the following: ''For purposes of determining whether an option, including a right of first refusal, to purchase property or partnership interests holding (directly or indirectly) such property is described in the preceding sentence—

''(i) such option or right of first refusal shall be exercisable with or without the approval of any owner of the project (including any partner, member, or affili1ated organization of such an owner), and

''(ii) a right of first refusal shall be exercisable in response to any offer to purchase the property or partnership interests, including an offer by a related party.''.

(c) CONFORMING AMENDMENTS.—Subparagraph (B) of section 42(i)(7) is amended by striking ''the sum of'' and all that follows and inserting ''the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants). In the case of a purchase of a partnership interest, the minimum purchase price is an amount not less than such interest's ratable share of the amount determined under the first sentence of this subparagraph.''

(d) EFFECTIVE DATES.—

(1) MODIFICATION OF RIGHT OF FIRST REFUSAL.—The amendments made by subsections (a) and (c) shall apply to agreements entered into or amended after the date of the enactment of this Act.

(2) CLARIFICATION.—The amendments made by subsection (b) shall apply to agreements among the owners of the project (including partners, members, and their affiliated organizations) and persons described in section 42(i)(7)(A) of the Internal Revenue Code of 1986 entered into before, on, or after the date of the enactment of this Act.

(3) NO EFFECT ON AGREEMENTS.—None of the amendments made by this section is intended to supersede express language in any agreement with respect to the terms of a right of first refusal or option permitted by section 42(i)(7) of the Internal Revenue Code of 1986 in effect on the date of the enactment of this Act.

As of the date this article went to print, it does not appear that the Build Back Better Act will pass the Senate, but similar proposals concerning the LIHTC are likely to appear in future legislation.

III. Implications for Combating the Affordable Housing Shortage

The shortage of affordable housing in the United States is not a new phenomenon, and it is not a phenomenon that is going away, especially for low-income and extremely low-income (ELI) households. Indeed, the demand for affordable housing—and the crisis for low-income and extremely low-income families—has only worsened with the COVID-19 pandemic.[127]

A number of factors were contributing to this trend even pre-COVID-19. As noted in the *America's Rental Housing 2020* report of Harvard University's Joint Center for Housing Studies, the rental market has fundamentally changed since the Great Recession of 2008, with rising demand for rental housing among higher-income households pushing rents higher as well as shifting the focus in new construction towards more expensive units.[128] Rising demand among higher-income households may also fuel the

127. *See* Stefan Sykes, *8 Million Americans Slipped into Poverty amid Coronavirus Pandemic, New Study Says,* NBC News (Oct. 16, 2020), https://www.nbcnews.com/news/us-news/8-million-americans-slipped-poverty-amid-coronavirus-pandemic-new-study-n1243762; *see also* Fact Sheet: Biden-Harris Administration Announces Immediate Steps to Increase Affordable Housing Supply, www.whitehouse.gov/briefing-room/statements-releases/2021/09/01/fact-sheet-biden-harris-administration-announces-immediate-steps-to-increase-affordable-housing-supply ("The large and long-standing gap between the supply and demand of affordable homes for both renters and homeowners makes it harder for families to buy their first home and drives up the cost of rent. Higher housing costs also crowd out other investments families can and should make to improve their lives, such as investments in education.").

128. *See generally* Joint Center for Housing Studies, *supra* note 2.

AffordableHousing_V31No1.indd 56 4/8/22 9:17 AM

conversion of existing units to higher-rent units.[129] Meanwhile, if not converted to higher rents, existing rental stock continues to age, demanding more and more maintenance and updates.[130] Rising construction, land, and labor costs increasingly pose challenges for subsidized as well as market-rate developments.[131] Along with other factors, these trends have conspired to shrink the supply of low-cost units as a share of the rental stock and increase the share of cost-burdened renters.[132] Even prior to the COVID-19 pandemic, the number of renters paying at least thirty percent of income for housing and utilities was on the rise, with more than half of these cost-burdened households being severely burdened and paying more than fifty percent of their incomes for housing.[133] As of 2015, 8.3 million very-low income households suffered from severe cost burdens or were living in housing with serious deficiencies.[134]

The LIHTC has a role to play in addressing this mounting rental affordability crisis, and history has shown that it can be quite effective in doing so. Recent legislative proposals to increase the 9% credit allocation cap, reduce the threshold for 4% tax-exempt bond-financed projects, and increase the eligible basis for buildings designated to serve extremely low-income households would allow the LIHTC program not only to expand to meet the country's growing rental housing needs but also to better serve families most in need. Such proposals are crucial to the country's ability to address the growing rental affordability crisis. At the same time, investment markets are fluid and highly efficient—from the investor's perspective, proposals like those targeted towards fundamentally changing the nonprofit ROFR threaten to alter core tax principles underlying the program that have fostered such a successful private-public partnership for the program's thirty-five-year existence. To the extent that Congress or the courts threaten those principles, they threaten continued investor interest and participation.

To be sure, nonprofits have a role to play in helping the country meet its rental housing needs, especially in markets (geographic or otherwise) where the market for credits is not able to fully meet those needs. But such considerations on such a blanket basis as that reflected in recent proposals should be balanced—and must be balanced, if the program is to see continued success—against the incentives and tax principles that guide and facilitate investor participation in the first place.

129. *Id*. at 2.
130. *See id.*
131. *Id*. at 30.
132. *Id*. at 31.
133. *Id*. at 26.
134. *Id*. at 32.

CONCLUSION

The LIHTC is the primary and arguably most successful government mechanism for spurring the development and rehabilitation of affordable rental housing in the United States. Investor participation—and the demand for tax credits—is the engine that has propelled the program's success thus far, and it is the engine that must be preserved and fostered if the program is to remain successful in the future. Indeed, now perhaps more than ever, the United States needs *more* investor participation in the LIHTC program, as well as greater demand for the tax credits among participants.

As such, the LIHTC program's success is largely centered on the demand that comes from a horizon view of expected stability of investments, with the concrete expectations of returns on investments free from legislative interference. Preserving and growing such demand requires, at a minimum, adhering to the basic, long-held tax principles that have guided investor participants thus far. This goal is true not only for legislators, but also for courts increasingly faced with disputes over ownership among program participants.

AffordableHousing_V31No1.indd 58 4/8/22 9:17 AM