LIHTC and The Battle At Year 15

The Low-Income Housing Tax Credit program (LIHTC) serves as the primary funding mechanism to create and preserve affordable housing in the United States. The strength of the LIHTC program, which has been responsible for funding over 3.2 million housing units since 1986, is that it successfully incentivizes private investors to partner with nonprofit developers to meet community needs (HUD: PD&R, n.d.). In the LIHTC process, investors "provide capital for new or rehabilitated affordable housing developments in exchange for valuable, government-backed tax credits for ten years; after year fifteen, the credits become irrevocable, at which point the nonprofit entity typically takes over full ownership of the project to continue its affordable status" (RiseBoro v. SunAmerica, 2021). Furthermore, to ensure a viable transfer of ownership and the long-term affordability of the subsidized housing units, Congress included a provision in 26 U.S.C. § 42(i)(7) that grants nonprofit partners with a "special 'right of first refusal,' under which the nonprofits may purchase the investors' interests after year fifteen at statutorily-defined, below-market prices" (RiseBoro v. SunAmerica, 2021). However, a trend in the last five years of investors refusing to relinquish ownership to their nonprofit partners has called into question how "special" this right of first refusal really is (Duong, 2020).

The danger of investors not ceding control after year 15 is the ongoing "incentive for investors to try to extract more from the partnership, the tenants, and the property," effectually undermining LIHTC's original purpose of providing ongoing affordable housing to low-income populations (RiseBoro v. SunAmerica, 2021). In such instances, investors can increase rents to market-level and "reap the benefits of years of public investment in those properties for their own private gain" while their nonprofit partners are left to pursue costly legal recourse (RiseBoro v. SunAmerica, 2021). The main issue that prevents nonprofits from being able to successfully

assume ownership of a LIHTC property after year 15 is the question of if their right of first refusal should be defined in accordance with its common law meaning, which, if applied, would leave them hamstrung. Ultimately, the ambiguity of Section 42's right of first refusal provision leaves nonprofits to be disenfranchised. This idea will be explored by examining the process by which LIHTC is used to create affordable housing, the terms surrounding the right of first refusal, and the critical juncture that takes place at the 15-year mark. This paper will relate these concepts to the real-life case of RiseBoro, a nonprofit housing developer currently embroiled in a costly litigation process with its investor partner, SunAmerica.

The main roles that an investor and a nonprofit partner assume are those of limited partner and general partner, respectively. Limited partners provide the upfront capital for construction or rehabilitation while the general partner is responsible for developing and managing the property as well as ensuring ongoing compliance with LIHTC guidelines (Duong, 2020). In most partnerships, the limited partner maintains 99% of property ownership while the nonprofit assumes 1% ownership and unlimited financial liability to ensure the success of both the partnership and the project; that is, until after the end of the 15-year compliance period when investors have fully reaped their LIHTC tax credits and nonprofits assume 100% ownership by exercising their right of first refusal (IRS, 2015). The LIHTC program further fosters partnerships between credit-interested investors and mission-driven nonprofits by mandating that "in each state, at least 10 percent of LIHTC Program tax credits are set aside for properties owned by a non-profit entity or by a partnership in which a non-profit entity or its subsidiary has a stake" (RiseBoro v. SunAmerica, 2020). In the case of RiseBoro vs. SunAmerica, RiseBoro Community Partnership Inc. serves as the general partner via 420 Stockholm Street Associates (its corporate subsidiary), while SunAmerica Housing Fund No. 682 functions as the limited partner (RiseBoro v. SunAmerica, 2020).

The relationship between RiseBoro Community Partnership Inc. (“RiseBoro”) and Stockholm Street Associates (“Stockholm”) is one that should be expanded upon, especially as it communicates RiseBoro’s intent to ensure the long-term financial success of the LIHTC property and the financial well-being of its partnership with SunAmerica. By creating Stockholm, a corporate subsidiary, RiseBoro guaranteed that the rental property would not be qualified as a “tax-exempt use property,” which would have been “depreciable over a forty-year period” instead of the standard and more desirable 27.5-year period (Callison, 2015). The decision to have Stockholm represent RiseBoro “avoid[ed] the reduction of annual tax losses (and a likely resulting reduction in [SunAmerica’s] capital contribution) that would [have] result[ed] if [RiseBoro served as the direct general partner and a] forty-year depreciation [was] used” (Callison, 2015). As Stockholm served as a stand-in general partner and a “tax-exempt controlled entity” - through making an “election under Code § 168(h)(6) (F)(ii)(II), whereby any gain... is treated as unrelated business taxable income” - the LIHTC property “remain[ed] eligible for 27.5-year depreciation” (Callison, 2015). It can be observed that RiseBoro made these decisions because it had a vested interest in the long-term success of the LIHTC venture with SunAmerica – a venture undertaken with the aim of being the eventual owner.

According to Case 20-2043 from the United States Court of Appeals for the Second Circuit, “the LIHTC program... encourages long-term [affordable housing] by providing a mechanism... the contractual “right of first refusal”... for investors to exit from the development and transfer their interest to a non-profit that will maintain the project’s affordability after the investor has fully reaped the tax benefits of its initial investment (RiseBoro v. SunAmerica, 2021). Thus, after the end of the 15-year compliance period, the right of first refusal provision facilitates a smooth transition of ownership to a mission-driven nonprofit who “is strongly committed to preserving affordability even when market pressures would otherwise encourage

higher rents" (RiseBoro v. SunAmerica, 2020). In effect, the right of first refusal stops the sale of the LIHTC property to a new owner who could increase rents to market rate standards, thereby ousting current tenants who are unable to pay. But what happens when an investor does not want to sell or exit the partnership? Such a question becomes pertinent in the case of RiseBoro vs. SunAmerica.

"In November 2015, after the [15-year] compliance period expired, RiseBoro notified [SunAmerica] that it would soon exercise [its right of first refusal]" (RiseBoro v. SunAmerica, 2020). In response, SunAmerica claimed that because it was "not interested in selling" and "consent was required," "RiseBoro could not exercise its [right of first refusal] (RiseBoro v. SunAmerica, 2020). The terms of the right of first refusal provided under IRC §42(i) (7) (A) are as follows: "...a qualified nonprofit organization... may hold a right to purchase the building after the close of the building's 15- year compliance period for a price which is not less than the minimum purchase price... an amount equal to the sum of: the principal amount of outstanding indebtedness secured by the building...and all federal, state, and local taxes attributable to the sale (IRS, 2015). The trouble that arises when analyzing Section 42 is that, while the minimum purchase price is guaranteed to RiseBoro, there is no mention of seller's intent within the provision.

In the original case that took place on August 28, 2020, in the Eastern District Court of New York, Judge Raymond J. Dearie concluded that the RiseBoro had "a right of first refusal, not an option" (RiseBoro v. SunAmerica, 2020). While an option can "be triggered unilaterally, even against the owner's unwillingness to sell at the time the option-holder invokes the option," Judge Dearie asserted that RiseBoro had no such power and that the right of first refusal in the agreement between RiseBoro and SunAmerica "operates by the New York common law definition of right of first refusal" (RiseBoro v. SunAmerica, 2020). The common law definition

has two critical components: 1) "the Partnership must be willing to sell and [2)] a third-party must have made a bona fide offer to buy" (RiseBoro v. SunAmerica, 2020). The owner must then "offer the property first to the party holding the preemptive right so that he may meet a third-party offer or buy the property at some other price set by a previously stipulated method" (RiseBoro v. SunAmerica, 2020). However, this ruling was examined in the United States Court of Appeals for the Second Circuit, which challenged that such a determination undermined the very purpose of the LIHTC.

On April 14, 2021, The United States Court of Appeals for the Second Circuit contended that Judge Dearie's "decision removes a long recognized and critical aspect of the LIHTC program's design and undermines its twin purposes of incentivizing the creation of new affordable housing and preserving long-term affordability" (RiseBoro v. SunAmerica, 2021). If investors "refuse to allow their non-profit partners to take full ownership of the affordable housing project," what incentive or assurance do nonprofits have to participate in LIHTC ventures? Inevitably, as nonprofits become ousted, dissuaded, and trepidatious, there would be a "loss of existing affordable units, fewer new affordable units created, and a needless waste of tens of millions of public dollars spent to support nonprofit partnership deals like the one [between RiseBoro and SunAmerica]" (RiseBoro v. SunAmerica, 2021). Additionally, the decision of the Eastern District Court of New York verges on nonsensical, particularly when reviewing the two main components of the term "right of first refusal" under common law. Firstly, if a limited partner has no desire to sell, then their nonprofit partner is effectively held hostage in the process, possessing little ability to maintain the affordability of the LIHTC property, especially after the end of year 30 (the extended use period) where LIHTC properties are no longer subject to any monitoring or compliance standards (IRS, 2015). Secondly, why would any third party "make an offer on the property in the first place where the nonprofit

sponsor could then underbid them and prevail" due to the terms of minimum purchase price present in Section 42 (RiseBoro v. SunAmerica, 2021)?

In an ideal scenario, an investor will honor the true intention of the LIHTC program and exit the partnership at year 15. In a worst-case scenario, a nonprofit partner will be rendered ineffectual, watching from the sidelines as their well-intentioned project turns into a trojan horse that eventually outprices the very community members they hoped to serve. Such is the burden that RiseBoro carries in its fight for housing justice. To best remedy this tragic reality, the right of first refusal stated in Section 42 must be elaborated on, clarified, and distinguished from the common law term. As is, LIHTC acts as an imperfect mechanism that skews power in favor of investors and has costly implications for its nonprofit "partner" and the real people who are fighting for stability and searching for a home.

References

Callison, J. W. (2015). Tax-Exempt Use Property and LIHTC Transactions: An Overview. *Journal of Affordable Housing & Community Development Law*, *23*(3–4), 307–310. https://www.jstor.org/stable/26408142

Duong, B. (2020, October 16). *Losing Nonprofit Control of Tax Credit Housing?* Shelterforce. https://shelterforce.org/2020/10/16/refusing-the-right-to-refuse/

HUD: PD&R. (n.d.). *Low-Income Housing Tax Credit (LIHTC) | HUD USER*. Office of Policy Development and Research (PD&R). https://www.huduser.gov/portal/datasets/lihtc.html

IRS. (2015, August). *IRC §42, Low-Income Housing Credit*. https://www.irs.gov/pub/irs-utl/IRC_42.pdf

RiseBoro Community Partnership Inc. v. SunAmerica Housing Fund No. 682 et al (N.Y. Eastern. Ct. 2020). Case 1:18-cv-07261-RJD-JRC https://www.govinfo.gov/content/pkg/USCOURTS-nyed-1_18-cv-07261/pdf/USCOURTS-nyed-1_18-cv-07261-1.pdf

RiseBoro Community Partnership Inc. v. SunAmerica Housing Fund No. 682 et al (U.S. Second. Ct. Appeals. 2021). Case 20-4223 https://ag.ny.gov/sites/default/files/riseboro_v._sunamerica_nys_and_nyc_amicus_brief_as_filed.pdf