Tax Topics

Proposed Regulation Sheds Additional Light on Operation of § 42 Qualified Contract Process

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Participants in the affordable housing industry eagerly awaited the June 19, 2007, release of the Treasury Department's proposed regulation providing guidance on the qualified contract provisions of Internal Revenue Code § 42.[1] Under statute § 42,[2] properties must comply with rent and income restrictions for fifteen years. After that period, the extended-use agreement restricts the use of the property for an additional fifteen years.[3] However, Congress provided for a qualified contract mechanism to allow the owner, after the completion of the initial fifteen-year compliance period, to either (1) dispose of the property at the statutorily determined qualified contract price, or (2) transition the property to market rate over three years. In brief, the qualified contract allows the owner of an affordable housing property to request that the state housing credit agency find a buyer for the property at the statutorily determined qualified contract price. The state housing

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credit agency has one year to find a buyer for the property. In the event that a buyer cannot be located, the property can transition to market-rate housing over three years.[4] Taxpayers should note that many state allocating agencies require that building owners waive their opportunity to use the qualified contract mechanism in order to be eligible to apply for a tax credit allocation.[5]

In the preamble to the proposed regulation, the Internal Revenue Service (IRS) announced that a public hearing would be held on October 15, 2007,[6] with a deadline of September 17, 2007, for written comments.[7]

The proposed regulation sheds additional light on the operation of the qualified contract process, including some welcome details regarding the calculation of the qualified contract price. Overall, the proposed regulation represents a balanced effort by the Treasury Department to interpret the qualified contract statute. However, there are many areas in which the proposed regulation is unclear or the regulation appears to create a result that seems inconsistent with congressional intent. Affordable housing advocates should note that the regulation is only proposed and cannot be relied on until the regulation is issued as either temporary or final.[8]

Under the proposed regulation, the qualified contract price is a relatively simple calculation. However, the application of the calculation to any specific property will likely be challenging and leaves significant room for judgment. The qualified contract price is the sum of two parts: (1) the fair market value of the non-low-income portion of the building and (2) the statutorily calculated price of the low-income portion of the building. The price of the low-income portion of the building is defined as (1) the sum of current outstanding debt secured by the building, adjusted investor equity, and other capital contributions; (2) less cash distributions; (3) multiplied by the applicable fraction.[9]

The following is a discussion of each of the various components of the qualified contract calculation. This discussion is then followed by a review of issues surrounding the qualified contract process.

I. Fair Market Value of Non-Low-Income Portion

The fair market value of the non-low-income portion of the building is determined on the date the property is offered for sale. The valuation must include the impact of the extended-use agreement on the valuation of the non-low-income portion of the building. To the surprise of many program participants, the fair market value of the non-low-income portion of the building includes the land allocable to both the non-low-income and the low-income portions of the building.[10] As such, land is included in the qualified contract price at its current fair market value, instead of using the price originally paid to acquire the land. This provision allows the owner to potentially capture increases in the fair market value of the land during the intervening years since the date of purchase. The ability to capture increases in land value, however, is greatly tempered by the requirement to take into account the restrictions on the land's use that result from the extended-use agreement. For some properties, this requirement may result in a value that is less than the amount originally paid to acquire the land.

Several commentators at the public hearing on the proposed regulation stated that they believed that land was inherently part of the price of the building. However, one commentator noted that his belief that land should not be treated separately was based on the assumption that the regulation did not limit either the adjusted investor equity or the outstanding indebtedness provisions to qualified building costs. As such, adjusted investor equity and outstanding indebtedness could include sources that were used to finance land.

The Treasury noted that another commentator did not believe the IRS had the authority to include land in the debt or equity because the statute refers to the qualified contract price as being for the acquisition of the building and that other references to buildings in § 42 never include land.

At the hearing, Miriam Colon, representing the New York City Department of Housing Preservation and Development, noted that for tax credit projects in New York City, the city has often provided land at a below-market price as a form of direct subsidy to create low-income housing. She expressed concern that the proposed regulation would allow developers who acquired land at below-market prices to be eligible to receive the fair market value of the land under the qualified contract rule.

II. Statutorily Calculated Price

The price of the low-income portion of the building is defined as the (1) sum of current outstanding debt secured by the building, adjusted investor equity, and other capital contributions; (2) less cash distributions; (3) multiplied by the applicable fraction.

A. Outstanding Indebtedness

Outstanding indebtedness is limited to the remaining stated principal balance of debt secured by the building that does not exceed the amount of qualifying building costs. Developer fee notes are specifically included in the definition of outstanding indebtedness.[11] In most situations, the balances for outstanding developer fee notes are likely to be small because most developer fee notes will likely either be repaid from cash flow or required capital contributions by the fourteenth year. Nonetheless, any lingering balances would be treated as outstanding indebtedness.

Of particular interest with affordable housing properties, any debts with interest rates below the applicable federal rate must be discounted; in these cases, the principal balance is recalculated using an imputed interest rate equal to the applicable federal rate in effect at the time of issuance.[12] As many LIHTC properties also use below-market loans to finance a portion of the cost of the properties, this provision is likely to be frequently encountered. However, many of those below-market loans also limit the use of the property to affordable housing for a longer time than the original compliance period. As a result, properties with this form of financing will often discover that the qualified contract process is not a viable alternative because the restrictions placed by the below-market financing cannot be removed through the qualified contract process. The requirement that the imputed principal balance be used applies whether or not the new owner will assume the below-market loan. This is significant because in the event that the debt cannot or will not be assumed, the seller receives a significantly reduced qualified contract price due to the discounting of the loan; and yet the payment of the loan from the sales proceeds made in current dollars is not similarly discounted, thereby leaving less net cash proceeds for the seller of the property.

Based on the current wording of the proposed regulation, it is unclear if debt must be traced to the eligible costs. As currently worded, it appears that debt used to finance ineligible costs must be traced directly to those costs.[13] By inference, it would seem that similar tracing is required for debt used to finance eligible costs, if for no other reason than to prove that the debt was not used to finance ineligible costs. However, the proposed regulation does not specifically identify whether direct tracing is required for debt proceeds. In the event that direct tracing of debt proceeds to underlying eligible costs is required, most owners of LIHTC properties will likely find the requirement to trace outstanding indebtedness to qualifying building costs tedious, cost-prohibitive, and potentially impossible fourteen years after the fact. For new LIHTC properties constructed going forward, the property owners may choose to plan ahead and trace these costs as construction is completed or at the time of the final cost certification.

The preamble to the proposed Treasury regulation and the proposed Treasury regulation itself allows for the potential double counting of cash distributions from debt refinancings. The double counting may occur because the qualified contract price

1. excludes a portion of refinancing debt used to make cash distributions,[14] and
2. is reduced by the amount of the cash distribution made.[15]

There are two different interpretations regarding the extent to which a portion of refinancing debt is excluded from the qualified contract price. One interpretation is that all refinance debt in excess of the original debt is excluded, and the other is that all refinance debt in excess of qualifying building costs is excluded.

1. All Excess Refinance Debt Excluded

The preamble to the proposed Treasury regulation identifies that "…proceeds from refinancing indebtedness or additional mortgages in excess of such qualifying building costs are not outstanding indebtedness…." Although this same wording does not appear in the proposed Treasury regulation, many commentators, based on the wording in the preamble, have concluded that refinancing indebtedness would be excluded from the calculation of outstanding indebtedness to the extent that the refinanced indebtedness exceeds the original indebtedness.

2. Refinance Debt in Excess of Qualifying Building Costs Excluded

The proposed Treasury regulation itself appears to allow for double counting against refinanced loan proceeds to the extent that the refinanced loan exceeds eligible building costs. For example, a partnership may arrange a $7 million loan as permanent financing on a $10 million LIHTC building. Ten years later, the partnership could refinance the loan with a new loan for $12 million, with the $5 million net proceeds used to make a distribution to the partners. Based on the proposed Treasury regulation, only $10 million of the refinanced loan would count toward outstanding indebtedness,[16] yet the full $5 million distribution to the partners would count as a reduction of the low-income portion amount.[17] This results in a double counting of $2 million. Therefore, a property experiencing a refinancing in excess of eligible building costs may be precluded from participating in the qualified contract process because its calculated contract price may be abnormally restricted due to this provision.

B. Adjusted Investor Equity and Other Capital Contributions

The proposed regulation divides capital contributions into two distinct groups for the calculation of the qualified contract price: adjusted investor equity and other capital contributions.

The calculation of the adjusted investor equity is based on the equity invested for qualifying building costs, grossed up for increases in the consumer price index (but not more than 5 percent per year). The grossing up of investor equity essentially allows for a moderate return on investment roughly equivalent to earning interest on a low-risk instrument. Only equity investments that are related to an obligation to invest as of the beginning of the credit period qualify for inclusion in the calculation of adjusted investor equity. As such, subsequent investments made by an investor but not related to an obligation to invest at the beginning of the credit period would not be includible in adjusted investor equity but may be included as other capital contributions.[18]

Capital contributions made later (for example, to fund the cost of a new furnace) are included as other capital contributions, which are not subject to adjustment for changes in the consumer price index. Although not specifically delineated in the proposed regulation, there appears to be no requirement to trace other capital contributions to specified uses. The example of using capital contributions to fund the cost of a new furnace was likely simply chosen as an illustration and is probably not intended to limit other capital contributions to those used to pay for specific uses.[19]

C. Cash Distributions

Finally, any cash distributions made to the owners are subtracted in arriving at the qualified contract price. Cash distributions include all distributions to owners and related parties, as well as all cash and cash equivalents available for distribution at the time of sale. The regulations also include an anti-abuse rule that reclassifies payments to owners or related parties for operating expenses in excess of amounts reasonable under the circumstances as cash distributions. For LIHTC properties in which the annual incentive management or asset management fees are exceedingly high, the IRS might take the position that a portion of those fees constitutes a cash distribution.[20]

D. Calculation of Statutory Price

The resultant sum of outstanding indebtedness, adjusted investor equity, and other capital contributions, less capital distributions, is multiplied by the applicable fraction to arrive at the statutory price for the low-income portion.[21] The statutory price for the low-income portion is then added to the fair market value of the non-low-income portion to arrive at the total qualified contract price. Under the statute, upon application by the LIHTC property owner, the state housing agency would have twelve months to find a buyer for the property at this price.

III. Qualified Contract Process

Although the proposed regulation answers many questions regarding the qualified contract process, many questions remain unanswered.

Previously, owners of properties were concerned about their ability to accept or reject a qualified contract found by the state housing credit agency. This concern significantly limited the attractiveness of the qualified contract process to existing owners due to the possibility of being forced to sell the property at potentially unattractive terms. However, the new guidance specifically indicates that if the agency provides a qualified contract within one year and the owner rejects or fails to act upon the contract, the building will remain subject to the extended-use agreement.[22] Although an LIHTC property owner may choose to reject the qualified contract, the proposed regulation specifically gives the state housing agency the administrative right to limit the number of subsequent requests for a qualified contract that may be submitted by the owner.[23] Accordingly, some state housing agencies may allow multiple subsequent requests, but most states will probably significantly limit the number of requests an owner may make for a given LIHTC property.

One of the most pressing questions that remain is the definition of *bona fide offer*. Without specific guidance on the criteria used to determine an offer's qualifications as bona fide, the opportunities for manipulation of the process have the potential to significantly curtail the effectiveness of the program. For example, potential buyers might offer to purchase the property based on unreasonable terms, such as requiring the current owner to provide financing or make guarantees not usually included in similar transactions. If such an offer were deemed to be bona fide, then the owner would likely have no choice but to reject the offer and potentially forfeit the opportunity to use the qualified contract mechanism going forward. As a result, many commentators have requested that the Treasury Department publish a list of terms that would preclude an offer from qualifying as bona fide.[24] Alternatively, some commentators have requested that the Treasury Department allow for binding mediation in the event of a dispute between the state housing agency and the property owner regarding whether an offer qualifies as bona fide.

As currently drafted, the proposed Treasury regulation allows the state housing agency to adjust the fair market value of the building if, after a reasonable period of time within the one-year offer of sale period, no buyer has made an offer.[25] It is unclear on what basis the state housing agency would decide when and how much to reduce the qualified contract price. Many commentators have noted that this provision is inconsistent with § 42 and the major thrust of the regulations because the qualified contract price is based on a specified formula, which is generally intended to represent a fair price to the owner and is not intended to necessarily result in a price consistent with current fair market values.

Some commentators have suggested that the IRS provide an overall fair market value limit on the qualified contract price.[26] However, in the preamble to the proposed regulation, the IRS noted that the "statute defines a qualified contract, in part, as a contract to acquire the low-income portion of the building for an amount "not less than" the applicable fraction of the statutorily provided formula. Therefore, the proposed regulations do not adopt a fair market value cap.[27]

In practice, this provision could lead prospective buyers to wait out the qualified contract process until the state housing agency has decided to reduce the qualified contract price one or more times, in order to secure a more favorable price for the property. Ultimately, this provision in many instances will likely thwart the purposes of the qualified contract because property owners will enter the qualified contract only if the statutorily calculated price meets their minimum criteria for selling the property. If the qualified contract price is significantly reduced by the state housing agency, most property owners will likely reject those offers as not meeting their minimum pricing criteria for the sale of the property.

Additionally, as currently drafted, the proposed Treasury regulation allows the state housing agency to adjust the fair market value of the building if market values have adjusted downward.[28] It is unclear from the proposed Treasury regulation precisely how the state housing agency would identify either that market values have adjusted downward or the degree to which market values have adjusted downward.[29] Of concern to many LIHTC property owners is that while the fair market value may be adjusted downward, there is no corollary provision allowing the fair market value to be adjusted upward in the event that market values have adjusted upward.

A. Qualified Building Costs

The proposed regulation appears to indirectly exclude accounting and legal fees from qualified building costs in the calculation of the qualified contract price.[30] Legal and accounting costs are similar to numerous other indirect or soft costs incurred in the development and operation of an LIHTC property. Such indirect or soft costs are treated for federal income tax purposes in a variety of ways, including (1) capitalized to the building and depreciated, (2) capitalized as intangibles and amortized, and (3) expensed. As such, it is unclear from the regulation why legal and accounting costs capitalized to the building should not be included as qualified building costs.

In addition, legal and accounting costs comprise a portion of many of the categories of costs routinely tracked within the LIHTC program. As a result of this standard record-keeping methodology, requiring LIHTC building owners to sort through accounting records from more than fourteen years ago to identify all legal and accounting costs included in the development of the project would represent a very significant administrative burden. As such, if this provision is included in the final Treasury regulation, many building owners will want to carefully track these costs as they are incurred to avoid the future administrative difficulty of tracking them.

B. Documentation

It is unclear how building owners will document the components of the qualified contract calculations. Some states believe that building owners must be able to submit "audited financials since the low income building was placed in service."[31] However, the Affordable Housing Tax Credit Coalition suggested that

> the approach established by the Florida housing credit agency with respect to information and documents to be submitted in making a written request is a good example. . . . The documents and information required to be submitted by Florida are as follows:
>
> (i) a calculation of the qualified contract price;
> (ii) a thorough narrative description of the project, including amenities;
> (iii) a description of the regulatory restrictions, if any, applicable to the project;
> (iv) photographs of the exterior and representative apartment units and buildings;
> (v) financial operating statements for the project for the prior 12 months;
> (vi) a current rent roll; and
> (vii) copies of any leases if any portion of the land or improvements is leased.[32]

IV. Conclusion

With the new proposed regulation in hand, our understanding of the qualified contract calculation and the overall process is significantly augmented. Additionally, the IRS now has an excellent opportunity to clarify a number of open areas when issuing temporary or final regulations on qualified contracts, which will lead to a much smoother qualified contract process and result in a fairer result for all stakeholders.

1. Section 42 Qualified Contract Provisions, 72 Fed. Reg. 33706 (proposed June 19, 2007) (to be codified at 26 C.F.R. pt. 1, § 1.42-18).

2. *See* Low-Income Housing Tax Credit Handbook, www.novoco.com (additional information on the Low-Income Housing Tax Credit program).

3. I.R.C. § 42(h)(6)(B), (D) (All references to the Internal Revenue Code refer to the Internal Revenue Code of 1986, as amended.) Many states require that the extended-use agreement be longer than an additional fifteen years. California, for instance, has a combined low-income use requirement of fifty-five years.

4. I.R.C. § 42(h)(6)(E)(1)(ii).

5. The California Tax Credit Allocation Committee is an example of an agency that requires owners to waive this opportunity. To clarify the right of state allocating agencies to require such a waiver, the Arizona Department of Housing submitted comments on the qualified contract proposed regulation and requested that the proposed regulation "be carefully drafted to foreclose argument that allocating agencies do not have authority to require tax credit applicants to waive their rights to qualified contracts." Letter from Randy Archuleta, Rental Programs Adm'r, Ariz. Dep't of Hous., to IRS (Sept. 7, 2007).

6. Speakers at the hearing were Richard S. Goldstein, Affordable Housing Tax Credit Coalition; Miriam Colon, New York City Department of Housing Preservation and Development; David Rammler, National Housing Law Project; and Scott Kline, NHT/Enterprise Preservation Corp. For a transcript of the hearing, see www.novoco.com/low_income_housing/resource_files/hot_topics/year_15/hearing_transcript_101507.pdf.

7. For a list of the various comment letters submitted, as well as a list of other qualified contract materials, see www.novoco.com/low_income_housing/news/hot_topics/irs.php.

8. See LIHTC Monthly Report (Aug. 2007).

9. Section 42 Qualified Contract Provisions, 72 Fed. Reg. 33706 (proposed June 19, 2007) (to be codified at 26 C.F.R. pt. 1, § 1.42-18) [hereinafter Proposed Regulation].

10. *Id*. § 1.42-18(b)(3).

11. *Id*. § 1.42-18(c)(3)(i). Presumably, this also means that cash payments for interest or principal on related-party developer fee notes are not treated as cash distributions.

12. *Id*. § 1.42-18(c)(3)(ii).

13. *Id*. § 1.42-18(c)(3)(i).

14. *Id*. § 1.42-18(c)(3)(i).

15. *Id*. § 1.42-18(c)(6).

16. *Id*. § 1.42-18(c)(3)(i).

17. *Id*. § 1.42-18(c)(2)(iv).

18. *Id*. § 1.42-18(c)(4).

19. *Id*. § 1.42-18(c)(5).

20. *Id*. § 1.42-18(c)(6).

21. *Id*. § 1.42-18(c)(2).

22. *Id*. § 1.42-18(a)(1)(ii)(B).

23. *Id*. § 1.42-18(d)(1)(iv).

24. For instance, the Arizona Department of Housing comment letter, *supra* note 5, stated thus:

> lndicia of a bona fide offer should include the following:
> i. Offer made in good faith
> ii. Legally binding on buyer

iii. Buyer has full capacity (legal and financial) to close
iv. Offer is based on due diligence determination
v. Offer provides adequate period for parties to review
vi. Offer provides a firm date for closing, manner of payment, earnest money requirements
vii. Dispute resolution provisions in event of breach including seller's right to damages for loss of right to terminate extended use period.

25. Proposed Regulation § 1.42-18(c)(1).

26. *See* proposed regulation comment letter submitted by Arizona Department of Housing, *supra* note 5 ("ADOH believes that it would advance the public interest for the IRS to restrict the qualified contract price to fair market value by using 'do not manipulate' language in proposed section 1.42-18(c).").

27. In his oral comments at the October 15, 2007, hearing on the proposed regulation, Rick Goldstein stated that the Affordable Housing Tax Credit Coalition believes that states do not "...have authority to impose more stringent requirements on the fair market value limit...."

28. *Id*.

29. One commentator suggested that "an owner should be provided a right to terminate the submission process if the Agency reduces the fair market value of the non low-income portion without sustaining a penalty against resubmitting subsequently." Letter from Gene E. Crick, Jr., Broad & Cassel, to IRS (Sept. 10, 2007).

30. Proposed Regulation § 1.42-18(c)(3)(i), (c)(4)(i), (c)(5).

31. *See* Arizona Department of Housing comment letter, *supra* note 5.

32. Letter from Affordable Housing Tax Credit Coalition to IRS (Apr. 30, 2007).