

IRS Issues New Qualified Contract Proposed Regulations

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Participants in the affordable housing industry have eagerly awaited the June 19, 2007 release of the Treasury Department's proposed regulations providing specific guidance on the qualified contract provisions of Internal Revenue Code §42. Under statute, §42 properties must comply with restricted rent and income limits for 15 years. After that period, the extended use agreement restricts the use of the property for an additional 15 years. However, Congress provided for a qualified contract mechanism to allow the owner, after the completion of the initial 15-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 contact price. The state housing 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.

The new proposed regulations shed 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 regulations represent a balanced effort by the Treasury Department to interpret the qualified contract statute. Affordable housing advocates should note that these regulations are only "proposed" and cannot be relied on until they are either temporary or final. Before making them temporary or final, the Treasury Department has requested public comment. There are many areas where the proposed regulations are unclear or where the regulations appear to create a result that seems inconsistent with congressional intent. Affordable housing advocates will want to comment on these proposed regulations and share their concerns. Novogradac & Company LLP will be submitting written comments to Treasury, and we invite you, our readers, to share your areas of concern with us. A public hearing on these proposed rules will be held by the Internal Revenue Service on October 15, 2007.

Under the proposed regulations, the qualified contract price is a relatively simple calculation. However, the application of the calculation to any specific property will likely be challenging, and leave 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 the sum of: (1) current outstanding debt secured by the building, (2) adjusted investor equity and (3) other capital contributions, less cash distributions, multiplied by the applicable fraction.

Fair Market Value Non Low-Income Portion

The fair market value of the non low-income portion of the building is determined at the date the property is offered for sale. The valuation must include the impact on the valuation of the non low-income portion of the building due to the extended use agreement. 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 building, and the low-income portion of the building. As such, the land is included in the qualified contract price at its current fair market value, instead of using the cost originally paid to acquire the land. This provision allows the owner to capture any increase in the fair market value of the land during the intervening years since the date of purchase.

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. Of particular interest with affordable housing properties, any debts with interest rates below the applicable federal rate are required to be discounted; in these cases the principal balance is recalculated using an imputed interest rate equal to the applicable federal rate. The requirement that the

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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 cash to be paid out to the seller of the property.

Based on the current wording of the proposed regulations, it is unclear if debt is required to 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. 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 regulations do not specifically identify whether direct tracing is required for debt proceeds.

Any property experiencing a debt refinancing will likely be faced with two relatively material questions in the calculation of the qualified contract price. The preamble to the proposed regulations indicates that only debt used *for* qualified costs is included in the calculation of the low-income portion of the qualified contract price. Although the proposed regulations themselves do not make this distinction, this wording could potentially exclude the proceeds of all refinanced loans, as the new loans are used to repay existing debt, instead of directly paying for eligible costs. Presumably this is not what the Treasury intended. Alternatively, the wording could be interpreted to exclude the amount of refinance proceeds in excess of the original loan, if those excess proceeds are used to make equity distributions to the owners. Both of these interpretations would result in a double reduction of the qualified contact price for cash distributions from refinancing proceeds. The double reduction would occur because debt used to finance the distribution would not be included in the price, but the actual distribution would reduce the price, by virtue of being included as a cash distribution.

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). Only 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. Capital contributions made later (for example, to pay to replace a furnace) are included as other capital contributions, which are not subject to adjustment for changes in the consumer price index.

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.

Calculation of Statutory Price for Low-Income Portion

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.

Qualified Contract Process

Although the new proposed regulations answered 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

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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.

One of the most pressing questions remains regarding the definition of a “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,” 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.

Potentially the most contentious provision of the proposed regulations allows the state housing credit agency to adjust the fair market value of the

building if no buyer can be located within a reasonable period of time, or if market values have adjusted downward. This provision appears to allow for an arbitrary reduction in the fair market value simply due to the lack of interest in the property at the qualified contract price.

Qualified Building Costs

The proposed regulations appear to indirectly exclude accounting and legal fees from qualified building costs in the calculation of the qualified contract price. It is unclear if this indirect exclusion was intended.

Affordable housing advocates should take the opportunity to comment on these proposed regulations. The receipt of a broad spectrum of comments will provide the Treasury Department needed feedback to address lingering questions and issues in a manner satisfactory to all the stakeholders in the qualified contract process. ❖