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Y15 Arrives for 1990 LIHTC Properties

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According to data compiled by the National Council of State Housing Agencies (NCSHA), there were more than 74,000 low-income housing tax credit (LIHTC) units approved in 1990. Fifteen years later in 2004, these LIHTC units are the first to work through Internal Revenue Code (IRC) §42(h)(6), more commonly known as the "extended use period." The requirements of IRC §42(h)(6) stipulate that LIHTC compliance must be maintained on all LIHTC properties receiving an allocation in 1990 and thereafter, ending no later than 15 years after the close of the compliance period or longer as specified in an agreement between the taxpayer and the respective housing credit agency. Therefore, all LIHTC properties receiving allocations in 1990 and subsequent years must fulfill a minimum 30-year compliance commitment. However, in general, there are two caveats that terminate the extended use period; foreclosure and the qualified contract. This article will examine the extended use period requirements, the termination of such period using the qualified contract and the methodology for calculating its value.

IRS Provisions

Generally IRC §42(h)(6) requires the owner of an LIHTC project, receiving an allocation after 1989, to maintain the percentage of low income tenants for at least 15 years after the close of the LIHTC compliance period. The LIHTC compliance period is defined in IRC §42(i)(1) as a the period of 15 taxable years beginning with the first taxable year of the credit period. Interestingly, it is only compliance violations occurring in the compliance period that elicit the tax credit recapture provisions outlined in IRC §42(j). Accordingly, though the risk of tax credit recapture ceases when the compliance period is fulfilled, projects receiving an allocation after 1989 are required to maintain the percentage of low income tenants, as defined by §42, for at least an additional 15 years beyond the compliance period.

The extended low-income housing contract is an agreement between the taxpayer and the housing credit agency. In accordance with §42(h)(6)(b), this agreement generally includes the following provisions:

- Requires the taxpayer to maintain the percentage of low-income tenants for at least 15 years after the close of the compliance period.
- The portion of the building used for low-income tenants each year in the extended use period will not be less than the applicable fraction specified during the compliance period.
- The agreement is binding on all successors of the taxpayer.
- The agreement must be recorded as a restrictive covenant with respect to the building under applicable state law.
- The agreement must prohibit evictions without good cause and rent increases not otherwise permitted in the agreement (i.e. LIHTC rents).
- No LIHTCs are allowed with respect to any building for the taxable year unless an extended low-income housing commitment is in effect at the end of such year.

The IRC states that the extended use period for any building shall terminate on the date that the building is acquired by foreclosure or if the housing credit agency is unable to present a buyer under a qualified contract arrangement.

By virtue of the contract, a building receiving an allocation is subject to the extended use period. However,

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there are two exceptions in §42(h)(6)(E)(i) that allow for the termination of the 15-year extended use contract and its related compliance requirements. The first exception is by property foreclosure. However, the Internal Revenue Service (IRS) may reject this exception if it determines that the foreclosure is an arrangement set forth by the taxpayer with the sole purpose to terminate the period. The second exception occurs on the day after a qualified contract expires.

The Qualified Contract

In the last year of the compliance period, or thereafter, the taxpayer may enter into a qualified contract with the housing credit agency. In this situation, the housing credit agency has one-year to find a buyer for the taxpayer's interest in the project and continue to operate the project as a qualified low-income property. To the extent no buyer is found, the extended use contract terminates the day after the qualified contract expires. This exception, however, does not apply where the commitment agreement with the housing credit agency provides for more stringent requirements. In recent years, more stringent requirements have been consented because of the increased competition for LIHTC allocations.

The qualified contract is a contract allowing the housing credit agency to find a buyer to acquire from the owner the market rate units for fair market value and the LIHTC units for the sum of the following items:

1) The adjusted investor's equity in the building.
2) The outstanding indebtedness secured by the building less any cash distributions to the owner.
3) Any capital contributions not reflected in the items listed above.

Should the housing credit agency fail to exercise the qualified contract, the LIHTC compliance restrictions end and the owner may convert the property to market rental rates or sell the property free of LIHTC compliance restrictions. However, to the surprise of many, §42(h)(6)(E) provides that there can be no conversion to market rental rates or evictions of tenants without good cause for a period of 3 years following the termination of the extended use contract.

Calculating the Value

Many questions are posed when determining the value of both the market rate and LIHTC units in a qualified contract (See related article on page 24). With respect to adjusted investor's equity, Jerome A. Breed of Powell Goldstein Frazer & Murphy stated in the May 2003 *LIHTC Monthly Report*, "§42(h)(6)(G)(i) suggests that adjusted investor equity excludes amounts not included in (eligible) basis." Thus, allowing for uncertainty in the calculation when investor equity is used to fund reserves or bond issuance costs. Additionally, Breed suggests that the definition of cash flow distributions to the owner is not clearly defined. For example, perhaps deferred developer fee

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payments and incentive management fees are subtracted from secured debt in this facet of the calculation. Breed also stresses that no guidance to the methodology for determining fair market value of the market rate units in a project exists at this time. For these reasons, it appears that significant differences in the price of the qualified contract could occur depending on how the provisions are interpreted.

The following two scenarios present two very simple fact patterns and then illustrate the value of the property under a qualified contract. For both scenarios, assume a three-year period (as opposed to 15 years) and that all units are LIHTC.

Scenario 1

Secured Debt	$1,200,000
Adjusted Investor Equity	$650,000
Consumer Price Index	2% (all three years)

	Year 1	Year 2	Year 3
Distributions to Owner	$ 30,000	$ 30,000	$ 30,000
Deferred Developer & Incentive Management Fees	(20,000)	(20,000)	(20,000)
Distributions less Fees	$ 10,000	$ 20,000	$ 20,000
Adjusted Investor Equity	$ 650,000	$ 663,000	$ 676,260

The value of this property would be $1,826,260. The value is the sum of the secured debt less the cash flow distributions ($1,200,000 - $50,000), plus the adjusted investor equity in year three.

In the next scenario, assume that the adjusted investor equity is reduced because the $125,000 that was used for syndication costs, loan fees and reserves is deemed to not be part of adjusted investor equity. In addition, assume that deferred developer and incentive management fees are deemed cash distributions to the owner.

Scenario 2

Secured Debt	$1,200,000
Adjusted Investor Equity	$525,000
Consumer Price Index	2% (all three years)

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	Year 1	Year 2	Year 3
Distributions to Owner	$ 30,000	$ 30,000	$ 30,000
Adjusted Investor Equity	$525,000	$ 535,500	$ 546,210

The value of this property would be $1,656,210. This is the sum of the secured debt less the cash flow distributions ($1,200,000 - $90,000), plus the adjusted investor equity in year three. Consequently, there is a more than a 10 percent change in price when applying different interpretations to the calculation.

Conclusion

It is possible for owners of LIHTC properties that received allocations after 1989 to terminate the extended use contract and either convert to market rental rates or sell the property without the §42 restrictions, subject to any stringent agreements made with the housing credit agency. However, owners and LIHTC professionals should be aware that depending on the interpretation of even the simplest of circumstances, the sale price of a qualified contract can vary significantly. In closing, owners and LIHTC professionals should consider exit strategies as early as year 11 of the compliance period and consider what interpretations the respective housing credit authority is making with respect to qualified contracts.

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