September 17, 2007

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Internal Revenue Service
CC:PA:LPD:PR (REG-114084-04)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations Implementing Section 42 Qualified Contract Provisions

Ladies and Gentlemen:

The Affordable Housing Tax Credit Coalition (the "Coalition") is submitting these comments in response to the above-cited notice of proposed rulemaking. The Coalition is a national trade association based in Washington, DC comprised of syndicators, investors, developers, lenders, housing credit agencies and professionals who are deeply involved in the low-income housing tax credit ("Housing Credit") industry. Our members are responsible for raising a substantial portion of the equity capital that is invested in properties which generate Housing Credits. We have a great deal of experience with respect to the financing, development and tax matters pertaining to the Housing Credit program. We appreciate your consideration of these comments.

BACKGROUND

In 1989, the Congress enacted Section 42(h)(6) of the Code. In doing so, Congress reflected a concern that the properties developed using the Housing Credit be preserved for low-income use for an extended period, generally at least thirty years. However, the Congress also recognized a concern expressed by owners, syndicators and investors, including Coalition members, that extending the low-income use period to thirty years could discourage or decrease capital investment in these properties; if investors had no opportunity to recoup their investment or benefit from the potential appreciation of the property's value as an unrestricted property for at least thirty years, then investors' would likely to be less willing to provide capital or as much capital.

Accordingly, the enactment of Section 42(h)(6) reflected a compromise recognizing the need to preserve Housing Credit properties

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for an extended period but providing a mechanism by which owners and investors could, if they chose to do so, either receive a fair return on their investment, determined by receipt of a "qualified contract" or be permitted to end the low-income use restrictions on the property (after a phase-out period). The ability to utilize a qualified contract makes it feasible to develop properties in areas where land costs are high, since it provides developers and investors with the ability to recognize a return on their investment. The mechanism to be employed permits the owner to request anytime after the fourteenth year of the compliance period that the housing credit agency present a "qualified contract" for the acquisition of the low-income portion of the building by any person who will continue to operate such portion as a qualified low-income building[1]. The housing credit agency is given a one-year period after the owner's written request to find a buyer. In the event that no qualified contract is presented, then the extended use period terminates, subject to a three year period during which existing tenants may not be evicted, except for good cause, and rents may not be raised except in conformity with Section 42.

A "qualified contract" is defined in Section 42(h)(6)(F) as a "bona fide contract to acquire (within a reasonable period after the contract is entered into) the non-low-income portion of the building for fair market value and the low-income portion of the building for an amount not less than the applicable fraction (specified in the extended low-income housing commitment) of—

(i) the sum of—

(I) the outstanding indebtedness secured by, or with respect to, the building,
(II) the adjusted investor equity in the building, plus
(III) other capital contributions not reflected in the amounts described in subclause (I) or (II), reduced by

(ii) cash distributions from (or available for distribution from the project.)"

[1] We note that there is an inconsistency in the statutory language. Under Section 42(h)(6)(B)(iii), there is a prohibition on disposing of a building unless the entire building is disposed of to one person. Accordingly, we believe that the Congress intended the qualified contract process to relate to both the low-income and nonlow-income portion of a building despite the language in Section 42(h)(6)(E)(i)(II) that refers only to the low-income portion.

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The "adjusted investor equity" is defined in sub-clause (G) as the "aggregate amount of cash taxpayers invested with respect to the project increased by the amount equal to—

(I) such amount, multiplied by
(II) the cost-of-living adjustment for such calendar year, determined under Section 1(f)(3) by substituting the base calendar year for 'calendar year 1987'.

An amount shall be taken into account as an investment in the project only to the extent there was an obligation to invest such amount as of the beginning of the credit period and to the extent such amount is reflected in the adjusted basis of the project."

Our comments are organized as follows: Section I deals with questions as to which the Service has specifically asked for comment in the Preamble to the Proposed Regulations. Section II deals with concerns with specific provisions set forth in the Proposed Regulations. Section III deals with areas which the Coalition believes should be, but are not addressed, in the Proposed Regulations.

SECTION I—RESPONSES TO QUESTIONS RAISED BY THE SERVICE

1) Are buildings ever sold without the underlying land, and if so, what is the appropriate treatment?

Response: Our experience is that while most buildings are constructed on land owned in fee simple by the owner, a substantial number of buildings are constructed on land subject to a long term ground lease. This is particularly true in buildings owned by public housing authorities and financed under the Department of Housing and Urban Development's mixed finance programs, including the HOPE VI program. However, in such cases, in order to demonstrate ownership of the buildings in the land lessee for federal income tax purposes, the ground lease has a very long term, generally in excess of 65 years and often as long as 99 years. Accordingly, buildings that are subject to a long term ground lease will continue to be held by the purchaser for a period that is generally in excess of fifty additional years. Such buildings, however, will be sold subject to that lease and we believe that the land should be valued based upon the fair market value of the land that is subject to the ground lease, which is the same way that land owned in fee simple would be valued. We also note that in many cases, the terms of the ground lease or other regulatory restrictions imposed in connection with the building's financing will limit the use of the building

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to low-income housing and that such restrictions should be taken into account in valuing the building and the land.

2) Do housing credit agencies have authority to provide more stringent requirements than the provisions contained in Section 42(h)(6)(F) and specifically, may such agencies impose a fair market value cap that would restrict any qualified contract price to the fair market value?

Response: The Coalition believes strongly that housing credit agencies have no authority under Section 42(h)(6)(F) or otherwise to impose a different formula for computing the qualified contract price and no authority to impose a fair market value limitation on such price. As noted earlier in our comments, the Congress carefully considered how to calculate the qualified contract price. That determination was a compromise that reflected a balancing of interests between investors concerned that they be able to recoup their equity investment and tenant advocates who wished to extend the low-income use restrictions. The result of its careful deliberations on this subject is the calculation set forth in Section 42(h)(6)(F). Had the Congress desired to set or limit the price to the fair market value, it would have done so, but it chose instead to set the price as set forth in Section 42(h)(6)(F). There is absolutely no legislative history of which we are aware that would support the proposition that the Congress intended a fair market value limitation. The flush language that the Service cites in Section 42(h)(6)(E), which allows for "more stringent requirements," relates to a wholly different concept—when the extended use period will terminate. Indeed, the language is very clear—the "more stringent requirements" relate to "Subclause II" of Section 42(h)(6)(E), which deals with the date for termination of the extended use period; it has nothing to do with the qualified contract price, which is set forth in Section 42(h)(6)(F). The Coalition recognizes that housing credit agencies have the authority, which has been regularly exercised, to terminate the extended use period at a date later than contemplated in Section 42(h)(6)(E). Indeed, our experience is that it is impossible to obtain a housing credit allocation in most states unless the owner agrees, in its application, to extend the termination of the extended use period. However, housing credit agencies have no ability to change the calculation of the qualified contract price, nor does the Service have the ability through regulations to alter the statutory language on the subject.

We also note that Section 1.42-18(c)(1) of the Proposed Regulations provide that housing credit agencies would have the right to reduce the fair market value of the building (presumably meaning the non low-income portion) if, after a reasonable period, no buyer has made an offer or market values have adjusted downward during the one year period. We question the statutory authority for giving housing credit

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agencies such a right. Moreover, it is unclear as to how agencies would decide precisely when to reduce the acceptable price and by what amount. Would the agencies be required to adjust the price upward if market values were determined to have increased? Accordingly, we object to giving housing credit agencies the right to adjust the fair market value during the one-year period.

SECTION II—COMMENTS ON SPECIFIC PROVISIONS OF THE PROPOSED REGULATIONS

1) **Definition of "outstanding indebtedness"**. Proposed Section 1.42-18(c)(3)(i) would define "outstanding indebtedness" for purposes of calculating that aspect of the qualified contract price as being limited to the amount of the qualified building costs as defined in paragraph (b)(4) of that Section. A qualified building cost is limited to costs includable in eligible basis and as explained in the Preamble, the proposal would exclude the proceeds of any refinancing or additional mortgages in excess of such qualifying building costs. Moreover, Proposed Section 1.42(c)(3)(ii) would require the discounting of any debt which has an interest rate below the applicable Federal rate ("AFR") under Code Section 1274. There is absolutely no statutory authority, nor legislative history, to indicate that the Congress intended that outstanding indebtedness be limited to qualified building costs or that debt with an interest rate below the applicable Federal rate be discounted as proposed. Had Congress intended either result, it would provided language to this effect. Contrast the language of Code Section 42(i)(7)(B)(i), enacted at the same time as the qualified contract provisions, which deals with the minimum purchase price under the exercise of a right of first refusal. In that situation, the Congress explicitly excluded debt that was incurred in the five year period prior to the sale to the tenants. Congress could have chosen to limit the debt to be taken into account in calculating the qualified contract price but unlike the provisions governing the minimum price for rights of first refusal, it did not do so. The Service's attempt to reduce the qualified contract price in a manner not contemplated by the Congress is not justified by the law nor the language allowing the Secretary of Treasury to issue regulations to prevent the manipulation of the qualified contract price. There is no abuse occurring here that the Proposed Regulations are preventing. Moreover, as a practical matter, it is virtually impossible to trace whether a particular cost of the development was paid for by debt or equity as these funds are fungible during the development and construction of a project.

In our experience a substantial number of projects are financed with debt which bears interest at rates below the AFR and in fact, these projects would not have been financially feasible without such favorable interest rates. In most instances, the buyer of the project would acquire the property subject to the debt and the residents of the project would

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continue to benefit from the lower debt service expense that permits the new owner to provide lower than market rental rates. Both the seller and the buyer would treat the full, undiscounted amount of the debt as part of the purchase price under general tax principles and there would generally not be any reduction to basis. Nor would there be any upward adjustment if the financing had an interest rate that was above the AFR and such financing was required to be assumed. Assuming the buyer acquired the property and did not assume or take subject to the below AFR financing, the seller would still have to pay off the full principal amount of the loan even if it received only the discounted amount as part of the purchase price. This would require that some of the purchase price that was attributable to the equity investment would have to be utilized to satisfy the below AFR financing. We see no policy justification for this result.

2) **Definition of adjusted investor equity.** Section 1.42-18(c)(4) of the Proposed Regulations also limits the adjusted investor equity to the amount of cash invested in qualifying building costs. The proposal is inconsistent with the statutory language which provides that the adjusted investor equity shall only be taken into account to the extent that such amount is reflected in the "adjusted basis of the project". We believe that the "adjusted basis of the project" should be determined in accordance with Section 1012 of the Code, i.e., the adjusted basis is the cost of the project. Accordingly, this would include land, real property, personal property, site improvements and intangible assets and not just qualifying building costs as defined in the Proposed Regulations. Moreover, in our view, tracing of capital contributions to specific uses of funds should not be required as the various sources of funds in a project, including debt and equity, are generally fungible and it will be impossible to trace, particularly for transactions that closed fifteen years ago. Finally, adjusted basis should not reflect adjustments to basis such as those required under Section 50(c) of the Code for rehabilitation or other investment credits or adjustments to eligible basis allowed for projects located in difficult development areas or qualified census tracts under Section 42(d)(5)(C) of the Code.

3) **Rejection of a contract by an owner or its failure to act.** Under Section 1.42-18(a)(ii)(B) of the Proposed Regulations, if the housing credit agency provides a qualified contract within the one-year period and the owner rejects or fails to act upon the contract, the building remains subject to the existing extended use commitment. For reasons explained in Section III below in these comments, we believe that the Service has paid insufficient attention to a number of procedural matters pertaining to the qualified contract process and that this statement does not adequately deal with this issue. If an owner rejects or fails to act on a contract presented by the housing credit agency

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because the qualified contract price is incorrect or because the presented contract contains unreasonable terms and conditions, we do not believe that the building should automatically remain subject to the extended use commitment. As explained below, a process needs to be developed as part of the Proposed Regulations to deal with disputes between the parties as to what constitutes a qualified contact or a bona fide contract.

4) **<u>Determination of cash distributions from or available for distribution from the building</u>.** Proposed Regulation 1.42-18(c)(6) provides that the qualified contract price is reduced by all distributions from the project to owners or to related parties to owners within the meaning of Code Sections 267(b) or 707(b) and by all reserve funds available for distribution at the time of closing.

Without legislative history, this has been perhaps the least understood concept in the qualified contract context. As a general matter, we believe that the Congress intended to look at what the owners (i.e., partners in a limited partnership, or members of limited liability companies, which are typically the owners of these projects) were distributed or could have been distributed in cash throughout the life of the partnership. We have reviewed the written policies of several of the housing credit agencies and believe that the Florida Housing Finance Corporation's approach to this point best reflects what we believe the Congress intended. For this purpose, Florida calculates all cash payments and distributions from net operating income, i.e., income remaining after payment of operating expenses, debt service and payments into reserves. The distributions to be taken into account include amounts paid to partners or affiliates as fees payable from operations (including, but not limited to, investor fees, partnership management fees, incentive management fees and guaranty fees) and amounts distributed as a return of capital, such as refinancing proceeds. However, the agency will not reduce the qualified contract price by payments of deferred development fees to the extent that the amount of such fee was within that agency's guidelines, even if paid to a related party (as is often the case). In addition, we believe that repayments of project expense loans, including interest, made by partners or affiliates of partners should not be treated as distributions that would reduce the qualified contract price. Of course, regular cash distributions to partners would serve to reduce the qualified contract price.

Florida also interprets the "available for distribution" language to include all cash held in partnership reserves and other accounts, the distribution of which to the owners is not prohibited by mortgage restrictions, regulatory agreements or similar third-party contractual provisions. We believe it is important to clarify in the Proposed Regulations that it is only the amount of reserves that are distributable to the owners which would serve to reduce the qualified contract price. To the extent that a reserve amount is required by such contractual

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provisions to remain with the property after sale, such reserve would not be computed in the qualified contract price. An amount currently held in such a restricted account that will become unrestricted and available for distribution on or before the expiration of the one-year qualified contract period is listed as available for distribution. We endorse the approach taken by the Florida housing credit agency and would urge the Service to consider adopting that approach.

5) **Administrative responsibilities of the Agency.**

While we do not object to the provisions of Proposed Regulation Section 1.42-18(d), for the reasons explained in Section III below, we believe that much more attention needs to be paid to outstanding procedural concerns and that this aspect of the Proposed Regulations does not adequately address administrative matters.

SECTION III—MATTERS NOT ADDRESSED IN THE PROPOSED REGULATIONS

1) **What constitutes a "bona fide contract"?** Although Black's Law Dictionary defines the term as "a contract in which equity may intervene to correct inequalities and to adjust matters according to the parties' intention", that definition has little relevance or meaning in the context of Section 42. A typical modern contract for the purchase and sale of real estate is often a lengthy, complicated and heavily negotiated document. In addition to negotiation on a sales price (which price is prescribed under the provisions of Section 42(h)(6)(F) in these circumstances), there are a myriad of other provisions that the parties will typically negotiate. For example, provisions often include representations and warranties on a number of topics, the scope of due diligence and the time frame for permitting due diligence review, the manner in which the purchase price will be paid, contingencies permitting the termination of the contract, provisions concerning a default by the parties, the amount of down payments, risk of loss during the contract period and so forth. Even in a particular state, there are seldom "form" purchase and sale agreements; indeed within a state, different regions may have substantially different forms and very different local business customs that guide the practice.

The Code provides that the extended use period terminates if the housing credit agency does not "present" a qualified contract (i.e., a bona fide contract) within the one-year period after a written request is made. But what if the presented contract contains terms and conditions (leaving the price aside for the moment) that are completely unreasonable, particularly given standard real estate practice in that jurisdiction? Suppose, for example, that the buyer arranged for by the state insisted that the seller guarantee for ten years that there will be a minimum of $1,000,000 of net cash flow each year even if the property is currently

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barely breaking even financially. Does that constitute a bona fide contract? If the owner does not agree to that term, can the housing credit agency argue successfully that its refusal to accept the presented contract results in the continuation of the extended use period?

Conversely, for example, it is common in most jurisdictions for the seller to certify the accuracy of the current rent roll; suppose the seller refused to take that simple step? Would the seller's refusal to accept the presented contract under these circumstances allow the seller to claim that the extended use agreement should be terminated? The examples of potentially unreasonable or bad faith dealing can go on and on but the point is that these are very complex transactions where the business practices will vary in different jurisdictions and the facts and circumstances of each transaction are likely to be very different. Defining a bona fide contract that would fit substantially different and myriad circumstances is simply not possible.

Moreover, despite the statutorily determined price to be set forth in the qualified contract, it is possible that the housing credit agency and the owner may disagree over the calculation of that price.

An essential question is whether a presented contract that fails to contain reasonable and standard terms can be considered bona fide, regardless of whether it is the buyer or the seller that is being unreasonable. Our position is that such a contract, if presented by the housing credit agency or its buyer, should not be treated as bona fide. In our view, if the state agency presented such a contract, then it would not have met the condition set forth in Section 42(h)(6)(E)(i)(I)(ii) and the extended use period should be allowed to terminate pursuant to Section 42(h)(6). The simple act of presenting a contract that is not bona fide should not result in a continuation of the extended use period.

On the other hand, if the state agency presented a reasonable contract that should be treated as bona fide, but the owner refused to act reasonably in response, then in our view, the owner should not be released from the extended use period. In other words, the Coalition believes that neither side should be able to act unreasonably in order to effectuate the extension or termination of the extended use agreement.

The most important question in this area is how to resolve fairly and efficiently disputes over what constitutes a bona fide contract where the parties are not able to agree on terms or the price to be paid under the Code. The Coalition's suggestion is to invoke binding arbitration, conducted in accordance with nationally recognized rules of arbitration such as the American Arbitration Association, if the parties are not able to agree after a certain period of time on the terms of a qualified contract. A substantial advantage of arbitration is that the opposing parties are much more likely to be reasonable in their negotiations if they face the possibility of an arbitration proceeding. A trained and experienced arbitrator will be able to determine which of the parties is acting reasonably (and if the dispute is over the price, the amount to be paid)

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and whether the contract being presented or rejected is bona fide in light of its terms and conditions.

In considering this suggestion, the Coalition thought about other alternatives. Despite our substantial experience in real estate, we were unable to devise a way of defining the term "bona fide contract" that would fit all circumstances. If the parties are able to agree, the issue resolves itself and the threat of arbitration is likely, in our view, to resolve many disputes. But in those cases, which could be numerous, where the buyer and seller are not able to agree on whether the contract is bona fide or the price, then having a conflict resolution process in place will help resolve disputes relatively quickly and efficiently.

Accordingly, we urge the Service to adopt a binding arbitration process to determine whether a presented qualified contract is a "bona fide contract" if the parties to the transaction are not able to agree.

2) **What is a reasonable time to acquire the property after the qualified contract is entered into?** Typically, the purchase and sale agreement will spell out the date on which the closing will occur and will permit extensions of that date under certain circumstances or if requested by one of the parties. However, facts and circumstances will dictate what is reasonable in any given situation and that may vary substantially from transaction to transaction. Like the questions posed above concerning bona fide contracts, we believe that if the parties cannot agree as to what constitutes a reasonable time to close, that this matter also be subject to binding arbitration.

Moreover, if the buyer does not acquire the project within the agreed upon timeframe due to its default, then the extended use period should be treated as terminated (unless the owner elects to allow the housing credit agency to present another contract). The Code contemplates that the extended use period terminates if the housing credit agencies does not present "**a**" qualified contract in response to the owner's request. (See Section 42(h)(6)(E)(i)(II)). In our view, this language must be read literally—"a" contract means one contract. If the buyer presented by the housing credit agency defaults in its obligation to acquire the project, the agency should not be given multiple chances to present additional contracts (absent the owner's election to do so); otherwise, the statutory scheme can be frustrated as one contract after another is presented and the extended use period is prolonged indefinitely.

3) **How should the fair market value of the nonlow-income portion of the building be calculated?** We believe that qualified real estate appraisers should determine fair market value. However, it is only fair and equitable that neither side be able to dictate the identity of the appraiser since in our experience, different appraisers, even though licensed and qualified, may differ in their conclusions. If

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the parties are able to agree on the identity of an appraiser, there will be no issue. However, if the parties each wish to engage their own appraiser, and the value determination is different, the resulting conclusion as to value should either be the average of the two appraisers or the two appraisers should jointly appoint a third appraiser whose determination of fair market value would be binding on the parties. These techniques are generally accepted in the real estate industry.

4) **What information and documentation can the housing credit agency require when an owner makes a written request of the agency to locate a buyer?** We expect that housing credit agencies will legitimately ask owners to submit certain information and documents about the project in order for the agency to seek potential buyers. However, we are also concerned that housing credit agencies may impose unreasonable and unnecessary information requirements on owners in making requests to find a buyer. If such information requests are unreasonable and burdensome, then the owner's statutory right to make a request can be effectively frustrated.

Once again, we believe 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 that the Service could adopt. 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;
- (vii) copies of any leases if any portion of the land or improvements are leased.

In addition, Florida requires the payment of a fee. While we do not expect the Service to regulate the amount of such a fee, it should be reasonable.

We urge the Service to state in its regulations that housing credit agencies which impose substantially more burdensome information and documentation requirements on owners will forfeit their right to require owners to go through the qualified contract process. Finally, the one year period should commence when the reasonably required information is submitted by the owner.

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5) **How can the qualified contract price be calculated, particularly if the project owner does not have complete tax and financial records for the prior 15 years?** Unfortunately, we have discovered that many project owners have not maintained their financial records and tax returns for the full 15 years, making the calculation of cash distributed or available for distribution difficult to determine with complete precision. To address this situation, the Coalition would suggest that the accounting industry, working together with housing credit agencies, develop an agreed upon procedures report where the accountants would draw upon the best available documents and resources in order to make these determinations. The accounting industry has taken a similar approach in developing cost certification and "ten percent test" reports for housing credit agencies.

6) **What is meant by the phrase "only to the extent there was an obligation to invest such amount [i.e., the aggregate amount of cash taxpayers invested] as of the beginning of the credit period"?** It is very common in the housing credit industry to provide in the governing documents (generally an agreement of limited partnership or a limited liability company operating agreement) that the investor's capital contributions will be subject to adjustment, based upon the amount of or timing of delivery of Housing Credits. The amount and timing of Housing Credits are usually determined by the accountants after completion and lease up of the project. These agreements are generally executed and are in place before the beginning of the credit period, although the final adjustments to the capital contributions may not be made until after the commencement of the credit period due to the timing of the accountants' determination in relation to the beginning of the credit period. Moreover, payment of these capital contribution adjustments may be contingent on the investor having sufficient funds to make the payment. These provisions are generally referred to as "adjuster clauses". We believe it is fair and equitable and within the Congress's intent, to interpret the "obligation to invest" language as including capital which is contributed after the commencement of the credit period as a result of an adjuster clause, provided that the adjuster clause was in place prior to the start of the credit period.

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The Affordable Housing Tax Credit Coalition appreciates the opportunity to submit these comments. Under separate cover, we are submitting an outline of topics to be discussed at the public hearing on these Proposed Regulations. We stand ready to work with the Service in this or any other matter pertaining to the Housing Credit. Thank you for your consideration of our views.

Very truly yours,

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