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IRS FINAL REGULATIONS ON LIHTC QUALIFIED CONTRACTS

IRS has on May 3, 2012 published final regulations on qualified contracts under Section 42(h)(6)(F) of the Internal Revenue Code governing the process for requesting a state low-income housing tax credit allocating agency to find a buyer for a low-income housing development to be operated as such for the remaining extended use period. 77 Fed. Reg. 26175. If the agency does not within one year find a buyer submitting a bona fide qualified contract, the 15 year extended use period is terminated ending the low-income occupancy and rent restriction requirements.

Many state allocating agencies have for a number of years required applicants for LIHTC to waive their right to request a qualified contract, and that waiver is usually contained in the low-income housing indenture of restrictive covenants. But some states have not required universal waivers of the qualified contract process, so examination of the applicable indenture should always be made to see if the qualified contract process is available. Particularly projects receiving LIHTC allocations in the 1990s may be eligible for the qualified contract process.

This memo will outline the qualified contract process in the final regulations and in particular the changes in that process from the 2007 published IRS proposed regulations.

Treas. Reg. §1.42-18. Qualified Contracts

1. The Owner of a qualified low-income housing development can request, at any time after the commencement of the fourteenth year of the compliance period, a state allocating agency to locate a buyer willing to acquire the low-income housing development and operate it for the remaining extended use period subject to all applicable low-income rent and occupancy requirements.
2. The agency must determine the qualified contract price based on the information provided by the owner.

3. The qualified contract price includes the fair market value of any non-low-income portion of the building and the formula contract price for the low-income portion of the building plus the fair market value of the land on which the building is located.
 - a. The Final regulations require that the fair market value of the land, as determined by appraisal, be added to the formula amount for even the low-income portion of the building.
 - b. The fair market value of the non low-income portion of the building is also determined by appraisal including the fair market value of the underlying land.
 - c. The land appraisal must consider the continuance of all recorded use restrictions that will remain even if the extended use restriction is eliminated.
4. The formula amount for the low-income portion of building equals the sum of (i) outstanding indebtedness of the building, (ii) adjusted investor equity, (iii) other capital contributions not specified in the original investment agreement and **minus** any cash distributions or cash available for distribution to the owners. Added to the formula amount is now the fair market value of the underlying land.
5. The outstanding indebtedness of the building is the **remaining principal balance** on any loan that does not exceed the qualifying building costs.
 - a. Outstanding indebtedness does not include any deferred, accrued or unpaid interest on any such loan secured by the building.
 - b. Outstanding indebtedness is limited to those items included in eligible basis of the building.
 - c. Outstanding indebtedness does not include the amount of refinancing indebtedness that exceeds the eligible basis of the building constituting the qualifying building costs.
 - d. Additional mortgage loans exceeding the qualifying building costs are also not included.
 - e. The principal amount of unpaid developer fee notes are included in outstanding indebtedness.
 - f. Outstanding indebtedness **does not include** debt used to finance nondepreciable land costs, syndication costs, legal and accounting costs, and operating deficit payments.
 - i. To the extent that legal and accounting costs are includable in eligible basis they should be considered as part of outstanding indebtedness.
 - g. Only indebtedness that conforms to general principles of Federal tax law and are actually paid to the lender on sale or assumed by the buyer are includable.
6. Adjusted investor equity equals the paid-in investor equity increased by the annual cost of living adjustment.
 - a. Adjusted investor equity is limited to equity invested for qualifying building costs, meaning items includable in eligible basis.

- b. Adjusted investor equity **does not include** equity paid for land, credit adjuster payments, Agency low-income housing credit application and allocation fees, operating deficit contributions, legal, syndication and accounting costs.
 - c. The exclusion of legal and accounting fees is not limited to those non includable in eligible basis. Perhaps further clarification will be provided if legal and accounting fees that would be otherwise includable in eligible basis should be excluded from adjusted investor equity.
 - d. Adjusted investor equity does not include amounts funded by outstanding indebtedness. No double counting. Tracing may be required.
7. Cost of living adjustment on investor equity. IRS has developed a formula which must be used to calculate the cost of living adjustment to investor equity.
- a. The formula is the average of the sum of 12 monthly CPI values for the calendar year that precedes the year in which the Agency offers the building for sale **divided by the** average of the sum of the 12 monthly CPI values for the base calendar year, meaning the first year of the credit period.
 - b. The methodology directs use of the non-seasonally adjusted CPI for all urban consumers, i.e. CPI-U.
 - c. The quotient must be taken to ten decimal places.
 - d. An IRS Example. The first year of the credit period is 1997 and the Agency is offering the building for sale in 2011. The CPI for 1997 is: 1913.9. The CPI for 2010 is 2605.959. Dividing the 2010 CPI by the 1997 CPI results in a quotient of: 1.3615962171. Owner's invested equity was \$20,000,000, so the adjusted investor's equity is \$27,231,924. (\$20,000,000 times 1.3615962171).
8. Other capital contributions are payments for "qualifying building costs" other than those funded by outstanding indebtedness or adjusted investor equity.
- a. Other capital contributions must be used to fund items that are of a type that could have been included in eligible basis though they may be incurred after the first year of the credit period.
 - b. Other capital contributions do not include expenditures for land, operating deficit payments, credit adjuster payments, and payments for legal, syndication and accounting costs.
9. Cash distributions and cash available for distribution **are deducted** from the sum of outstanding debt plus adjusted investor equity and other capital contributions.
- a. Includes cash distributions to building owners or persons who are related parties to building owners under Code Section 267(b) or 707(b)(1).
 - b. Reserve funds that are not required to remain with the building by contract or other obligation are considered as available for distribution.
 - c. Proceeds from refinancing in excess of qualifying building costs are not considered cash available for distribution.

10. The qualified contract amount is determined in the manner set forth above, and when completed, the Agency begins the process of trying to find a buyer who will pay the qualified contract price while agreeing to continue operating as a qualified low-income building during the remainder of the 15 year extended use period.
11. If the Agency cannot find a buyer willing to pay the qualified contract price by submitting a bona fide offer within twelve months, the remaining 15 year extended use period is terminated.
 - a. The Agency is to use reasonable efforts to find a buyer.
 - b. If the Agency provides a bona fide qualified contract to the owner of the building, and the owner rejects the qualified contract offer or fails to close on it, the 15 year extended use period continues in effect.
12. The qualified contract price is not subject to a fair market value cap. IRS claims it has no authority to impose a fair market value cap limiting the qualified contract price.
 - a. Many commentators felt that without a fair market value cap, the qualified contract price would too often exceed what a willing buyer would pay for the property while being obligated to continue operating as a qualified low-income building.
 - b. IRS also concluded that state Agencies do not have authority to impose fair market value caps on the determined qualified contract price.
13. Adjustments to the qualified contract price are to be made to reflect debt service payments to principal prior to the closing but made after the qualified contract price was set.
14. The Agency and the owner may also agree on a change in the fair market value of the non-low-income portion of the building, but no change may be made unless the Agency and owner agree.
15. IRS Anti-abuse rule. IRS reserves the right to prevent manipulation of the qualified contract price by limiting cash distributions to amounts reasonable under the circumstances.
16. The Qualified Contract regulations are effective as of May 3, 2012.