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Qualified Contract - 15th Year Issues for Post-1989 Allocation Properties

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Much has been written about the preservation of projects that have reached the end of the 15-year low-income housing tax credit (LIHTC) compliance period. Projects that received allocations of LIHTCs in 1987, 1988 and 1989 are released from low-income usage restrictions under the LIHTC program at the expiration of the 15-year compliance period. In 1989, however, Congress enacted the Revenue Reconciliation Act of 1989 that added the "extended use period" requirements to § 42(h)(6) of the Internal Revenue Code of 1986. Effective with respect to projects that received an allocation of LIHTC after December 31, 1989, § 42(h)(6)(E) requires projects to be maintained under the LIHTC program throughout the "extended use" period of 15 years after the end of the compliance period.

Knowing that investors typically would want to exit from LIHTC investments when the risk of recapture terminates, Congress provided an escape valve to the 30-year extended use restrictions by creating the "qualified contract" exception to the 30-year extended use period restrictions. Pursuant to § 42(h)(6)(E)(i)(II), an owner of an LIHTC project may avoid the extended use period by offering to sell the project to the allocating agency according to a qualified contact at any time after the expiration of the 14th year of the compliance period. The price under which the project would be offered to an allocating agency under a qualified contract is established according to a formula described in § 42(h)(6)(F). While at first glance the qualified contract process appears straightforward, many issues must be resolved before the process can be implemented and before a developer can make a rational decision whether to make a qualified contract offer to sell his project.

Some threshold questions should be addressed before analyzing the details of the qualified contract sales program. In many states, applicants for LIHTC allocations routinely waive their rights to sell projects under the qualified contract sales program when they agree to extend the minimum period that they will maintain the project as affordable housing. As competition for LIHTC allocations has increased, so has the prevalence of waivers as applicants seek to remain competitive in the allocation process. Second, many projects are subject to usage restrictions under grant or loan programs, such as U.S. Department of Housing and Urban Development (HUD) or state and local subsidy programs. This article will not discuss the effect of usage restrictions outside the LIHTC program.

In deciding whether to make a qualified contract sales offer, it is helpful to know what will happen if the offer is not made. If an offer to sell according to a qualified contract is not made, the project will remain subject to the § 42 restrictions for the additional 15-year extended use period. As a result, an owner will not be permitted to convert the property to market rate rental and will not be able to convert the property into a for-sale condominium or cooperative project. Phantom income problems may be exacerbated by an additional holding period, without the ability to raise rents.

If the owner decides to exercise his right to make a qualified contract sales offer, the allocating agency has one year from receipt of the offer to decide whether to acquire the property, assign the contract to another party, or to

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decline to purchase. If the agency declines to purchase the property, § 42 restrictions are lifted and, subject to the 3-year vacancy decontrol rules, the owner may convert the property to market rate rental, or sell the property to another owner free of the § 42 restrictions.

While the qualified contract offer process appears to be straightforward, no guidance has been issued by the IRS as to the process by which the offer is to be made to the allocating agency or the calculation of the qualified contract price. Accordingly, each allocating agency must establish its own program to implement the qualified contract offer process, including the determination of the sales price.

Pursuant to § 42(h)(6)(F), the qualified contract price to be paid for a project is the sum of (1) the fair market value of any portion of the project that is not low-income; plus (2) the product of "adjusted investor equity" increased by the consumer price index for each year (not to exceed 5 percent); plus (3) capital contributions not reflected in "adjusted investor equity"; and (4) the outstanding debt secured by or with respect to the project minus cash flow distributed by the owner. Many questions arise with respect to the calculation of the "qualified contract price." First, no guidance exists as to the determination of the fair market value of the non-low-income portion of the project. What cap rate should be used? What vacancy rate should be assumed? Should the valuation be based on current, past or projected rents? Should an appraiser determine the price? If so, what valuation methodology should appraisers apply, who should select the appraiser and what happens if the allocating agency disagrees with the appraised value?

The qualified contract price for the low-income units is reduced by cash flow. How will the owner establish the amount of cash distributed for each of the 15 years of the compliance period? What if records are not available? How is cash flow calculated? For example, does cash flow include fees such as deferred developer fees and incentive management fees paid out of cash flow? Is cash flow subtracted before the application of the cost of living factor?

The qualified contract price includes secured debt. How is unsecured debt treated? Will the price include outstanding operating deficit loans, outstanding credit adjuster payments, outstanding development advances?

How is "adjusted investor equity" calculated? Is it gross equity (including syndication costs) or equity to the project? § 42(h)(6)(G)(i) suggests that adjusted investor equity excludes amounts not "included in basis." Does that mean that adjusted investor equity is reduced by reserves, syndication costs, loan costs, bond issuance costs, and agency compliance fees paid from

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investor contributions? What happens if the developer cannot prove which costs were funded from investor equity? Will allocating agencies establish presumptions in the event that the owner cannot identify the source of funds that are included in basis?

Section 42(h)(6)(G) refers to "cash" contributions. How are contributions of land or other property treated? How are general partner contributions treated? Is general partner capital included in adjusted investor equity? Contributions appear to be limited to amounts required to be invested at the beginning of the credit period. Are capital contributions to pay for deficits, repairs, casualty loss, etc., excluded from adjusted investor equity, but included in "other capital contributions"? If so, they are not increased by the cost of living factor.

No guidance exists to answer these questions.

The process by which properties are offered for sale also is uncertain. The agencies have one year to determine whether to buy and then a "reasonable" time to close the purchase. Can the agencies defer their response until the last day of the year and then offer a "take it or leave it" price? Can the owner withdraw a qualified contract offer once it is made? How will disputes with respect to the calculation of the contract price be resolved?

Allocating agencies, perhaps with the participation of the National Council of State Housing Agencies (NCSHA) and developer organizations, should begin developing qualified contract sales programs for their jurisdiction. Properties that received allocations of LIHTCs in 1990 and began to claim LIHTCs in 1990 would be eligible to make a qualified contract sales offer to the allocating agency on January 1, 2004. While it is a rare project that begins to claim LIHTCs in the year of allocation, many more projects will be eligible to make qualified contract sales offers on January 1, 2005.

The qualified contract process may provide opportunities for a number of participants in the low-income housing tax credit program. First, allocating agencies may contract with service providers to manage the qualified contract program and to evaluate offered projects to determine if an agency should accept the offer or assign the offer to another purchaser. An allocating agency (or its assignee) may need financing to close the purchase of offered properties. Parties that are interested in preserving these properties as affordable housing may contract with allocating agencies to accept assignments of qualified sales contracts. Developers may seek to acquire projects that can be rehabilitated through a second round of LIHTC allocations and may wish to lobby allocating agencies to include second round allocation preferences in their qualified allocation plans (QAPs). Not-for-profit housing organizations may be able to finance the purchase of these properties through the issuance

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of § 501(c)(3) tax-exempt bonds. Some agencies may employ brokers to attempt to locate purchasers to whom qualified contracts may be assigned. In short, opportunities to participate in the qualified contract sales program abound and are limited only by the imagination of the prospective participants.

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