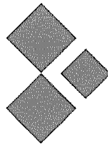

NOVOGRADAC
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CERTIFIED PUBLIC ACCOUNTANTS

September 17, 2007

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

Re: Proposed Treasury Regulation §1.42-18 Qualified Contracts

Dear Sirs:

As participants in the low-income housing credit (LIHC) industry, we are submitting our comments on Proposed Treasury Regulation §1.42-18. We believe that our suggestions for guidance will help clarify and eliminate confusion related to the proposed treasury regulation. We commend the Department of Treasury and the Internal Revenue Service for their continuing efforts to improve and clarify tax guidance for the LIHC program to ensure its continuing success.

Bona Fide Offer (Proposed Treasury Regulation §1.42-18(c)(1))

It is currently unclear what is meant by the term "bona fide offer". Although the proposed treasury regulation identifies that the offer must be a bona fide offer, we are concerned that the effectiveness of the qualified contract process could be significantly curtailed through the presence of onerous terms or conditions in the offer to purchase the LIHC property. 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 extensive guarantees of the sort not usually included in similar transactions conducted on the open market. We recommend that to qualify as "bona fide" offers, the Treasury Department should develop a list of required provisions, as well as a list of prohibited provisions. We also believe that the determination as to whether an offer is "bona fide" should be determined through binding arbitration.

Ability of the state housing agency to reduce the FMV (Proposed Treasury Regulation §1.42-18(c)(1))

As currently drafted, the proposed treasury regulation allows the state housing agency to adjust the fair market value of the building if, after a reasonable period of time within the one-year offer of sale period, no buyer has made an offer. It is unclear on what basis the state housing agency would decide precisely when to reduce the acceptable price of the qualified contract and precisely how much to reduce the qualified contract price. Additionally, this provision is inconsistent with Section 42 and the major thrust of the regulations, as the qualified contract

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price is calculated based on a specified formula, which is generally intended to represent a fair price to the owner, and is not intended to necessarily result in a price consistent with current fair market values.

In practice, this provision could lead prospective buyers to wait out the qualified contract process until the state housing agency has decided to reduce the qualified contract price one or more times, in order to secure a more favorable price for the property. Ultimately, this provision in many instances will likely thwart the purposes of the qualified contract, as property owners will enter the qualified contract only if the statutorily calculated price meets their minimum criteria for selling the property. In the event the qualified contract price is significantly reduced by the state housing agency, most property owners will likely reject those offers as not meeting their minimum pricing criteria for the sale of the property.

As such, we recommend that the provision be removed from the proposed treasury regulation which enables the state housing agency to adjust the fair market value of the building if, after a reasonable period of time, no buyer has made an offer.

Additionally, as currently drafted, the proposed treasury regulation allows the state housing agency to adjust the fair market value of the building if market values have adjusted downward. It is unclear from the proposed treasury regulation precisely how the state housing agency would seek to identify that market values have adjusted downward, or to identify the degree to which market values have adjusted downward. To that end, we recommend that this provision be altered to require that any changes to the qualified contract price be supported by updated appraisals from appraisers acceptable to both the state housing agency and the owner. Similarly, we believe that if market values can be adjusted downward during the one year period if market values have fallen, then the building owner should have the right to request that fair market value be adjusted upwards, if market values have risen.

<u>Outstanding Indebtedness (Proposed Treasury Regulation §1.42-18(c)(3)(i))</u>

The preamble to the proposed treasury regulation and the proposed treasury regulation itself allows for the potential double-counting of cash distributions from debt refinancings. The double counting occurs because the qualified contract price:

(1) excludes a portion of refinancing debt used to make cash distributions, and
(2) is reduced by the amount of the cash distribution made.

There are two different interpretations regarding the extent to which a portion of refinancing debt is excluded from the qualified contract price. One interpretation is that all refinance debt in excess of the original debt is excluded, and the other is that all refinance debt in excess of qualifying building costs are excluded.

<u>1. All excess refinance debt excluded</u>

The preamble to the proposed treasury regulation identifies that "...proceeds from refinancing indebtedness or additional mortgages in excess of such qualifying building costs are not outstanding indebtedness..." Although this same wording does not appear in the proposed treasury regulation, based on the wording in the preamble, many commentators have concluded that refinancing indebtedness would be excluded from the calculation of outstanding indebtedness to the extent that the refinanced indebtedness exceeds the original indebtedness.

2. Refinance debt in excess of qualifying building costs excluded

The proposed treasury regulation itself appears to allow for double-counting against refinanced loan proceeds to the extent that the refinanced loan exceeds eligible building costs. For example, a partnership may arrange a $7 million loan as permanent financing on a $10 million LIHC building. Ten years later, the partnership could refinance the loan with a new loan for $12 million, with the $5 million net proceeds used to make a distribution to the partners. Based on the proposed treasury regulation, only $10 million of the refinanced loan would count toward outstanding indebtedness under Prop. Reg. §1.42-18(c)(2)(i), yet the full $5 million distribution to the partners would count as a reduction of the low-income portion amount under Prop. Reg. §1.42-18(c)(2)(iv). This results in a a double counting of $2 million. As a result, any property experiencing a refinancing in excess of eligible building costs would likely be precluded from participating in the qualified contract process, as their calculated contract price would be abnormally restricted due to this provision.

In addition to the potential for refinanced debt to trigger a double counting of the reduction in the calculation of the qualified contract price, based on the wording of the proposed treasury regulation it is unclear if outstanding indebtedness is required to be traced to qualifying building costs. As dollars are fungible, and the cost to trace outstanding indebtedness to qualifying building costs would be tedious, cost prohibitive, and potentially impossible 14 years after the fact, we recommend that outstanding indebtedness should not be required to be traced to qualifying building costs.

Ultimately, the proceeds of any debt secured by a LIHC building are used for one of three possible uses: 1) to fund a reserve, 2) to pay for the construction of or the improvement of the LIHC property, or 3) to distribute the cash to the owners. The proposed treasury regulation, as currently drafted, adjusts the calculation of the low-income portion of the building for any cash on hand and for any distributions paid to the owners. As a result, any loan proceeds used to fund those two uses would be accurately captured in the calculation of the low-income portion of the building without an additional provision limiting outstanding indebtedness to only indebtedness used for eligible building costs. Therefore, in consideration of the issues highlighted above, along with the compensating provisions already included in the proposed treasury regulation, we recommend that all debt, regardless of the use of the proceeds of the debt, should be included in the calculation of outstanding indebtedness.

Indebtedness with Yield to Maturity below the Applicable Federal Rate (Proposed Treasury Regulation §1.42-18(c)(3)(ii))

The provision for discounting the amount of the outstanding indebtedness for indebtedness with a yield to maturity below the applicable federal rate at the time of issuance would lead to an abnormally depressed qualified contract price in the event that the purchaser is unable or unwilling to assume said indebtedness. As a simple example, a property might have a single loan with a face value of $5 million, but a discounted value of $3 million. Assuming that there are no other factors present in the calculation of the qualified contract price, if the buyer were unable or unwilling to assume the loan, the qualified contract price would result in a $3 million purchase price. In this example, the seller of the property would still be required to repay the full $5 million loan balance, even though the seller received only $3 million in cash proceeds from the sale of the property.

Legal, syndication, and accounting costs

The proposed treasury regulation provides a blanket exclusion of legal, syndication, and accounting costs from the calculation of outstanding indebtedness, adjusted investor equity, and other capital contributions. Legal and accounting costs are similar to numerous other indirect or "soft costs" incurred in the development and operation of a LIHC property. Such indirect or "soft costs" are treated for federal income tax purposes a variety ways, including, capitalized to the building and depreciated, capitalized as an intangible and amortized, and expensed. We believe that legal and accounting costs should not be subject to a blanket exclusion and should be treated similar to other indirect or "soft costs". We also note that legal and accounting costs comprise a portion of many of the categories of costs routinely tracked within the LIHC program. As a result of this standard recordkeeping methodology, requiring LIHC building owners to sort through accounting records from over 14 years in the past to identify all legal and accounting costs included in the development of the project would represent a very significant administrative burden. In light of these issues, we recommend that the proposed treasury regulation treat legal and accounting costs similar to other project costs and not provide for a separate blanket exclusion of such costs.

Affordable Housing Tax Credit Coalition

We also express our support of the comment letter submitted by the Affordable Housing Tax Credit Coalition.

Conclusion

We are very pleased with the positive impact of the LIHC program over the last 20 years and the potential for future success. We appreciate the opportunity to submit our comments on the proposed treasury regulation. We believe that additional clarity in the qualified contract regulations is essential to sustain and increase the impact of the LIHC program. Thank you in advance for your time and consideration.

Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

Yours very truly,
NOVOGRADAC & COMPANY LLP

by
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by
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