REGULATORY & HOUSING POLICY

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Mr. Jack Malgeri
Office of Associate Chief Counsel (Passthroughs and Special Industries)
Internal Revenue Service
CC:PA:LPD:PR (REG-113084-04)
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Section 42 Qualified Contract Provisions
REG-114084-04
RIN 1545-BD20

Dear Mr. Malgeri:

On behalf of the National Association of Home Builders (NAHB), I am writing to offer comments on the proposed regulations for the Internal Revenue Code Section 42 Low-Income Housing Tax Credit (LIHTC) provisions concerning “qualified contracts.” NAHB is a Washington, D.C.-based trade association whose mission is to enhance the climate for housing, including the LIHTC program. Founded in 1942, NAHB is a federation of more than 800 state and local home builder associations (HBAs). About one-third of NAHB’s 235,000 members are home builders and/or remodelers. The remaining members are associates working in closely related fields within the housing industry, such as mortgage finance and building products and services. These comments are presented on behalf of the Housing Credit Group, which is an organization within NAHB that brings together builders, property owners, tax professionals and other stakeholders in the LIHTC program.

NAHB appreciates the work the Department of the Treasury and the Internal Revenue Service have completed concerning qualified contract issue. The LIHTC is the nation’s leading affordable housing program, and the qualified contract process is an important element in attracting investment in this public-private partnership. NAHB has several recommendations concerning the proposed regulations.

Background

Section 42 provides a nonrefundable income tax credit on a per unit basis for the construction and operation of low-income housing units.[1] Owners of qualified low-income housing properties claim the credit over a ten-year period in an amount equal to the applicable credit percentage (4% or 9%) multiplied by the qualified basis of the low-income units. The credit is subject to the limitation, Alternative Minimum Tax, carryback and carryforward rules associated with the Section 38 general business credit.

Section 42(h)(6) denies the credit unless the owner of the low-income housing building is subject to an enforceable extend low-income use agreement with the applicable housing credit agency. In general,

[1] All Section references in this letter refer to sections of the Internal Revenue Code of 1986 unless otherwise noted.

Section 42(h)(6) requires that the extended use period last at least 30 years from the beginning of the Section 42(i) 15-year credit compliance period.

In addition to promoting the long-term low-income housing purpose of LIHTC properties, Congress enabled flexibility with respect to the ownership of LIHTC units. Consequently, Section 42(h)(6) allows a process by which a LIHTC property may be transferred to a new owner who will continue to abide by the low-income housing unit restrictions. Section 42(h)(6)(E)(i)(II) permits a request for a qualified sale contract to the applicable housing credit agency by a LIHTC property owner at the end of the 14th year of the compliance period.

Section 42(h)(6)(E)(i)(II) stipulates that if the housing credit agency is unable to find a buyer who presents a qualified contract, then the extended use period is terminated. If the extended use period is terminated, then a three-year period exists during which LIHTC owners may not evict (other than for good cause) an existing tenant of a low-income unit or increase the gross rent for any unit except as otherwise permitted by Section 42.

Section 42(h)(6)(F) establishes the minimum amount for which a qualified contract may provide for purchase of a LIHTC project.

> *(F) QUALIFIED CONTRACT.—For purposes of subparagraph (E), the term "qualified contract" means 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.*

The proposed regulations (REG-113084-04) provide additional details by which the qualified contract process will operate. However, NAHB believes these proposed regulations are flawed or unclear with respect to certain issues.

Qualified Contract Definition

The proposed regulations do not sufficiently define what constitutes a bona fide qualified contract. The lack of definitions in this regard leaves the process open to manipulation or confusion. For example, suppose a contract is presented to a prospective seller by a potential buyer that is an acceptable contract with respect to price, timing of sale and other standard arrangements for real property exchanges, except the contract requires the seller to make certain improvements to the property by a date certain. LIHTC properties traditionally have been underwritten on a thin margin. With operating expenses increasing and rents not keeping pace in many parts of the country, current LIHTC owners may not have the resources to cover this proposed contractual requirement, which would then prevent the sale of the property. Does this contract constitute a "qualified contract" given this peripheral and infeasible requirement? The proposed regulations provide no recourse in this situation for the prospective seller.

NAHB suggests that the final regulations provide a more technical definition of what elements are explicitly required and what elements are explicitly excluded for a contract to be considered qualified for the purposes of Section 42(h)(6). For example, these elements should include timing requirements, improvements requirements, revenue and/or cost guarantees, and administrative requirements.

Of course, given the complexity of real estate transactions and LIHTC projects, such an explicit list cannot be comprehensive. For proposed contractual elements not explicitly addressed by the final regulations or other situations in which the either party finds a component of a contract objectionable, NAHB recommends that an arbitration process be allowed to determine whether the contract is indeed a qualified contract.

Refinancing Accounting

The proposed regulations do not adequately account for refinancings, which are an important tool for the financial management of LIHTC properties, especially given the problem of stagnant income limits. The proposed regulations exclude that portion of indebtedness from the sum defined by Section 42(h)(6)(F)(i) that is allocable to a "cash out" refinancing. However, the proposed regulations appear to require that cash be included in the Section 42(h)(6)(F)(ii) definition of available cash distributions, thereby reducing the minimum contract price. Hence, on one side of the ledger is a requirement that prohibits increasing the contract price, and on the other is a rule requiring a reduction of the contract price. This is an important contradiction. Under the formula proposed by the draft regulations, despite no substantive change in the value of the property from a refinancing, the minimum price required by Section 42(h)(6)(F) has decreased. Furthermore, this unexpected rule is unfair to LIHTC properties that have in the past used legitimate financial management techniques to operate properties existing under tighter than normal economic constraints.

NAHB recommends allowing debt created by refinancing for the purpose of Section 42(h)(6)(F)(i), and retaining the existing cash treatment in the proposed regulations.

Deferred Developer's Fee

The proposed regulations correctly allow debt used to finance deferred developer's fees, which are service expenses taxed at ordinary income tax rates, to be included in the sum defined by Section 42(h)(6)(F)(i). However, it is not clear that the proposed regulations exclude money held to pay such fees from the amount defined by Section 42(h)(6)(F)(ii), which defines cash distributions. It is not correct for such money to be treated as equivalent to cash held for distribution to property owners as income allocable to capital. The developer fee is taxed as ordinary income but may be deferred as a means providing financial support to the LIHTC property.

NAHB requests that the final regulations provide an explicit mention of cash held for the purpose of paying a deferred developer fee as being excluded from the cash distribution definition of Section 42(h)(6)(F)(ii)

Fair Market Value Cap

The proposed regulations asked commentors to consider providing state agencies and regulators the authority to require in agreements a fair market value cap that would restrict any qualified contract price to fair market value. NAHB believes that this proposal should be rejected. There is no statutory authority in Section 42 for such a restriction. NAHB believes that fair market value should be determined by the marketplace.

Buyer Contract Default

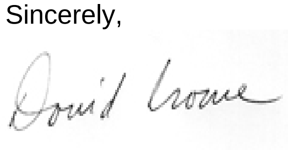
The proposed regulations do not discuss the rules concerning an event for which a qualified contract has been presented but for which the buyer fails to complete the purchase. NAHB requests that the final regulations explicitly note that in such situations the extended use period is terminated. This is consistent with Section 42(h)(6)(E)(II) which only requires that the contract be presented. The prospective LIHTC property seller should not be responsible for the failure of the buyer to complete the sale.

Non-Low Income Building Portion Valuation

To ensure that the price of the low-income portion of the building is not subject to manipulation or "thin market" price failure due to lack of competition on the buyer-side of the market, the minimum fair market value of the non-low income portion of the property should be subject to determination by a real estate market appraiser, agreed upon by the prospective seller and buyer. This is particularly important given that the proposed regulations require all the land associated with the property to be treated as part of the non-low income portion of the building. This is a common real estate market technique and should be an allowable part of the qualified contract process.

Thank you for considering these comments regarding the proposed regulations concerning Section 42 qualified contracts. If you have any questions concerning these comments, please contact Robert Dietz, NAHB's Tax Issues Director (202-266-8285) or Carmel McGuire, NAHB's Director of Affordable Housing (202-266-8207).

Sincerely,



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