

## **Tax Credits**

### **ABA Tax Section Comments on Proposed Rules (REG-128274-03) on Low-Income Housing Qualified Contracts**

#### **Section 42**

**Document Date: September 28, 2007**

September 28, 2007

Ms. Linda Stiff  
Acting Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Low-Income Housing Qualified Contract Proposed Regulations

Dear Acting Commissioner Stiff:

Enclosed are comments concerning the Low-Income Housing Qualified Contract Proposed Regulations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

/s/  
Stanley L. Blend  
Chair, Section of Taxation

Enclosure

cc:

Donald L. Korb, Chief Counsel, Internal Revenue Service

Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury

Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury

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Jack Malgeri, Attorney Advisor (Passthroughs and Special Industries), Internal Revenue Service

## **COMMENTS CONCERNING LOW-INCOME HOUSING QUALIFIED CONTRACT PROPOSED REGULATIONS**

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation ("Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Mitch Thompson of the Section's Real Estate Committee (the "Committee"). Substantive contributions were made by Steven Berman, Alan Cohen, and Craig Emden. The Comments were reviewed by Kevin Thomason, Chair of the Committee. The Comments were further reviewed by Michael Cook of the Section's Committee on Government Submissions and by Barbara de Marigny, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these comments have clients who might be affected by the federal income principles addressed by these Comments no such member or firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific matters of these Comments.

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Date: September 28, 2007

### **EXECUTIVE SUMMARY**

On June 19, 2007, the Internal Revenue Service ("Service") and Department of the Treasury ("Treasury") issued proposed regulations under section 42<sup>1</sup> (the "Proposed Regulations"). <sup>2</sup> The Proposed Regulations provide a formula for determining the purchase price amount of a low-income housing building when such building is purchased pursuant to a "qualified contract," as such term is defined in section 42(h)(6)(F).

The Section commends the Service and the Treasury for the well-considered Proposed Regulations addressing this issue. These Comments address the calculation of the qualified contract price for both the low-income and non low-income portions of a building, procedural issues concerning qualified contracts, and provide general comments on other topics raised in the preamble to the Proposed Regulations (the "Preamble"). Specifically, we recommend that the Regulations, when finalized:

1. Clarify that an appraisal should be used to determine the fair market value of the non low-income portion of a building, address the treatment of underlying land in leased-land situations by requiring a determination of the fair market value of the remaining lease term, and establish a tie-breaking procedure to minimize potential disputes concerning fair market value.
2. Explicitly address situations where insufficient documentation exists to establish whether debt was incurred for qualifying building costs. In such cases, a reasonable allocation or other presumption could eliminate potential disputes. We also believe it is inconsistent with the policies supporting enactment of section 42(h)(6) to discount below-market indebtedness for purposes of determining the qualified contract price. Lastly, we recommend that the Proposed Regulations should not "double count" reductions to the qualified contract price that could result from the treatment of certain project reserves.
3. Address the terms, conditions and time period allowed for closing for purposes of defining a "bona fide contract."

4. Clarify certain rules relating to qualified contracts.

## **I. Background**

### **A. Statutory Authority for Regulations.**

For calendar years after 1989, section 42(h)(6)(A) provides that no credit is available under that section for any year unless an extended low-income housing commitment is in effect as of the end of such taxable year. The term "commitment" is defined in section 42(h)(6)(B) to mean any agreement between the taxpayer and the low-income housing credit agency (an "Agency") that (1) requires that the applicable fraction of the building used for low-income units (measured either by units or floor space) for each taxable year in the extended use period will not be less than the applicable fraction specified in the commitment and (2) prohibits both (a) the eviction or termination of tenancy (other than for good cause) of an existing tenant of any low-income unit and (b) any increase in the gross rent with respect to the unit not otherwise permitted under section 42. The extended use period is the greater of 15 years after the close of the 15-year compliance period or the date provided in the commitment.

Under the statute, the extended low-income use commitment may be terminated upon either of two events. The first such event is foreclosure of the building. The second such event exists when all of the following have occurred: (1) the taxpayer is unable to transfer the building at the end of the initial 15-year compliance period for continued low-income use; (2) the taxpayer has notified the low-income housing credit agency of its intent to dispose of the property; and (3) when, within the year after the taxpayer's notice of its intent to dispose of the building, the low-income housing credit agency has failed to present a qualified contract for the acquisition of the building by a person who will continue to operate the applicable fraction of the building as a low-income building.

Section 42(h)(6)(F) defines the term "qualified contract" as a bona fide contract to acquire (within a reasonable period of time 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 commitment) of the sum of: (1) the outstanding indebtedness secured by, or with respect to the building; (2) the adjusted investor equity in the building; plus (3) other capital contributions not reflected in these amounts, reduced by cash distributions from (or available for distribution from) the project.

The flush language of section 42(h)(6)(F) provides that the Secretary of the Treasury (the "Secretary") shall prescribe regulations as may be necessary or appropriate to carry out that subparagraph, "including regulations to prevent the manipulation of the amount determined under the [formula provided in that subparagraph]." It is under this statutory authority that the Service has issued the Proposed Regulations.

The Proposed Regulations provide guidance on (1) determination of the price of the qualified contract; (2) the administrative discretion and responsibilities of an Agency; and (3) when an offer of sale to the public has occurred.

### **B. Description of the Proposed Regulations.**

#### **1. Qualified Contract Formula.**

Proposed Regulation section 1.42-18(c)(1) defines the price to be paid under a qualified contract formula as the sum of the fair market value of the non low-income portion of the building plus the low-income portion of the building. Proposed Regulation section 1.42-18(c)(2) defines the low-income portion of the building as an amount not less than the applicable fraction (as specified in the commitment) of the total of: (1) outstanding indebtedness on the building; plus (2) the adjusted investor equity in the building; plus (3) other capital contributions not reflected in the amounts in described in (1) and (2); minus (4) cash distributions from (or available for distribution from) the project.

Under Proposed Regulation section 1.42-18(b)(3), the fair market value of the non low-income portion of the building is its fair market value at the time of the Agency's offer of sale. The Preamble states that the fair market value must reflect the restrictions on the use of the low-income portion of the building because the intent of the extended-long term commitment is the continued use of the low-income portion of the building as low-income housing. Thus, the Proposed Regulations provide that the valuation must take into account the existing and continuing requirements under the commitment for the building.

The Preamble also notes that section 42(h)(6) does not discuss the appropriate treatment of land in the calculation of qualified contracts. Qualified contracts are defined by reference to the building, which for other purposes of section 42 generally does not include the underlying land. The Preamble notes that it is anticipated that the sales of the building without the underlying land would be infrequent and so the Proposed Regulations provide that the non low-income portion also includes the fair market value of the land underlying the entire building, both the non low-income portion and the low-income portion, regardless of whether the building is entirely low-income.

For purposes of determining the low-income portion of the building, Proposed Regulation section 1.42-18(c)(3) defines the term "outstanding indebtedness" as the outstanding principal balance, at the time of the sale, of any indebtedness or loan that is secured by, or with respect to, the building, and that does not exceed the amount of qualifying building costs. Qualifying building costs are generally defined in Proposed Regulation section 1.42-18(b)(4) as those costs that would have been includible in eligible basis of a low-income housing building under section 42(d)(1), provided the amounts were expended for depreciable property that is conveyed under the contract with the building. The Preamble contains the following example: The outstanding mortgage on the building will generally be outstanding indebtedness for purposes of section 42(h)(6)(F), even if the indebtedness is incurred after the first year of the credit period, but only up to the amount of costs included in original eligible basis established at the end of the first year of the credit period under section 42(f)(1), plus indebtedness for qualifying building costs incurred after the first year of the credit period of a type that could be includible in eligible basis under section 42(d)(1). Under the Proposed Regulations any proceeds from refinancing indebtedness or additional mortgages in excess of such qualifying building costs should not count as outstanding indebtedness for purposes of section 42(h)(6)(F).

The Preamble also notes, and the Proposed Regulations provide, that outstanding indebtedness with an interest rate below the applicable Federal rate (as determined under section 1274(d)) at the time of issuance must be discounted using a present value calculation to obtain an imputed principal amount. Thus, in such cases an imputed principal amount constitutes the amount of indebtedness that must be utilized in calculating the amount of outstanding indebtedness under the qualified contract formula.

Proposed Regulation section 1.42-18(c)(4) provides that adjusted investor equity includes only those cash investments by owners of the low-income building used for qualifying building costs. Investor equity is adjusted by application of a cost of living adjustment not to exceed five percent.

Under Proposed Regulation section 1.42-18(c)(5), "other capital contributions" are defined as contributions for qualifying building costs other than amounts included in the calculation of outstanding indebtedness or adjusted investor equity as defined in Proposed Regulation sections 1.42-18(c)(3) and 1.42-18(c)(4). The Preamble explains by way of example that such other capital contributions include amounts expended to replace a furnace after the first year of the credit period, provided any loan taken to finance the furnace was not secured by the furnace or the building.

Qualifying building costs are defined under Proposed Regulation section 1.42-18(b)(4)(i) and (ii). Under Proposed Regulation section 1.42-18(b)(4)(i), a qualifying building cost is a cost included in eligible basis under section 42(d)(1) which is included in (1) the adjusted basis of depreciable property subject to section 168 and the property qualifies as residential rental property under section 142(d) and Regulation section 1.103-8(b)(4)(iii); or (2) the adjusted basis of depreciable property subject to section 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building, but only if the property is conveyed under the contract with the building. A qualifying building cost also

includes costs incurred after the first year of the credit period (as defined in section 42(f)) of the type included in eligible basis under section 42(d)(1).<sup>3</sup>

Under the qualified contract formula set forth in the statute, the sum of the outstanding indebtedness, adjusted investor equity, and other capital contributions is reduced by cash distributions from or available for distribution from the project. Proposed Regulation section 1.42-18(c)(6) defines cash distributions as including all distributions to owners or related parties within the meaning of sections 267(b) or 707(b) (for example, cash distributions to owners from the proceeds of refinancings and second mortgages in excess of existing mortgages), and all cash and cash equivalents including reserve funds (for example, replacement and operating reserves) generated by cash flow from the project. To the extent an owner contributed his or her own funds to a reserve fund for replacement and improvements, such amounts are evaluated as either adjusted investor equity or other capital contributions.

## **2. Administrative Discretion and Responsibilities of an Agency.**

Under Proposed Regulation section 1.42-18(d)(1), the Agency may exercise administrative discretion in evaluating and acting upon an owner's request to find a buyer to acquire the building. For example, the Agency may determine that an owner's request to find a buyer for the project lacks essential information and it may suspend the one-year period for finding a buyer until essential information is submitted.

## **3. Actual Offer of Sale.**

Proposed Regulation section 1.42-18(d)(2) provides that in order to satisfy the qualified contract requirements under section 42(h)(6), the Agency must offer the building for sale to the general public at the determined qualified contract price upon receipt of a written request by the owner to find a buyer to acquire the building.

## **II. Discussion**

### **A. Non Low-Income Portion of a Building.**

Under Proposed Regulation section 1.42-18(a)(3), the fair market value of the non low-income portion of a building is determined at the time of an Agency's offer of sale of the project to the general public.

We believe that the approach to revaluing the building set forth in the Proposed Regulations is inconsistent with the real-world factors that influence project values. The offer that a purchaser will make for a project will, in fact, be for the entire property. This offer will include both the low-income portion and the non low-income portion of the building. The fact that no purchaser makes an offer for the entire property within a reasonable period of time does not necessarily mean that the fair market value of the non low-income portion was determined incorrectly or has changed significantly since that determination. Rather, the lack of such an offer is more likely to result from the portion of the qualified contract price calculated for the low-income portion exceeding its fair market value. As the Preamble makes clear, the Service and Treasury concluded that they did not have the option of limiting the qualified contract price for the low-income portion to the fair market value of that portion of the building, and so the potential for such price to exceed fair market value is present. To avoid the possibility of the price of the non low-income portion inappropriately triggering a revaluation, we recommend that an Agency be permitted to adjust the fair market value of the non low-income portion of the building only if market values have in fact dropped during the one-year offer of sale period. We believe an Agency should not have the ability to adjust the fair market value of the non low-income portion of the building merely because no buyer has made an offer within a reasonable time.

The Proposed Regulations do not address the specific methodology to be used to determine the fair market value of the non low-income portion of the building. Presumably, a customary appraisal will be used to make that determination. It is often the case that reasonable, well-respected appraisers can differ

as to the appropriate value for a given building. Accordingly, we recommend that a "tie breaker" be considered in the Regulations when finalized so that, for example, a third appraiser renders a binding valuation opinion when an Agency and an owner disagree as to the fair market value of the non-low-income portion of a building.

Under Proposed Regulation section 1.42-18(a)(3), the non low-income portion of a building includes the fair market value of the underlying land, at least in cases where a fee interest in such land is held by the owner. Comments were requested in the Preamble regarding the treatment of leased land and cases in which underlying land is not sold with the building. In our experience, buildings that are constructed on land owned by another owner will be sold subject to the existing ground lease which often will have a very long remaining term. In this instance, it may be appropriate to value the leasehold interest in the ground in the same way that the underlying land value would be determined if a building were being sold along with the fee interest in the underlying land. In other cases, however, ground leases are only 45 to 50 years (for example, the Bureau of Indian Affairs limits leases on Native American land to 50 years), so there may only be 30-35 years remaining on a lease at the end of the compliance period. In those cases it is not clear that the value of the remaining leasehold will be equivalent to a fee interest. For this reason we recommend that the Regulations, when finalized, provide that an appraiser should determine the value of the remaining leasehold interest. It is important to address this issue in the Regulations, when finalized, because there are many low-income buildings constructed on leased land, particularly in mixed-finance transactions involving public housing authorities.

Finally, from a purely technical perspective, if no buyer has made an offer at the qualified contract price after a reasonable period of time, it appears that Proposed Regulation section 1.42-18(c)(1), would permit, but not require, an Agency to adjust the fair market value of the non low-income portion. That provision references the adjustment of the "fair market value of the building" rather than the fair market value of the non low-income portion of the building. This reference is potentially confusing, and we recommend that the phrase "fair market value of the non low-income portion of the building" be used instead.

## **B. Low-Income Portion of a Building.**

As described above, the language in Proposed Regulation section 1.42-18(c)(3) and (4) establishes a regime under which, in order to determine funds used with respect to the building, as opposed to non-depreciable costs, one would have to be able to allocate or trace both the indebtedness secured by the property and the investor equity contributed to the entity that owns the property.

The concept of only taking into account the debt and equity that went into the building that is being sold, *i.e.*, "qualifying building costs," generally seems to be correct, although we recommend that the Regulations, when finalized, clarify whether basis reductions under section 50(c) should be restored for this purpose. Importantly, however, a potential problem could arise in those cases where there will be no good evidence of whether equity or debt was used to pay for various non-qualifying costs, especially 15 years after the fact. In such cases, a presumption or rule of convenience would allow for an appropriate calculation of the portion used with respect to non-depreciable costs and avoid potential disputes between owners and Agencies. For example, if one allocates more or less of the debt to basis eligible expenses in cases where unpaid interest accrues to increase the debt, the calculation of the qualified contract price could be different depending upon the relationship between the interest rate on the debt to the CPI adjustment to which the equity contribution is entitled each year. We therefore recommend that a presumption be added providing that the original debt and equity would be treated as funding all of the qualifying building costs proportionately, absent a clear requirement or prohibition in the underlying funding documents that earmarks a particular source of financing to a particular use.

We also have concerns with the approach set forth in Proposed Regulation section 1.42-18(c)(3)(ii) requiring that the amount of secured indebtedness bearing an interest rate less than the applicable Federal rate be discounted under section 1274. In most instances, the purchaser of the project would take the property subject to the indebtedness and thus would realize the benefit provided by the below-

market interest rate. Under generally applicable tax principles, both the seller and the purchaser would treat the undiscounted amount of the indebtedness as part of the purchase price and there would not be any reduction to basis or allocation made to purchase of an instrument with "favorable" financing. Alternatively, if the purchaser were to acquire the project and not take it subject to the below-market loan, the seller would still need to pay off the loan at its full principal amount. If the seller would only receive the discounted amount of the indebtedness at closing, as a practical matter, this rule would require that some of the purchase price that was otherwise attributable to the equity investment would have to be utilized to satisfy the below-market interest rate debt secured by the property. It is our belief that an important policy objective of section 42(h)(6) is to establish a qualified contract price that provides the return of an owner's equity, adjusted to reflect an appropriate return, and that is neutral with respect to outstanding debt. Discounting below-market debt for purposes of establishing the qualified contract price appears to be inconsistent with that policy objective.

Under Proposed Regulation section 1.42-18(c)(2)(iv), the low-income portion amount is decreased for cash distributions from (or available for distribution from) the building. Proposed Regulation section 1.42-18(c)(6)(B) refers to cash available for distribution and includes reserve funds in this category. Because Proposed Regulation sections 1.42-18(c)(3) and (4) already exclude from the outstanding indebtedness amount and the adjusted investor equity amount any amounts not used for qualifying building costs, amounts originally used to fund reserves have already been deducted from the calculation of the low-income portion amount. Therefore, it would appear to be incorrect to deduct, as cash distributions, amounts held by the owner as reserves that were originally funded out of debt or equity. To the extent that reserves, such as replacement reserves, have been funded out of net cash flow from the project, those amounts should be treated as available for distribution only to the extent that they are not required to be maintained with the property and transferred to a purchaser. We therefore recommend that the Regulations, when finalized, provide that the qualified contract price be reduced only to the extent that a replacement reserve (1) has been funded by contributions from operating cash flow and (2) can be retained by the owner when the property is sold to a purchaser at the qualified contract price.

### **C. Procedural Points with Respect to Qualified Contracts.**

The Proposed Regulations do not define the term "bona fide contract," which may result in unexpected obstacles to actually closing a qualified contract. We recommend that the Service and Treasury consider defining bona fide contract for purposes of section 42 to be one that contains usual and customary terms and conditions. In addition, the Proposed Regulations, following section 42(h)(6)(F), provide that a qualified contract must close within a reasonable period after being entered into. The term "reasonable period" is not defined in the Code or the Proposed Regulations and this could lead to uncertainty and inconsistent treatment by different Agencies. We therefore recommend the Service and Treasury consider defining the length of the "reasonable period" within which a qualified contract must close. Furthermore, if a bona fide contract has been agreed upon and the proposed purchaser defaults and does not consummate the purchase within the specified reasonable time period, we recommend that it be deemed that the proposed seller has met its requirement and that the extended use commitment has expired.

### **D. General Comments on Qualified Contracts.**

The anti-abuse rule in Proposed Regulation section 1.42-18(c)(6)(B)(ii) provides that the Commissioner will interpret and apply the rules in Proposed Regulation section 1.42-18(c)(6) as necessary and appropriate to prevent manipulation of the qualified contract amount. The Proposed Regulations state that, as an example, cash distributions should include payments to owners or related parties within the meaning of sections 267(b) or 707(b) for any operating expenses in excess of amounts reasonable under the circumstances. We assume that this anti-abuse rule is intended primarily to deal with cash distributions to partners that are characterized under partnership agreements as incentive fees such as an "incentive supervisory management fee." We believe this concept is appropriate. We, however, would not characterize the use of an "incentive supervisory management fee" as a device intended to manipulate the qualified contract amount. This characterization of what would otherwise be distributable

cash flow is done for other purposes. Accordingly, we recommend the Regulations, when finalized, include within the definition of cash distributed to partners a category of incentive fees that are in the nature of cash distributions and then delete the example.

In the Preamble, comments were requested regarding how cash distributions should be handled when a low-income housing development is owned other than by a corporation or partnership (including an LLC). We believe the incidence of ownership by sole proprietors, estates, and trusts are so limited that the Regulations, when finalized, need not specifically address those possibilities.

Proposed Regulation section 1.42-18(d) allows for an Agency to require substantiating information to establish a number of criteria, some of which may not be available due to either inadequate records by the building owner or transfer of the property during the initial compliance period. We recommend that Agencies be permitted to allow for either the building owner's accountants or an independent accounting firm to "fill in the gaps" that might exist in such documentation through an agreed upon procedure.

Finally, in the Preamble, comments were requested on the extent of Agency authority to provide more stringent requirements, particularly limiting the qualified contract price to fair market value. As a practical matter, the Agencies in most states have, for many years, required applicants for tax credits to waive their entitlement to the qualified contract approach. In spite of the prospective effective date, realistically the Regulations, when finalized, will be used to interpret qualified contract arrangements that were entered into in transactions that were allocated credits in the early 1990s. Given that, for many years, these Agencies have required applicants in many cases to waive these provisions entirely in order to compete for allocations of tax credits, we do not believe there is any need or benefit to extending to the Agencies the authority to provide more stringent requirements.

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<sup>1</sup> Unless otherwise expressly stated herein, all references to section are to Internal Revenue Code of 1986, as amended (the "Code"), and all references to regulations are to the Treasury Regulations promulgated under the Code.

<sup>2</sup> 72 Fed. Reg. 33,706, (June 19, 2007).

<sup>3</sup> See Prop. Reg. §1.42-18(b)(4)(ii). 