Background on Qualified Contracts under Section 42
April 2018

Summary

Housing Credit properties are subject to a minimum 30-year affordability commitment: a 15-year initial compliance period, plus a minimum 15-year extended use period per a deed restriction recorded against the property. A number of states either require or incentivize longer affordability periods. This paper discusses a serious issue with a provision in Section 42 that permits owners to take properties out of the program after just 15 years, thereby releasing these properties from the 30-year affordability commitment. This situation has recently come to the attention of the affordable housing community and requires prompt action at both the state and federal level.

Discussion

Properties receiving subsidies under the Low-Income Housing Tax Credit ("Housing Credit") program are required to be rented to qualified residents at affordable rents for a minimum of thirty years. There are two exceptions to this requirement as provided for under Section 42(h)(6)(E): 1) in the case of foreclosure, and 2) where a "qualified contract" is presented to the housing credit agency.

Under the qualified contract provision, an owner that desires to remove its property from the extended use restriction must first approach the housing credit agency sometime after year 14 to give the agency one year to find a qualified buyer who will maintain the remaining 15-year affordability commitment on the property. The purchase price under this "qualified contract" is established under Section 42(h)(6)(F) and is designed to give the owner an inflation adjusted return on its original equity contribution. If, after one year's time, the Housing Credit agency is unable to find a buyer, the original owner is released from the Housing Credit affordability restrictions. In practice, the qualified contract formula price in most all cases significantly exceeds the market value of the property so it is very rare for the Housing Credit agency to find a buyer who will maintain the affordability of the property for the remainder of the 30-year period, allowing the current owner to exit the program after 15 years.

The qualified contract provision was added to Section 42 in 1989 as a compromise measure designed to prevent owners from obtaining windfall returns from appreciation in the value of the Housing Credit property. The contract price limiting the growth in the value of the property to the rise in inflation on the equity contribution was thought to be a significant limit on returns. However, because the statutory formula price is typically in excess of market value, the provision has emerged as a means of enabling owners to remove properties from the extended low-income use commitment, thus permitting higher rents and likely displacement of low-income residents. As owners raise rents after completing the qualified contract process, there is a loss of affordable housing.

In 2012, HUD published a major study of what happens to Housing Credit properties in Year 15, "What Happens to Low-Income Housing Tax Credit Properties in Year 15 and Beyond"

https://www.huduser.gov/publications/pdf/what_happens_lihtc_v2.pdf. The study largely found that properties were remaining affordable and no significant public policy concerns were presented. More recent information, however, indicates that the qualified contract process is becoming more common, as some owners seek to take advantage of strong multifamily markets across the country.

Some states exercise their authority under the law to require applicants to waive their right to using qualified contracts at the time a credit allocation is made. Other states effectively eliminate this as an option by providing scoring incentives in their Qualified Allocation Plans ("QAP") to Housing Credit applicants that agree to forgo their rights to a qualified contract. However, a number of states are silent on this issue or have established a specific process for taking properties through the qualified contract process.

According to the National Housing Trust, 33 states today either require Housing Credit applicants to waive their right to submit a qualified contract or give extra points in the scoring process under the 9% program, but in nine of those states the waiver is for less than 15 years. For the 4% bond program, only 17 states require or encourage applicants to waive the right to submit a qualified contract.

As a result of a recent survey, we have learned that thousands of units of affordable housing are being lost annually as a result of the qualified contract provision. This is an unacceptable skirting of the 30-year minimum affordability required by the program. A broad range of affordable housing advocates including state agencies, syndicators, national nonprofits and tenant advocates are now proposing repeal of the qualified contract exception as soon as possible. But a change in federal law could take years. States must take action immediately, both to require that all new allocations include a requirement to waiver the qualified contract option, and to discourage current owners from utilizing the qualified contract option.

In its most recent version of its "Recommended Practices in Housing Credit Administration," released in December 2017, the National Council of State Housing Agencies recommends that all states require Housing Credit applicants to waive their right to submit a qualified contract for both 9% and 4% properties. It also recommends that states establish in their QAPs disincentives for owners to undertake the qualified contract process for existing developments, including potentially awarding negative points on future applications. In addition, states are encouraged to formulate other policies that will curtail the use of qualified contracts by owners of existing developments, including conditioning the approval of transfers of Housing Credit properties or interest in Housing Credit property ownership entities on a waiver of the qualified contract option by the purchaser/transferee.

Enterprise Community Partners
Local Initiatives Support Corporation/National Equity Fund
National Association of Affordable Housing Lenders
National Association of State and Local Equity Funds
National Housing Trust
Housing Partnership Network
Stewards of Affordable Housing for the Future

Misconceptions Regarding Qualified Contracts (QC)

Misconception #1: Lenders and investors will not finance Housing Credit developments, especially bond-financed/4% projects, without the QC Option.

As is abundantly clear in states where QC waiver is required for both 9% and 4% projects, as well as in Rental Assistance Demonstration (RAD) projects in which the documents functionally require perpetual affordability, lenders and investors are very willing to finance Housing Credit projects in which the affordability is "locked down" for 30 or more years. The proof is in hundreds of projects with QC waivers placed in service in just the last several years.

Misconception #2: The 4% credit associated with bond-financed projects is a shallow subsidy, and developers need the QC to induce them to develop bond/4% project.

Bond/4% projects have the same overall feasibility requirements as 9% projects: sources must equal uses, projects can't be over-leveraged with must-pay debt, and adequate "cushions" such as reserves and paid developer fee must be structured into the deal. Additionally, the developer fee structure amount and limits are typically the same for 9% and 4% projects, so the developer's incentives are the same in both types of projects. A 4% project requires more sources other than Housing Credit equity than a 9% project, but no project should proceed if it is considered feasible only on the basis that the development team assumes the property will be converted from affordable to market rate housing in 15 years.

Misconception #3: The QC is needed to reposition projects that are in physical or financial distress.

Allocating agencies and other stakeholders have alternative options when a project is experiencing distress, including:

- easing certain aspects of compliance monitoring (as discussed in Recommended Practice #43);
- restructuring debt;
- making new loans;
- resyndicating the property; and
- in rare cases, amending the extended use agreement to modify the affordability restrictions on a small portion of the units.

Allocating agencies should develop appropriate tools to facilitate preservation and should refuse to release them from affordability restrictions via QC.

Misconception #4: The QC is needed to redevelop an existing Housing Credit development as new affordable housing.

In rare cases, an owner may propose to redevelop a property by demolition and rebuilding (to better meet community needs, increase density, etc.) during the extended use period, which when completed would serve at least the same number of qualified residents. Allocating agencies may allow this under an extended use agreement. Exit from the program via QC is not required.

Misconception #5: Policies which sanction or otherwise dis-incentivize developers who pursue QC for an existing development amounts to reneging on a contractual right that is a part of Section 42.

Allocating agencies typically have many requirements for developers who are applying for Credits, and they may disqualify developers for a variety of past actions. Disqualifying a developer who chooses to pursue the QC process is no different. The core mission of allocating agencies is to develop and preserve affordable housing, and developers are partners in fulfilling this mission. If a particular developer engages in activities that undermine the mission, an agency should take that into account should the developer approach the agency in the future to apply for Housing Credits. Developers are not entitled to Housing Credit subsidies and it is ultimately the developer’s choice to request a QC, knowing full well the consequences of such action. For example, anyone has a right to declare bankruptcy, but doing so is problematic under most QAPs.

Misconception #6: Housing Credit limited partnerships are required to maximize the partners’ profits, including by requesting a QC if that would result in greater proceeds to them.

As intended by Congress, Housing Credit partnerships are formed for the purpose of developing and operating rental housing affordable to low-income individuals and families for a minimum of 30 years. The partners carry out this purpose by structuring and operating the Housing Credit project in a way that maintains its affordability and its physical and financial viability, and such actions serve the best interests of the partnership.[1] This is possible because return on equity is provided by taxpayers in the form of Housing Credits and deductions, not by cash flow and residuals as in conventional real estate. In exchange, taxpayers—the “public” in these public-private partnerships—expect the partners to act in the best interest of the partnership in carrying out its purpose.

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[1]A 2016 Minnesota trial verdict in *Cottages of Stewartville Limited Partnership vs. American Tax Credit Corporate Fund, L.P.* affirmed this purpose.

Thus, the first priority in a partner exit or other capital event (such as refinancing, sale or investor exit at Year 15) is to maintain the affordability and physical and financial viability of the asset until at least the end of the 30-year minimum affordability period. This requires ensuring that the financial structure, provision for capital needs and operating expenses, and any successor partners continue to serve these goals. If, after all such needs are met, there is residual value which the partners can share, that is a bonus for the partners. However, such residuals should be secondary in a Housing Credit partnership. Use of the QC provision to generate a windfall to the partners is contrary to the purpose of the Housing Credit program and Congress' intent in the extended use provision.