Closing the Qualified Contract Loophole

Updated August 2024

Summary

The Low-Income Housing Tax Credit ("Housing Credit") is our nation's most successful tool for encouraging private investment in the production and preservation of affordable rental housing. Since its creation in 1986, it has financed over 3.8 million affordable apartments, providing homes to roughly 9 million low-income households, while transferring risk from the government to the private sector. However, some owners have been taking advantage of a loophole in the law that poses a threat to the affordability of Housing Credit properties and is limiting the full benefits of the program.

This paper discusses an issue with the qualified contract provision in Section 42 of the Internal Revenue Code that enables some owners to take properties out of the program after just 15 years, thereby releasing these properties from the 30-year affordability commitment.

About Qualified Contracts

The Housing Credit is a production subsidy provided to developers who agree to rent their properties to qualifying low-income residents at reduced rents for a period of at least 30 years, including a 15-year tax compliance period and another 15-years or more of extended use subject to deed restriction. This is the essential structure of the program and it is commonly understood. However, there are two little-known exceptions to the requirement that Housing Credit properties remain affordable for 30 years: 1) in the case of foreclosure; and 2) where a "qualified contract" is presented to the state Housing Credit agency. Under the qualified contract provision, an owner of a Housing Credit property may, after Year 14, approach the Housing Credit allocating agency to request to go through the qualified contract process. This request begins a one-year period during which the allocating agency seeks a qualified buyer to purchase the property and maintain it as affordable for the duration of the extended use period. The required purchase price for a qualified contract is stipulated by Section 42 and was designed to prevent backend windfalls to owners and investors by limiting them to an inflation-adjusted return on the original equity contribution.

While the original intent of this provision was to create a limited return and some liquidity for investors at a time when the Housing Credit was an unproven program, for those owners who utilize the provision it has come to function as a nearly automatic affordability opt-out after just 15 years of affordability. This is because the qualified contract formula price in nearly all cases significantly exceeds the market value of the property as affordable housing. As a result, it is rare for the allocating agency to find a buyer willing to pay the qualified contract price. If the allocating agency fails to identify a qualified buyer within one year, the property is released from the affordability requirements of the Housing Credit program. At that point, <u>the owner is free to either sell the property at market value without any deed restriction or continue to own and manage the property charging market rents after a three-year rent protection period for existing tenants.</u>

How Frequently Are Qualified Contracts Being Used, and Why Now?

In recent years, many rental markets have heated up considerably. Rents have risen sharply, causing more renter households to be cost-burdened than ever before. At the same time, the supply of low-cost units has been declining substantially. According to Harvard University's Joint Center for Housing Studies, "In 2022, just 16 percent of units had rents below $600, down from 22 percent of the rental stock in 2012. Meanwhile, the share of units renting for $2,000 or more increased from 7 percent to 16 percent."[1]

In many markets, Housing Credit properties could demand far higher rents if they did not have the affordability restrictions required by the program. Some owners have sought a way to lift the affordability restrictions on their properties even though such action was not contemplated when the property was originally financed with Housing Credit subsidies. These owners did not build Housing Credit properties on the basis that they would be able to get out of the affordability restrictions after 15 years because at the time of construction, there was no expectation the statutory formula would result in an above-market price, and thus function as an "opt-out." This was an after-the-fact realization.

Housing Credit properties located in high opportunity areas or areas that have gentrified since the property was placed in service are most at risk. These neighborhoods are often the most difficult to develop new affordable housing in and/or are experiencing high rates of displacement of low-income households, so preserving existing affordable housing is extremely important.

<u>Recent analyses indicate that the qualified contract process is resulting in the premature loss of approximately 6,000 - 10,000 low-income homes annually, and often more. As of the end of 2023, approximately 115,000 apartments nationwide have exited the Housing Credit program's rent and income constraints through the qualified contract process.</u>

Affordable housing and tenant advocates are deeply concerned that unless the qualified contract process is corrected, the number of Housing Credit properties lost before fulfilling their intended affordability period will continue to grow at an accelerating rate.

Correcting Qualified Contracts

As a result of recent efforts to address this issue, nearly all states now require or incentivize owners to waive their right to a qualified contract as a condition of receiving an allocation of Credits. However, this does not prevent owners who received Credits before such policies went into place from exercising the qualified contract option. Federal legislation is needed to correct the qualified contract provision in Section 42 and prevent the loss of affordable housing through this loophole.

Senate Finance Committee Chairman Ron Wyden's Decent, Affordable, Safe Housing for All (DASH) Act (S. 680) would close the qualified contract loophole by:

- Repealing the qualified contract option in Section 42 for future projects, thus eliminating the qualified contract provision being used as an opt-out for properties awarded credits or bonds beginning in 2022; and
- Correcting the statutory price for purchase of existing properties so that it is based on the fair market value of the property as affordable housing.

Expected Savings from Closing the Qualified Contract Loophole

Closing the qualified contract loophole is not only the best policy for protecting residents and ensuring long-term affordability, but it would also save the federal government money. The fix was previously included in legislation

[1] *The State of the Nation's Housing 2024*, Joint Center for Housing Studies of Harvard University

considered during the 117^{th} Congress. At that time, the Joint Committee on Taxation found that repealing the qualified contract option would create a revenue savings of $457 million over ten years.

Affordable housing practitioners and advocates agree that it is imperative that Congress advances legislation to ensure that the Housing Credit can fulfill its intended program goal of financing at least 30 years of affordability for low-income residents.

National Organizations Supporting Closing the Qualified Contract Loophole

Council of Large Public Housing Authorities
Enterprise Community Partners
Housing Partnership Network
Local Initiatives Support Corporation/National Equity Fund
Low Income Investment Fund
National Affordable Housing Management Association
National Association of Affordable Housing Lenders
National Association of Local Housing Finance Agencies
National Association of State and Local Equity Funds
National Council of State Housing Agencies
National Housing Conference
National Housing Law Project
National Housing Trust
National Low Income Housing Coalition
Public Housing Authorities Directors Association
Stewards of Affordable Housing for the Future