Closing the Qualified Contract Loophole

Updated November, 2021

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 nearly 3.5 million affordable apartments, providing homes to roughly 8 million low-income households, while transferring risk from the government to the private sector. However, there is an emerging practice 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 30 years, including a 15-year tax compliance period and another 15-years 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 a qualified contract. 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 some properties 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, 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.

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

In recent years, many rental markets have heated up considerably. According to the U.S. Census Bureau, on average apartment rents climbed by 36 percent in the decade prior to the pandemic. This means that 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 are now seeking 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.

Recent analyses indicate that the qualified contract process is resulting in the premature loss of approximately 10,000 low-income homes annually, and often more. As of 2020, over 93,300 apartments nationwide have already been lost, and in the year 2020 alone, owners served notice to state allocating agencies that they wanted to begin the qualified contract process on additional properties comprising approximately 11,650 homes.

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 30-year affordability period will continue to grow at an accelerating rate.

Correcting Qualified Contracts

While some states have or are in the process of implementing policies to mitigate as best they can the loss associated with qualified contracts, federal legislation is required to correct the qualified contract provision in Section 42.

The Build Back Better Legislation currently under consideration in Congress would close the qualified contract loophole by:

- Repealing the qualified contract option in Section 42 for future, 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.

These important fixes are also included in the Decent, Affordable, Safe Housing for All Act (S.2820) sponsored by Senate Finance Committee Chairman Ron Wyden (D-OR) and in the Save Affordable Housing Act of 2021 (H.R. 4205) sponsored by Representative Joe Neguse (D-CO).

Expected Savings from Closing the Qualified Contract Loophole

Not only is closing the qualified contract loophole the best policy for protecting residents and long-term affordability, but it would also save the federal government money. The Joint Committee on Taxation, in its most recent score of the Build Back Better Act, 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

As of April, 2021

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 Trust
National Low Income Housing Coalition
Public Housing Authorities Directors Association
Stewards of Affordable Housing for the Future