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.

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