October 15, 2024

The Honorable Mike Kelly
United States House of Representatives
1433 Longworth House Office Building
Washington, DC 20515

The Honorable Mike Carey
United States House of Representatives
1433 Longworth House Office Building
Washington, DC 20515

The Honorable Claudia Tenney
United States House of Representatives
2349 Rayburn House Office Building
Washington, DC 20515

The Honorable Blake Moore
United States House of Representatives
1131 Longworth House Office Building
Washington, DC 20515

The Honorable Darin LaHood
United States House of Representatives
1424 Longworth House Office Building
Washington, DC 20515

Dear Representatives Kelly, Tenney, LaHood, Carey, and Moore:

Thank you for this opportunity to provide input to the Ways and Means Committee's Community Development Tax Team as you consider how the Tax Code can better support affordable housing and community development, and how such changes could be incorporated into tax legislation that focuses on extending the *Tax Cuts and Jobs Act of 2017* (TCJA).

We are an *ad hoc* coalition of organizations focused on measures that can be implemented to help preserve Low-Income Housing Tax Credit ("Housing Credit") properties as affordable housing. <u>As you know, taxpayers have provided critical subsidies for the development of affordable housing using the Housing Credit program and we believe these subsidies should not be wasted through abusive practices that prematurely end rent affordability restrictions or drain resources from the properties.</u>

The two issues that we urge you to address are the qualified contract provision and the nonprofit right of first refusal in section 42 of the Tax Code. The remainder of this letter describes our proposals and the reasons why these changes are so needed. Not only would fixing these problems preserve the affordability of these properties as intended by Congress, but it also would raise revenue to help offset the cost of other tax priorities under consideration. The congressional Joint Committee on Taxation has produced revenue estimates in the past projecting these two provisions combined would increase revenue by approximately $1 billion over a ten-year period.

<u>Qualified Contracts</u>

The basic structure of the Housing Credit program is that subsidies are provided to developers who agree to rent their properties to qualifying low-income residents at reduced rents for a minimum of 30 years, including a 15-year tax compliance period and another

15-years of extended use subject to deed restriction. While this is how the program is commonly understood, 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"[1] 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, 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.

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 sixteen percent of units had rents below $600, down from 22 percent of the rental stock in 2012.[2] Meanwhile, the share of units renting for $2,000 or more increased from 7 percent to 16 percent."

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.

---

[1] Internal Revenue Code Section 42(h)(6)(E)

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

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 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 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.

Affordable housing 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.

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

Closing the qualified contract loophole would protect taxpayer investment in affordable housing while also ensuring that residents are not subjected to unconscionable rent increases when the property is converted to market rates.

We urge the Ways and Means Committee: 1) to repeal the qualified contract provision in section 42 for future allocations of Housing Credits, and 2) to modify the formula in current law so that purchasers may acquire an existing Housing Credit property at its fair market value as affordable housing rather than the faulty formula in current law which ascribes a fictional, elevated value to the property.

Right of First Refusal

The Housing Credit program is designed to attract equity capital to affordable housing through tax subsidies, without any promise of residual value to the equity capital providers at the end of the 15-year Compliance Period. This is the operating assumption of the general partners (GP) and limited partners (LP) when deals are structured and it is the basis upon which Housing Credit properties are underwritten and financed. In Housing Credit deals, the general expectation of all parties, as typically expressed in their partnership agreements, is that the LP investors will exit the partnership after Year 15 pursuant to either (i) a below market Right of First Refusal (ROFR) purchase price in favor

of a nonprofit sponsor[3], or (ii) a Purchase Option used by both for-profit and nonprofit sponsors. For decades, this structure has functioned successfully, and LPs have accepted the terms of this arrangement.

However, in recent years, some entities controlling investor limited partnerships have begun to systematically challenge the GPs' project-transfer rights disrupting the normal exit process in hopes of generating windfall returns. This has led to troubling legal disputes and litigation that drain GP resources and threaten the long-term viability of these critical affordable housing assets. This situation was succinctly summarized in a 2020 Florida state court case involving a Housing Credit property where the investor refused to transfer its LP interest pursuant to the partnership agreement, *CED Capital Holdings 2000 EB, L.L.C. v. CTCW Berkshire..., 2020 WL 6537072*... "The Court further concludes that this type of activity has become more common in the LIHTC industry and the Court's decision here is in accord with decisions from other, similar cases in different jurisdictions where parties, like Hunt, have come into LIHTC partnership agreements and attempted to extract value or proceeds that is not otherwise permitted under the operative contracts like the Partnership Agreement here."

The most egregious practices involve so-called "Aggregators" which are companies who acquire control of existing Housing Credit investor limited partnerships for the purpose of generating profits by refusing to recognize GP post-year-15 acquisition rights. Their business strategy is to exploit the structure of Housing Credit financing by acquiring control of investor partnerships that have traditionally been of little value once investors have claimed all their housing tax credits. With their control of the LP interest, they challenge the rights of nonprofit GPs to exercise their right of first refusal unless additional money is paid to the Aggregator.

Aggregators typically challenge the ability of nonprofits to exercise their rights of first refusal by insisting: 1) this is just a common law right and therefore there must be a a *bona fide* third-party offer to purchase the property even when the partnership agreement does not require it; and 2) the LP has the sole discretion to sell the property regardless of the terms of the agreement.

Even when a third-party offer is presented, Aggregators claim it is not a bona fide offer and does not conform to state law requirements. Another common feature of these disputes is for the Aggregator to allege that the GP has breached its fiduciary duty, which gives the LP tremendous leverage since partnership agreements typically provide this as ground for removing the general partner. The dispute then becomes not only an issue of whether the nonprofit which developed the property can exercise its right of first refusal, but also whether it will forfeit complete ownership of the property.

---

[3] Section 42(i)(7) permits a right of first refusal to be provided to tenants (in cooperative form or otherwise), a qualified nonprofit organization or government agency.

The overall goal of the Aggregators is to seek windfall returns by demanding the payment of money from the GP -- obtained either from the affiliate nonprofit's balance sheet, from property reserves, or from new debt -- or to insist the property be sold, stripping resources out of the affordable housing property and the community.

This problem has been exacerbated by the failure of the Internal Revenue Service to provide any guidance on section 42(i)(7) which leaves its terms uncertain.

To eliminate this problem in the future, and ensure the perpetual affordability for Housing Credit properties, we urge the Ways and Means Committee to modify section 42(i)(7) to permit general partners and their investor limited partners to agree to language in the partnership agreement that gives the nonprofit and other qualifying organizations a purchase option. This should be accompanied by language providing that the purchase price covers all assets of the partnership, not just the real property. In addition, to creating a purchase option for future Housing Credit deals, we urge the Committee to adopt language clarifying current law with respect how a right of first refusal is triggered and what partnership property is covered in the purchase price.

Thank you again for this opportunity to provide input to your work on affordable housing and community development issues. We look forward to working with you on these and other Housing Credit issues important to the future of affordable housing.

Council of Large Public Housing Authorities
Enterprise Community Partners
Housing Partnership Network
Local Initiatives Support Corporation/National Equity 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
Stewards of Affordable Housing for the Future