

The Low-Income Housing Tax Credit: HERA, ARRA and Beyond

by

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Abstract

The Low-Income Housing Tax Credit (LIHTC) has arguably been the most successful government subsidy to finance affordable housing. Since its creation in the Tax Reform Act of 1986 as Internal Revenue Code (IRC) Section 42, the LIHTC program has helped finance over 1,670,000 housing units. LIHTC has endured the test of time due to its strength both in the public policy and political spheres as well as its effectiveness in attracting significant private capital and in encouraging private oversight.

The collapse of corporate earnings in late 2008 led to the subsequent collapse of the LIHTC syndication markets as demand for LIHTCs practically evaporated. Proposed affordable housing developments that anticipated receiving private investment through the sale of LIHTCs stalled. In response to the overall national housing crises, Congress enacted the Housing and Economic Recovery Act of 2008 (HERA 2008), which contained numerous LIHTC amendments. In early 2009, Congress passed the American Recovery and Reinvestment Act of 2009 (ARRA), which temporarily converted the LIHTC program into a grant program. While HERA 2008 and ARRA were well intentioned, ARRA is a stopgap measure that could become costly to the US budget. This thesis argues that additional changes to IRC Section 42 should be implemented by Congress in order to reinvigorate the LIHTC syndication markets and improve LIHTC efficiency.

This thesis will first provide a detailed, yet comprehensible, background on how the LIHTC functions. Armed with that background, the reader will then be introduced to the recent legislation affecting the LIHTC program. Finally, additional changes to the LIHTC will be proposed that, if enacted by Congress, should serve to further strengthen the LIHTC program and help revive affordable housing production. These changes include but are not limited to: expanding the passive investor rules to individuals, permitting LIHTC investors to carryback the LIHTC for five years, amending the LIHTC state allocation formula, accelerating the 10 year credit period, implementing methods to better control development and program costs, and expanding the Community Reinvestment Act.

Thesis Supervisor: Lynn Fisher
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Many affordable housing industry professionals provided significant input both as interviewees and readers. I scheduled an unplanned trip to Washington, DC in June 2009. Despite the last minute notice, numerous industry experts carved out time in their busy schedules to meet with me. These included HUD Deputy Assistant Secretary Carol Galante, Attorneys Richard Goldstein and Charles Edson, Mark Keightley, and Robert Rozen. In addition, Lauren Bazel, Senior Advisor for Tax Policy for Senator Cantwell, provided her insight and introduced me to numerous individuals. We are all extremely lucky that someone of Lauren's skill, knowledge and experience is formulating Low-Income Housing Tax Credit legislation.

In addition to subjecting themselves to interviews, a few of individuals spent many hours reading and rereading this document and provided invaluable feedback. I am forever indebted to David Greenblatt, David Longworth, Paul Bouton, Forrest Milder, Kathleen Sheehan, and Pamela Goodman. They carefully read each word and multiple drafts of this thesis and I extend my sincere gratitude to them. Note, however, that the conclusions drawn in this thesis are my own and should not be attributed to any interviewee.

The country's leading syndicators also shared information regarding their industry sector and spent considerable time speaking with me and reviewing various sections. These individuals included Aaron Stevens, David Gasson, and Paul Hoffman. Kate Racer, one of the foremost government advocates for Massachusetts's highly successful affordable housing program, also provided thoughtful information.

Finally, my former and future colleague, Howard Cohen, supplied his intellectual wisdom to this thesis. There are few people I respect more than Howard and I am honored that is he my mentor.

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Introduction

Chuck Edson, one of the original affordable housing pioneers in the United States, and one of its most influential participants, summarizes the Low-Income Housing Tax Credit (LIHTC) as “old enough to have had a bar mitzvah, to vote, and to legally drink.” Since its creation through the Tax Reform Act of 1986, the LIHTC has subsidized 29,225 affordable residential developments and approximately 1,670,000 affordable units.¹ It is far and away the longest surviving affordable housing subsidy ever implemented in the nation’s history and its political support in Congress spans both political parties and ideologies.

The LIHTC operates differently than any other affordable housing subsidy. The LIHTC is a tax credit that is allocated to investors in low-income developments in exchange for private equity in those transactions. Rather than a direct subsidy to public or non-profit sponsors, the LIHTC makes the private sector a stakeholder in affordable housing. Congress views private enterprise involvement in LIHTC as a positive trait, as it garners private sector oversight of these developments. The private sector brings significant financial and real estate expertise that the government cannot provide.

In addition, whereas Congress appropriates other subsidies annually and can easily eliminate them by not renewing them, the LIHTC is written into the U.S. tax code as IRC Section 42. By securing a place in the tax code, the LIHTC is less vulnerable – its existence must intentionally be rescinded by Congress, a feat that, although not impossible, would be difficult to enact. Since the LIHTC is in the tax code, it is administered by the U.S. Treasury Department instead of the Department of Housing and Urban Development. A number of LIHTC industry professionals credit the Treasury Department for not over-regulating the program, which has allowed the LIHTC to thrive.

The combination of LIHTC’s private sector participation and its solid position in the US tax code is directly correlated with LIHTC’s durability and endurance. Some may argue that the program is inefficient and should be supplanted with a direct grant subsidy program that does not

¹ <http://www.huduser.org/datasets/lihtc.html>.

contain LIHTC's high transaction costs. Others contend that the program is too complicated and accommodates only the most sophisticated developers. Nonetheless, in my opinion, the LIHTC should continue to be improved to further streamline the program and increase its effectiveness. This thesis proceeds to investigate modifications to, and not the elimination of, the LIHTC program.

2008 Recession

In the summer of 2008, the U.S. and world economy collapsed, sending the Dow Jones Industrial Average plummeting approximately 50% and wiping out trillions of dollars of wealth. Unrealistic and unseen home price appreciation led to the massive retrenching of real estate markets. In Florida, condominium buildings that sprouted up like weeds now sit partially or completely empty. In the southwest, prolific homebuilders filed for bankruptcy protection as they were unable to carry constructed, but unsold, homes. Across the country, real estate markets stalled and prices reset to previous lows.

At the same time house prices were climbing, Wall Street indulged in more and more securitized debt products such as Commercial Mortgage Backed Securities (CMBS) and Residential Mortgage Backed Securities (RMBS), and derivatives such as Credit Default Swaps. Rating agencies provided credibility to these highly unregulated financial instruments by assigning ratings to them. Unfortunately, the strong ratings did not correlate with the actual risk associated with the underlying investments. As the underlying investments defaulted, the financial markets buckled. The U.S. government provided liquidity to the American Insurance Group (AIG), Bank of America and Citigroup, but when the smoke cleared, investment powerhouses Lehman Brothers collapsed and Bear Stearns and Merrill Lynch were forced to merge with larger banks.

The economic turmoil of 2008 also severely affected the LIHTC markets. Companies that historically purchased tax credits no longer had an appetite for LIHTC tax credits because they had no net earnings from which they could offset the tax credits. As described above, banks suffered greatly in the crisis. Unfortunately for the LIHTC program, banks were one of the

primary LIHTC tax credit investors. With no liquidity in the LIHTC market and with rapidly deteriorating market fundamentals, proposed affordable housing developments that had been allocated tax credits and had anticipated commencing construction were indefinitely delayed. In reacting to this crisis, Congress enacted legislation in early 2009 to temporarily provide grants in lieu of tax credits and other assistance to help fund proposed affordable housing developments.

Thesis Overview

The collapse of the LIHTC markets in 2008 exposed significant vulnerabilities in the program. This thesis was born out of the concept that the LIHTC is inherently a positive program, as described above, and should continue to persist. However, the program can be substantially improved to revive private investment and reduce, and eventually eliminate, dependence on recent government grants. Therefore, this thesis will (1) describe the recent regulatory changes, and (2) look for longer term opportunities and improvements to the LIHTC program.

It is assumed that the reader has a limited or no knowledge of the LIHTC program. The program is complicated and a number of rules govern its requirements. These conditions include items such as maximum affordable household incomes, types of private investors permitted to invest in LIHTC tax credits, and developer profit limitations. Chapter 1 provides a detailed overview of the LIHTC program.

Chapter 2 describes the recent grant legislation mentioned above. It also outlines the significant and positive changes to LIHTC contained in the Housing and Economic Recovery Act of 2008. Finally, Chapter 3 details proposed changes to the LIHTC program that, if enacted by Congress, could spur private investment once again in the market.

Methodology

Various sources were consulted and reviewed in formulating this thesis. Novogradac and Company LLP's 2009 Low-Income Housing Tax Credit Handbook was especially useful to help guide Chapter 1. A number of primary sources, such as government regulations, tax codes,

rulings, handbooks, legislation, and notices were reviewed and are cited throughout the thesis. Affordable housing industry publications were also incorporated and reviewed. These include memorandums, articles, and other publications.

The most useful source toward generating Chapter 3's proposed changes was interviews with industry professionals. I am fortunate to know personally some of the leading LIHTC experts in a cross section of fields from syndicators to developers to policy makers to attorneys. These interviews inspired and informed many of the proposed changes in Chapter 3.

Although I reviewed many academic papers, I found few helpful. Many were outdated, and more recent ones demonstrated a disconnect between academia's perception of the LIHTC program and the program's actual workings. As a former and future affordable housing developer, I wrote this thesis from a practitioner's perspective and it is intended to represent that point of view.

Chapter 1: Introduction to the Low-Income Housing Tax Credit

The Low Income Housing Tax Credit (LIHTC) is a complicated instrument to finance affordable housing. Its complexity dissuades many developers from embarking on a new development that incorporates LIHTC as a funding source. Lenders, many investors, and even policy makers that vote on LIHTC legislation do not fully understand how LIHTC works. Therefore, this chapter will breakdown LIHTC in a concise, easy to understand format. The intent of this chapter is to enable those not familiar with LIHTC's intricacies to gain fundamental knowledge of the various players, rules, and steps to completing a successful LIHTC development. An incredibly valuable resource which was essential in developing the below and which can provide additional detail to anybody seeking information beyond this chapter is Novogrdac & Company LLP's Low Income Housing Tax Credit Handbook 2009 Edition.

Incentives Prior to LIHTC

Prior to the enactment of the Tax Reform Act of 1986, there were some liberal and developer/investor friendly methods to encourage private investors to engage in affordable housing development.² First, the Internal Revenue Code (IRC) permitted affordable housing owners to rapidly amortize low income housing over a 5 year straight line basis rather than the current 27.5 years.³ If an owner did not choose the 5 year approach, an owner could depreciate 200% of low income housing costs over 15 years.⁴ Third, rather than capitalizing construction period interest and taxes, those items were permitted to be expensed. In order to be eligible for these tax treatment bonuses, an owner of multiple housing units was required simply to rent a certain number of units to low income households.⁵ There were no rent restrictions so an

² Note that there were many government programs that had been in prior existence for certain years such as 221(d)(3), Section 8, 236, etc. that were direct government subsidies into affordable housing.

³ IRC § 167(k)(1).

⁴ IRC § 168(b)(4).

⁵ IRC § 189(d)(1).

owner could charge whatever he or she desired. Also, there was no incentive to increase the number of low income units above the minimum threshold to receive such benefits.⁶

Prior to 1986, any individual was able to invest in a development, whether or not it contained low income units, and could offset the tax losses from those developments against his or her ordinary income. The rapid depreciation and amortization and special expense treatments described above created significant tax losses and shelters for those individual investors. Income categorization did not exist prior to 1986, so many wealthy individuals such as doctors and lawyers invested heavily in low income housing in order to partially or completely shelter their income. In fact, individuals who invested in these developments were basically purchasing tax losses rather than making active investments for income.⁷

Policy makers viewed these shelters as mechanisms for wealthy individuals to avoid paying taxes. The Tax Reform Act of 1986 (TRA 86), in addition to simplifying the tax code, attempted to reposition the IRC to prohibit individuals from taking advantage of what policy makers saw as abusive tax shelters. TRA 86 reclassified income into three categories – active, passive, and portfolio income and prohibited investors from offsetting gains in one with losses from the other. In addition, TRA 86 repealed the various provisions previously discussed that enabled low income housing investors to potentially fully shelter their other income.

Since TRA 86 repealed provisions that encouraged affordable housing, Congress realized that it needed to also include language in TRA 86 that would promote affordable housing

⁶ Novogradac, Michael J. *Novogradac & Company LLP Low-Income Housing Tax Credit Handbook, 2009 Edition*. New York: Thompson Reuters/West, 2009. Print.

⁷ Depreciation is an assumption by the IRC that a building will lose value over time due to wear and tear, physical deterioration, and age. Properties, regardless of their affordability, are permitted to deduct depreciation annually from their taxable income. Residential properties are depreciated on a straight line 27.5 years, while commercial properties are depreciated on a straight line 39 years. For example, if Susan purchases an apartment complex for \$1,000,000, and the building was valued at \$825,000 (the land was therefore \$175,000), then Susan can deduct \$30,000 ($\$825,000/27.5$) a year from her taxable income until the building is fully depreciated after 27.5 years. This enables Susan to “shelter” \$30,000 of income a year from her taxes until she sells the building, at which point the accumulated depreciation is taxed at 25% (higher than the 15% capital gains tax rate but lower than the 35% ordinary income tax rate she would have been subject to in year 1). Typically building owners can further shelter this accumulated depreciation and other gains upon sale through a 1031 “Like Kind” Exchange; thereby fully sheltering their income until death, at which point the basis is stepped-up.

development. The Low Income Housing Tax Credit (LIHTC) was created as IRC Section 42 to fulfill this purpose. In contrast to previous affordable housing subsidy programs, LIHTC would not be administered through the Department of Housing and Urban Development (HUD), but instead through the Treasury Department.

History of LIHTC

Since its initial enactment in 1986, LIHTC has been the subject of a number of legislative additional initiatives, most recently the Housing and Economic Recovery Act of 2008 (HERA 2008), the Emergency Economic Stabilization Act of 2008, and the American Recovery and Reinvestment Act of 2009 (ARRA). Chapter 2 will exclusively focus on these recent legislative efforts. The initial TRA 86 legislation signed into law on September 27, 1986 anticipated the LIHTC expiration on December 31, 1989, beyond which time it would be subject to annual appropriations. In November 1989, the Omnibus Budget Reconciliation Act extended LIHTC through December 31, 1990. The Omnibus Budget Reconciliation Act of 1990 extended LIHTC through December 31, 1991 and the Tax Extension Act of 1991 extended it through June 30, 1992.

In March 1992, Congress took a major step toward LIHTC's permanency by passing the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210) that would have extended LIHTC permanently. However, President George H.W. Bush vetoed the bill and on June 30, 1992 the LIHTC program was terminated. In October 1992 Congress then passed the Revenue Act of 1992 (H.R. 11) which included a second attempt to secure LIHTC as a permanent subsidy, only to have President Bush veto that bill. The Omnibus Reconciliation Act of 1993 signed by Present Bill Clinton on August 10, 1993 finally secured LIHTC's long term nature.⁸

⁸ Novogradac, pgs. 4-5.

Tax Credits and LIHTC Overview

Tax Credits vs. Tax Deductions

Before launching into a detailed discussion of LIHTC, it is important to understand the difference between a tax credit and a tax deduction. A tax deduction enables a taxpayer to reduce his or her taxable income. For example, if John earned \$50,000 in 2008 and gave \$6,000 to charity, John would generally be eligible to take a \$6,000 deduction on his taxes, meaning that instead of being taxed on \$50,000, John would be taxed on \$44,000. Assuming a flat tax rate⁹ of 25%, without the deduction John would owe \$12,500 ($25\% \times \$50,000$) in taxes to the federal government. However, because John gave \$6,000 to charity, John is only being taxed on \$44,000 which would result in a tax burden of \$11,000 ($25\% \times \$44,000$). Therefore, John saved \$1,500 ($\$12,500 - \$11,000$ or $25\% \times \$6,000$) on his taxes because he made a charitable contribution. In simple terms, a deduction is worth an individual's or corporation's tax rate multiplied by the amount of the deduction.

A tax credit is much more valuable than a deduction. Rather than reducing one's taxable income as with a deduction, a tax credit enables an individual or corporation to reduce its tax liability one for one. Let's revisit our example with John. Now, instead of having given \$6,000 to charity, John made an investment that allocated tax credits to him of \$6,000. John's full \$50,000 of income would result in a tax liability of \$12,500. However, John is able to use his \$6,000 of tax credits to offset his tax liability by \$6,000. So instead of paying \$12,500 to the federal government in taxes, John will only pay \$6,500 ($\$12,500 - \$6,000$) in taxes. Whereas a dollar of deduction was only worth the applicable tax rate multiplied by a dollar (in John's case \$0.25), a dollar of tax credit is worth a full dollar.

LIHTC Overview

The LIHTC encourages investment in affordable housing through the allocation of tax credits to owners committed to building and operating affordable housing. The states are responsible for

⁹ The US uses a progressive tax rate; however for this description a flat tax is easier understand and does not degrade the usefulness of the example.

allocating the tax credits to owners if their developments meet various tenant household income and rental restrictions. The owners then typically allocate those tax credits to an investor in exchange for equity in the owners' developments. Prior to the collapse of the housing market in the US in 2008, the Government-Sponsored Enterprises (GSEs), in particular, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (commonly known as Fannie Mae and Freddie Mac, respectively) were the largest purchasers of LIHTCs in the country. Other investors in LIHTC transactions include large utility companies, oil companies, insurance companies and banks seeking credit under the Community Reinvestment Act (CRA).¹⁰

Even though a dollar of tax credit is worth a dollar to a potential investor, an investor typically purchases the credits at somewhat of a discount, usually in the range of \$0.70-\$0.90 per \$1 of credit. This is primarily due to uncertainty of future tax liabilities to be offset by the tax credits since LIHTCs are allocated to investors basically proportionately over a ten year period rather than all at once in year one. Investors also place a discount on the future tax credits due to the time value of money principle. An example of the time value of money principle is if someone were offered a dollar today versus a dollar ten years from now, most people would choose the dollar today. This is due to both the certainty of having it in one's pocket today and the ability to earn a return on that dollar when invested.

In addition, there is the risk of a property becoming non-compliant so that the investor might lose its credits or be subject to recapture, the need for an additional return beyond depreciation and losses. The equity generated from the sale of the credits subsidizes the development as the major cash equity component in the deal. In addition to receiving the tax credits, the tax credit investor typically receives a pro rata allocation of depreciation and losses from the development. Finally, the investor may receive some cash flow and residual payments when the property is refinanced or disposed. According to the syndicators and developers interviewed, investors primarily calculate their required yield based on losses, depreciation and tax credits rather than on property-level cash flow and residuals.

¹⁰ See the Community Reinvestment Act (CRA) section in this Chapter for more info on CRA.

Despite the history of tax credit discounts, in 2007 tax credits in some states were being sold for over \$1. This was due to the economic boom in 2007 that translated into increased demand for tax credits. In addition, tax credit pricing was high because as interest rates dropped, losses and competing yields also dropped, driving up prices. Finally, LIHTC property default rates are exceptionally low and investors began to view the risk of losing the tax credits as minimal. With the collapse of corporate earnings and the stock market in late 2008 and coupled with the near demise of Freddie Mac and Fannie Mae, the demand for LIHTCs also precipitously crumbled. Chapter 3 will discuss potential solutions for reinvigorating the LIHTC market and preventing a future meltdown.

Affordable Housing Definition

Under LIHTC rules, a development will qualify for funding if at least 40% of the units are set-aside for households earning at or below 60% (also commonly termed “40/60 deal”) of the Area Median Gross Income (AMGI) or if at least 20% of the units are set-aside for households earning at or below 50% of AMGI (also commonly termed “20/50 deal”). AMGIs are published each year by HUD for Metropolitan Statistical Areas (MSAs), Primary Metropolitan Statistical Areas (PMSAs), and non-metropolitan counties. HUD typically releases updated AMGI figures in springtime each year. One of the better sources for determining the applicable AMGI for a particular development is the Rent and Income calculator on Novoco’s website:

<http://www.novoco.com/products/rentincome.php>

When a developer/owner agrees to these minimum set-aside requirements¹¹ and rents a specified number of units to low income households, then the development will be considered a Qualified Low Income Housing Project for purposes of the LIHTC program. A Qualified Low Income Building is part of a Qualified Low Income Housing Project and subject to the TRA 86 depreciation rules. In order to qualify for LIHTCs, the project must meet one of these minimum set-aside requirements by the end of the first year after that the property is placed in service for tax credit purposes. This tax credit placed in service year may be the year that the property

¹¹ In lieu of the 40/60 deal, projects in New York City are permitted a minimum set-aside of at least 25% of the units must be rented to households earning at or below 60% AMGI.

receives its certificate of occupancy or it may be the subsequent year. The owner chooses based on the timing of the completion of the leasing to qualified tenants.

Tax Credits and Allocations

Types of LIHTCs

There are two types of tax credits specifically authorized in TRA 86 – the 30% present value credit (also called the 4% Credit) and the 70% present value credit (also called the 9% Credit). The 4% Credit is often an “automatic” credit in that it is automatically coupled with a project that has received tax-exempt bond financing. The 4% Credit is uncapped, meaning that there are enough 4% Credits to correspond with the bond volume cap authority delegated to each state.¹² For example, Massachusetts is permitted to issue \$302,000,000 in housing bond volume cap for 2009.¹³ All projects that are eligible for LIHTCs that receive a portion of the bond volume cap will receive the full amount of 4% Credit LIHTCs that corresponds with their Qualified Basis. The 4% Credit is reserved for the acquisition of existing buildings and new construction developments that utilize additional federal subsidies such as tax exempt bond

¹² According to the IRS *Tax Exempt Activity Bonds Compliance Guide*, “Qualified private activity bonds are tax-exempt bonds issued by a state or local government, the proceeds of which are used for a defined qualified purpose by an entity other than the government issuing the bonds (the “conduit borrower”). For a private activity bond to be tax-exempt, 95% or more of the net bond proceeds must be used for one of the several qualified purposes described in sections 142 through 145, and 1394 of the Code.

- Section 142 – exempt facilities such as: airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, **qualified residential rental projects (emphasis added)**, facilities for the furnishing of local electric energy or gas, local district heating or cooling facilities, qualified hazardous waste facilities, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities, and qualified public educational facilities

- Section 143 – qualified mortgages and qualified veterans’ mortgages

- Section 144 – qualified small issue manufacturing facilities, qualified small issue farm property, qualified student loans, and qualified redevelopment projects

- Section 1394 – qualified enterprise zone and empowerment zone facilities”

States are permitted to annually issue the greater of \$85 per capita or \$262,095,000 in private activity bonds.

States are also permitted to carry forward any unused volume cap for three years.

¹³ Massachusetts Office of Administration and Finance. "Patrick-Murray Administration Announces Funding for Affordable Housing, Jobs and Education." Letter. 13 Feb. 2009. MS.

financing.¹⁴ However, if a sponsor of a tax-exempt bond transaction reduces Eligible Basis by the amount of the federal subsidy, then it will qualify for the 9% Credit.

The 9% Credit is a capped and competitive credit that is subject to credit allocation from the state housing credit agency. The 9% Credit is typically almost twice as valuable as the 4% Credit (see following discussion) and reserved for new construction with no additional federal subsidies, but can also be used for rehabilitations.¹⁵ Despite the minimum set asides described above, many 9% Credit projects commit to higher percentages of low income occupancy (up to 100%) in order to be viewed more favorably in the competitive process administered by the state housing credit agencies. A developer files an application with the state housing credit agency in accordance with the state's Qualified Allocation Plan (QAP). Treasury requires every state to draft and approve, with a public comment process, an annual QAP that, in 2009, uses the following criteria as priorities for allocating the 9% Credit:

1. Project location (e.g., designated target areas)
2. Housing needs characteristics (e.g., income mix of tenants within the project)
3. Project characteristics including whether the project includes the use of existing housing as part of a community revitalization plan (e.g., percentage of low income units, number of units)
4. Sponsor characteristics (e.g., nonprofit sponsorship, minority participation in development and management, experience in development)
5. Tenant population with special housing needs (e.g., elderly, disabled, homeless)
6. Public housing waiting lists
7. Tenant populations of individuals with children
8. Projects intended for eventual tenant ownership

HERA 2008 added the following two additional criteria that must be incorporated into QAPs:

¹⁴ IRC § 42(b)(1)(B).

¹⁵ IRC § 42(b)(1)(A).

- 9. The energy efficiency of the project
- 10. The historic character of the project

The QAP also outlines the method for attaining tax-exempt bond financing and 4% Credits. Any deviation from the priorities outlined above must be publicly disclosed in writing.¹⁶ It is also important to note that Congress, in the Revenue Reconciliation Act of 1993, specifically designated responsibility to state housing credit agencies for ensuring that all proposed costs are reasonable.

The following numeric example illustrates the applicability of the 4% and 9% Credits in terms of determining an LIHTC allocation. Assume a new construction development is utilizing the 40/60 set-aside requirements under LIHTC. The Eligible Basis (total development cost less acquisition of the *land* and other specific costs, to be defined later) of the building is \$1,000,000 and the Low Income Occupancy Percentage (LIOP), “the percentage of the building that is considered rented to low-income tenants (whether or not occupied)”¹⁷, is also exactly 40%. The IRC formally terms LIOP as the Applicable Fraction. The Applicable Fraction is determined as the lesser of: (1) the total square feet of the low income units divided by the total square feet of all the units¹⁸, or (2) the number of low income units divided by the total number of units.¹⁹ The following calculation determines the amount of credits for which the development will be eligible to receive utilizing the 9% Credit.

| | |
|---|-------------------|
| [1] Eligible Basis of Low Income Building: | \$1,000,000 |
| [2] Applicable Fraction: | 40% |
| [3] Qualified Basis of Low Income Building: | \$400,000 [1]*[2] |

¹⁶ IRC § 42(m)(1)(A)(iv).

¹⁷ Novogradac, pg. 83.

¹⁸ Note that a unit reserved for a property manager that is free-of-charge to that manager or other public space that is available free of charge is considered common area and not part of the square footage or unit calculation.

¹⁹ For example, if a developer is attempting to meet the 40/60 minimum set-aside and 61 units are affordable out of 150 units (40.7%) but the affordable units only contain 59,000 sf out of 150,000 sf (39.3%), then the developer will not meet the minimum set-aside test as the Applicable Fraction would be 39.3%. In order to increase the Applicable Fraction over the 40% threshold, the developer could convert one or two market rate units into affordable units or could designate larger units under the minimum set aside.

| | |
|---|-------------------|
| [4] Applicable Percentage ²⁰ : | 9% |
| [5] Maximum Qualified Annual Credits: | \$36,000 [3]*[4] |
| [6] Total Credits Allocated (10 years): | \$360,000 [5]*10 |
| [7] Credit Price: | \$0.80 |
| Tax Credit Investor Equity: | \$288,000 [6]*[7] |

Based on the above example, the development will qualify for a maximum of \$36,000 of tax credits annually for 10 years, or stated differently, \$360,000 of tax credits in the aggregate. If an investor were willing to pay \$0.80 per \$1 of tax credit, then the development would receive \$288,000 in equity from a tax credit investor upon allocating the tax credits to the investor.

State Allocations

LIHTCs are allocated to each state through a specific formula based on population. On December 21, 2000, President Clinton, in his budget, increased the per capita cap from \$1.25 to \$1.50 per capita in 2001 and to \$1.75 in 2003. Since 2003, increases to the per capita LIHTC state allocation correlated directly with inflation. In response to pressure from states with low population, Congress also enacted a provision that set a floor of \$2,000,000 in allocation for all states. HERA 2008 increased the per capita allocation from \$2.00 to \$2.20 and increased the small state amount to \$2,555,000. Both of these changes are effective for 2008 and 2009, after which the per capita allocations revert back to the amounts that would have been specified per the inflation formula. Congress also mandated that 10% of credit allocations be set aside for use by not-for-profit organizations. The non-profit must own an interest in and “materially participate” in the development and operation of the project.²¹

States are permitted to carryover one year of unallocated credit authority; however, if after one year those credits are not allocated, they are transferred to a National Pool. States that fully committed their tax credit authority and desire additional tax credit authority are required to submit a request for that authority from the national pool no later than May 1 of the

²⁰ A more in depth discussion of the Applicable Percentage will follow.

²¹ IRC § 42(h)(5)(B).

following year. Allocations from the national pool are distributed based on relative population. A new temporary program that is part of the American Recovery and Reinvestment Act of 2009 (ARRA) also provides a further outlet for these unused credits. Chapter 2 will discuss ARRA in more detail.

Affordability Commitments

For a property to be eligible to receive LIHTCs, the owner must agree to a 15 year Compliance Period in which the property shall adhere to the minimum set-aside affordability requirements. The first year of the Compliance Period corresponds with the first taxable year of the property. In addition, as of 1989, an owner must agree to execute a 15 year Extended Low Income Housing Agreement that requires the property to maintain the minimum set-aside for an additional 15 years, which therefore results in a 30 year minimum aggregate affordability. It is important to note that the Extended Low Income Housing Agreement can terminate upon foreclosure.

Also, if an owner desires to dispose of a property after the initial Compliance Period, the owner must allow the housing credit agency one year to find an eligible buyer at a specified price. The specified price is determined by outstanding indebtedness, adjusted investor equity, other capital contributions, and cash distributed or available for distribution. If the state housing credit agency cannot find a buyer, the Extended Low Income Housing Agreement terminates and the owner can sell the property without any rent restrictions. If this occurs, the rules prevent a low income tenant from being evicted (other than for good cause), and gross rent cannot be increased within three years after the end of the Compliance Period.²²

LIHTC Investors

Only certain prescribed types of investors' income tax liability are eligible to be offset by LIHTCs. As previously enumerated, TRA 86 reclassified income as active, portfolio and passive. Income from real estate rental activities in most cases is considered passive. As of 1986, wealthy

²² Novogradac, pgs. 213-217.

individuals who previously invested in affordable housing, but were not actively engaged in the operation of that housing, could no longer offset their active income (e.g. compensation) with passive real estate losses. This restriction also carried over to LIHTC investment rules, with a few exceptions. One exception allows an investor to annually claim LIHTCs up to the value of taxes paid on \$25,000 of income as explained below.

The passive loss restrictions severely restrict the types of investors that are able to invest in LIHTC transactions. The majority of LIHTC investors are widely held corporations, while individuals, non-profits, and subchapter S and closely held corporations are constrained from investing. Most taxpayers do not have passive income, primarily because passive income is mostly generated from real estate transactions, which themselves are typically sheltered through depreciation and other losses. The following subsections detail the ability of each type of investor to utilize the LIHTC and the viability of each for LIHTC transactions.

Individual Investors

An individual investor can use the LIHTC to offset that individual investor's active income up to a specified amount. In non-LIHTC real estate transactions, the individual investor's annual Adjusted Gross Income (AGI) must be lower than \$100,000 and the investor must be an active participant²³ in the deal in order to receive no more than a \$25,000 real estate loss from a property. However, the Omnibus Budget Reconciliation Act of 1989 (OBRA 89) eliminated these income and active participation restrictions specifically for LIHTC transactions and permitted individual LIHTC investors of any income and participation level to offset up to \$25,000 of their income with low income housing tax credits.²⁴ For example, assuming the highest tax bracket of 39.6% in 2010, this would entitle an individual investor to utilize approximately \$9,900 (\$25,000 x 39.6%) of tax credits per year. Individual investors can only utilize the tax credit as the

²³ The IRC specifically addresses "Active participant" when it states "An individual shall not be treated as actively participating with respect to any interest in any rental real estate activity for any period if, at any time during such period, such interest (including any interest of the spouse of the individual) is less than 10 percent (by value) of all interests in such activity. (IRC § 469(i)(6)(A)).

Limited partners are not active participants (IRC § 469(i)(6)(C)).

²⁴ Note that individual investors are not allowed to offset losses from the property.

exclusion does not permit the use of tax losses.²⁵ It is important to note that for a deal of any significant size, the \$25,000 limitation will result in having to attract a significant number of individual investors. In reality, this level of involvement by numerous investors is not practical and therefore individual investors are not currently considered a strong and viable investor population for the credit.

Corporate Investors

There are four types of corporate investors: S corporations, personal service corporations, closely held C corporations and widely held corporations. S corporations are pass-through entities and therefore the rules regarding individual investors are relevant to S corporations. Personal service corporations are corporations that meet the following three criteria:(1) they provide personal services (defined as accounting, actuarial science, architecture, consulting, engineering, health, law, and the performing arts); (2) at least 10% of the company stock is owned by employees; and (3) employee owners substantially perform the services.²⁶ Personal service corporations can use LIHTC against any taxes associated with passive tax liability. Closely held C corporations, as defined above, can more easily use the LIHTC as they can offset both passive and active income; however, they are not permitted to offset portfolio income.

Finally, widely held corporations do not fit into any of the above categories and are not subject to the passive loss rules.²⁷ Therefore, a widely held corporate investor can offset any of their income with LIHTCs, depreciation and other losses from real property. Widely held corporations are the primary purchasers of LIHTCs due to their ability to easily use the LIHTC to offset their income. As previously discussed, Fannie Mae and Freddie Mac were two of the largest widely held corporations that invested in LIHTC transactions. Though often thought to be public institutions, Fannie Mae and Freddie Mac are public shareholder controlled entities. In addition, banks, oil companies and others historically were large investors.

²⁵ Novogradac, pg. 21.

²⁶ United States. Department of the Treasury. Internal Revenue Service. *Publication 542*. 2006. Print.

²⁷ IRC § 469(a)(2).

Community Reinvestment Act

The Community Reinvestment Act (CRA) was passed in 1977 as a way to place regulatory pressure on FDIC insured banks to invest in low and moderate income communities and to counteract “redlining” or disinvestment in those communities. Bank regulators consider LIHTC investments favorably when banks are scored for CRA compliance. In 1989 CRA was amended to include a rating system for all banks that created the following four categories: “outstanding”, “satisfactory”, “needs to improve” and “substantial non compliance”. Those banks not in compliance with CRA can be prohibited from opening new branches and merging with other banks. Banks are required to reinvest in low income communities in which they accept deposits. The enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 was especially important in linking Fannie Mae and Freddie Mac to CRA, and subsequently to LIHTC, as it required those GSEs to invest heavily in affordable housing. In 2000, Fannie Mae and Freddie Mac committed to focus 50% of their business on low and moderate income communities. Without CRA incentives, the pool of investors in LIHTC deals would be significantly diminished.

A discussion of the CRA would not be complete without addressing its recent criticism by a number of groups that the CRA was a major force in promoting the overleveraged housing market and initiated the subprime mortgage crises. Neil Bhutta and Glenn B. Canner, economists in the Division of Research and Statistics at the Board of Governors of the Federal Reserve System, wrote an article in March 2009 that refuted the notion that the CRA caused the mortgage crises. The authors wrote:

Using loan origination data obtained pursuant to the Home Mortgage Disclosure Act (HMDA), we find that in 2005 and 2006, independent nonbank institutions— institutions not covered by the CRA—accounted for about half of all subprime originations. Also, about 60 percent of higher-priced loan originations went to middle- or higher-income borrowers or neighborhoods, populations not targeted by the CRA. In addition, independent nonbank institutions originated nearly half of the higher-priced loans extended to lower-income borrowers or borrowers in lower-income areas.

In total, of all the higher-priced loans, only 6 percent were extended by CRA-regulated lenders (and their affiliates) to either lower-income borrowers or neighborhoods in the lenders' CRA assessment areas, which are the local geographies that are the primary focus for CRA evaluation purposes. *The small share of subprime lending in 2005 and 2006 that can be linked to the CRA suggests it is very unlikely the CRA could have played a substantial role in the subprime crisis* (emphasis added).²⁸

Hence, this study, along with others, consequently bolsters the importance of the CRA and rebuts its involvement in the current mortgage crises.²⁹

Partnership Structure

The partnership structure in an LIHTC transaction is similar to that of a typical real estate deal with one or more equity investors. The standard form of ownership entity is a limited liability company (LLC), which is taxed as a partnership under the IRC. Interests in this owner LLC are in

²⁸ Bhutta, Neil, and Glenn B. Canner. "Did the CRA cause the mortgage meltdown? Two Federal Reserve economists examine whether available data support critics' claims that the Community Reinvestment Act spawned the subprime mortgage crises." *Community Dividend: Federal Reserve Bank of Minneapolis* (2009). Print.

²⁹ For more evidence that the CRA did not cause or contribute to the subprime mortgage crises see the following: (1) Randall Kroszner. The Community Reinvestment Act and the Recent Mortgage Crisis.; (2) Sheila Bair; FDIC Chairman (2008-12-17). "Prepared Remarks: Did Low-income Homeownership Go Too Far?". Conference before the New America Foundation. FDIC. <http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spdec1708.html>.; (3) Ellis, Luci. "The housing meltdown: Why did it happen in the United States?". BIS Working Papers (259): 5. <http://www.bis.org/publ/work259.pdf?noframes=1>.; (4) "Comptroller Dugan Says CRA Not Responsible for Subprime Lending Abuses". Remarks Before the Enterprise Annual Network Conference. Office of the Comptroller of the Currency. 2008-11-19. <http://www.occ.gov/ftp/release/2008-136.htm>.; (5) Westrich, Tim. "Setting the Record Straight". www.americanprogress.org. <http://www.americanprogress.org/issues/2008/09/cra.html> .; (6) Gordon, Robert. "Did Liberals Cause the Sub-Prime Crisis?". www.prospect.org. http://www.prospect.org/cs/articles?article=did_liberals_cause_the_subprime_crisis.; (7) Gross, Daniel (2008-10-07). "Subprime Suspects". http://www.slate.com/id/2201641/pagenum/all/%23page_start.; Pressman, Aaron. "Community Reinvestment Act had nothing to do with subprime crisis - BusinessWeek". www.businessweek.com. http://www.businessweek.com/investing/insights/blog/archives/2008/09/community_reinv.html.; (8) Description of Michael S. Barr, Nonresident Senior Fellow, Brookings Institute.; Barr, Michael S. (2008-02-13). "Prepared Testimony" (PDF). Hearing on The Community Reinvestment Act: Thirty Years of Accomplishments, but Challenges Remain. United States House Committee on Financial Services. <http://financialservices.house.gov/hearing110/barr021308.pdf>.; (9) Yellen, Janet L. (2008-03-31). "Prepared Opening Remarks". 2008 National Interagency Community Reinvestment Conference. President and CEO, Federal Reserve Bank of San Francisco. <http://www.frbsf.org/news/speeches/2008/0331.html>.; (10) Traiger & Hinckley LLP. (2008). The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis; (11) O. Emre Ergungor, "Foreclosures in Ohio: Does Lender Type Matter?", Federal Reserve Bank of Cleveland working paper.

turn owned by two or more entities, typically a second LLC that is the manager or managing member and the equity investor that is a non-managing member. Historically, a limited partnership (LP) was utilized in LIHTC transactions, with the sponsor as the general partner and the equity investor as a limited partner. The LLC structure affords greater liability protection to the owner and therefore represents the majority of current LIHTC transactions.

The equity investor is typically, but not always, attracted to an LIHTC deal through a third-party syndicator. The syndicator represents the equity investor and is typically the sole point of contact between the sponsor and the equity investor during construction as well as during operations. The syndicator locates the LIHTC investor and receives a portion of the investor's equity as its fee. For example, if the LIHTC investor pays \$0.90 per \$1.00 of tax credit, the syndicator may take \$0.05 per \$1.00 of tax credit as its fee. This would result in a net \$0.85 of equity in the transaction. The syndicator conducts extensive due diligence to ensure the proposed transaction is viable and the developer's assumptions reasonable. The developer retains significant control over the day to day management of the construction and property management.

The syndicator, representing the investor, retains a number of approval rights that are negotiated in the Operating Agreement (the agreement that governs the rights of each party in the LLC). These rights would include having to approve a seller refinancing, any changes in development sources and uses, construction change orders over a certain dollar amount, etc. The sponsor is typically also required to submit financial statements on a regular basis for the syndicator's review. During construction, the syndicator engages a construction inspector who performs onsite inspections to ensure work is satisfactorily completed before the syndicator distributes its equity installments.

The Operating Agreement also dictates the milestones for the syndicator to contribute its equity into the transaction. An example of equity installments in a Contribution Agreement could be 30% at the construction loan financing closing, 20% at 50% completion, 20% when the building(s) receives its certificate(s) of occupancy, 15% when the property is stabilized and 15%

at the permanent financing closing. These percentages and milestones are entirely negotiable with the syndicator. More recently, the reduced demand for LIHTCs has enabled syndicators to be more conservative in the contribution of their investors' equity. In an effort to mitigate construction risk, many syndicators have recently refused to contribute equity during construction, or contributed the minimum required by the development's lenders. Owners are therefore forced to assume bridge loan gap financing that increases interest costs, further increasing costs during construction.

Equity Investor Yields

In addition to the benefits conferred by CRA on a bank investing in LIHTC deals, the financial benefits to an equity investor primarily include the utilization of the tax credits against its income tax liabilities and the tax benefit of deductible losses mostly from interest expense and depreciation from real property that shelter an investor's other taxable income. The ability to realize the benefits of taxable losses and tax credits on the same capital expenditures is, in effect, a double subsidy provided by the federal government. Tax credit investor yields had dropped dramatically since LIHTC's inception in 1986 through 2007 and the first half of 2008, primarily due to the minimal proven risk inherent in a LIHTC transaction and the significant influence of CRA. However, in the past year yields have shot up substantially, approaching those of the late 1990's, despite the continued low foreclosure risk. The following figures from Ernst and Young's *Understanding the Dynamics III Housing Tax Credit Investment Performance* illustrate the low rate of foreclosure in LIHTC properties as compared with other asset classes, the decreasing investor yields, and the corresponding increasing credit pricing over time.

Figure 1: Average Annual Foreclosure Rate by Asset Classes

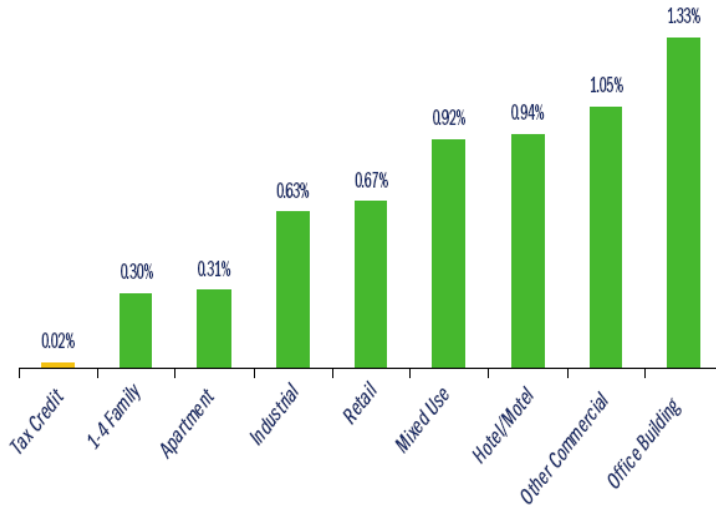
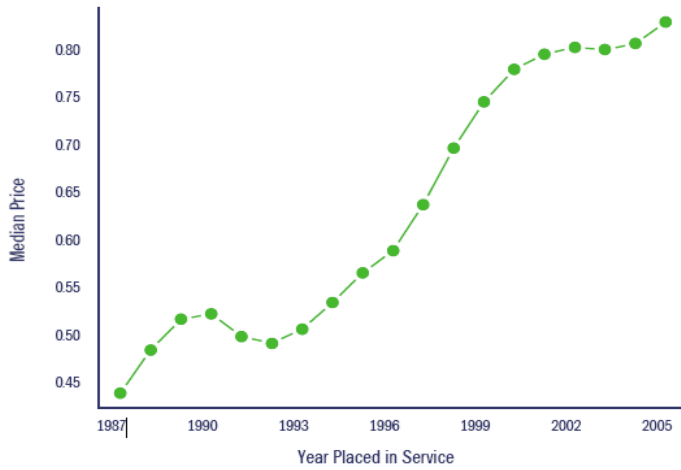
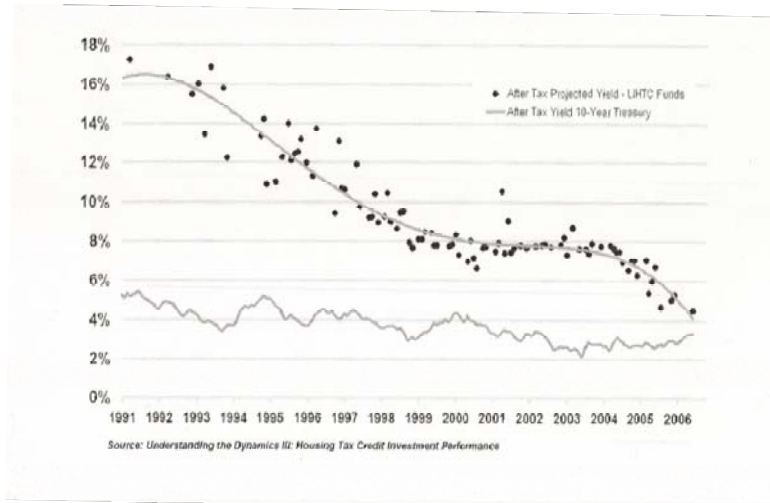


Figure 2: Equity Pricing by Year Placed in Service



****Note that the median price fell in 2008-2009 to approximately \$0.65***

Figure 3: LIHTC Fund Yields vs. Tax-Adjusted 10-Year Treasury Bonds



****Note that the 2009 LIHTC fund yields are approximately 11-13%, significantly above the 3.6% 10 year Treasury note***

The simplified numerical example on the following page utilizes discounted cash flow analysis and demonstrates in simple terms how an investor calculates its yield (Internal Rate of Return or “IRR”) on its equity investment. The example assumes that all of the tax credit equity is paid at time 0³⁰ and the building is fully leased up in year 1. It also presumes the following assumptions in the previous example on page 19:

- Building’s eligible basis of \$1,000,000
- \$0.80 LIHTC tax credit price
- \$360,000 in LIHTC allocation and \$288,000 in tax credit equity

In addition, it assumes the following additional assumptions:

³⁰ In reality, tax credit equity is typically contributed over time, with contributions made during construction and lease-up, which can be over a 2+ year period.

- No gain or loss on sale
- A 100% investor membership interest in the deal (which entitles it to 100% of the LIHTCs, depreciation, and losses)³¹
- 30 year amortizing mortgage of \$912,000 at 6% interest and a 1.28 debt service coverage ratio
- Four affordable units (40% of total) are projected to earn net rents of \$600 per month and six market rate units are projected to garner net rents of \$1,500 per month
- Total development cost including land is \$1,200,000
- Operating expenses are projected to be \$4,500 per unit
- Operating expenses and projected gross income both increase by 3% annually

³¹ The manager/managing member always retains an at least .01% interest for tax purposes.

Figure 4: Investor Yield Calculation Example

| Operating Loss Calculation | | | | | | | | | | | | | | | |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | <u>Y1</u> | <u>Y2</u> | <u>Y3</u> | <u>Y4</u> | <u>Y5</u> | <u>Y6</u> | <u>Y7</u> | <u>Y8</u> | <u>Y9</u> | <u>Y10</u> | <u>Y11</u> | <u>Y12</u> | <u>Y13</u> | <u>Y14</u> | <u>Y15</u> |
| Projected Gross Income (PGI) | \$137k | \$141k | \$145k | \$149k | \$154k | \$159k | \$163k | \$168k | \$173k | \$178k | \$184k | \$189k | \$195k | \$201k | \$207k |
| Vacancy (5%) | -\$7k | -\$7k | -\$7k | -\$7k | -\$8k | -\$8k | -\$8k | -\$8k | -\$9k | -\$9k | -\$9k | -\$9k | -\$10k | -\$10k | -\$10k |
| Effective Gross Income (EGI) | <u>\$130k</u> | <u>\$134k</u> | <u>\$138k</u> | <u>\$142k</u> | <u>\$146k</u> | <u>\$151k</u> | <u>\$155k</u> | <u>\$160k</u> | <u>\$165k</u> | <u>\$170k</u> | <u>\$175k</u> | <u>\$180k</u> | <u>\$185k</u> | <u>\$191k</u> | <u>\$197k</u> |
| Operating Expenses (\$4,500 per unit) | -\$45k | -\$46k | -\$48k | -\$49k | -\$51k | -\$52k | -\$54k | -\$55k | -\$57k | -\$59k | -\$60k | -\$62k | -\$64k | -\$66k | -\$68k |
| Net Operating Income | \$85k | \$88k | \$90k | \$93k | \$96k | \$98k | \$101k | \$104k | \$108k | \$111k | \$114k | \$118k | \$121k | \$125k | \$129k |
| Debt Service | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k | -\$66k |
| Before Tax Cash Flow (BTCF) | \$19k | \$21k | \$24k | \$27k | \$29k | \$32k | \$35k | \$38k | \$41k | \$45k | \$48k | \$51k | \$55k | \$59k | \$62k |
| Debt Service Interest Tax Loss | -\$55k | -\$54k | -\$53k | -\$53k | -\$52k | -\$51k | -\$50k | -\$49k | -\$48k | -\$47k | -\$46k | -\$44k | -\$43k | -\$42k | -\$40k |
| Depreciation Tax Loss | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k | -\$36k |
| After Tax Cash Flow (-Loss) (ATCF) | -\$72k | -\$69k | -\$66k | -\$62k | -\$59k | -\$55k | -\$51k | -\$47k | -\$43k | -\$39k | -\$34k | -\$29k | -\$25k | -\$20k | -\$14k |

| Investor Yield Calculation Example | | | | | | | | | | | | | | | | |
|--|----------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|----------------|
| | <u>Time 0</u> | <u>Y1</u> | <u>Y2</u> | <u>Y3</u> | <u>Y4</u> | <u>Y5</u> | <u>Y6</u> | <u>Y7</u> | <u>Y8</u> | <u>Y9</u> | <u>Y10</u> | <u>Y11</u> | <u>Y12</u> | <u>Y13</u> | <u>Y14</u> | <u>Y15</u> |
| Equity Investment | -\$288k | | | | | | | | | | | | | | | |
| Tax Credits Benefit | | \$36k | \$36k | \$36k | \$36k | \$36k | \$36k | \$36k | \$36k | \$36k | \$36k | | | | | |
| Net Cash Flow (BTCF x 10%) | | \$2k | \$2k | \$2k | \$3k | \$3k | \$3k | \$4k | \$4k | \$4k | \$4k | \$5k | \$5k | \$5k | \$6k | \$6k |
| Losses Benefits (ATCF x 35% tax rate) | | \$25k | \$24k | \$23k | \$22k | \$21k | \$19k | \$18k | \$16k | \$15k | \$13k | \$12k | \$10k | \$9k | \$7k | \$5k |
| Accumulated Depreciation Tax on Sale <i>(1M/27.5*15 years*25% tax rate)</i> | | | | | | | | | | | | | | | | -\$136k |
| Total Benefit/-Loss | -\$288k | \$63k | \$62k | \$61k | \$60k | \$59k | \$58k | \$57k | \$56k | \$55k | \$54k | \$17k | \$15k | \$14k | \$13k | -\$125k |
| Investor Yield (IRR) | 15.8% | | | | | | | | | | | | | | | |

As one can observe, the combination of receiving tax credits over 10 years, the minimal cash flow, and the taxable loss benefits over the 15 year compliance period results in an investor yield (IRR) of 15.8%. If the investor paid more than \$0.80, the yield would drop, and the yield would increase at lower prices as has recently been the case.

It is also in the best interest of an investor in a LIHTC development to allocate as many costs as possible to personal property and site improvements. Whereas the IRC allows an investor to depreciate a residential building over 27.5 years using the straight-line method, it allows an accelerated 5 year depreciation for personal property and 15 year depreciation for site improvements. A number of investors complete cost segregation analyses to realize as much accelerated depreciation as possible. As with all investments, accelerated depreciation is desirable from a time value of money standpoint.

Carry Back, Carry Forward and Additional Investor Rules

LIHTC is considered a general business tax credit, a category which also includes the rehabilitation credit, the energy credit, and several others. Subject to the limitations described previously, general business credits can be used against 100% of the taxpayer's first \$25,000 of tax liability and then can be used to offset 75% of the remaining taxpayer's liability. In addition, prior to the enactment of HERA 2008, the LIHTC could not be used to offset a taxpayer's tax liability under the Alternative Minimum Tax (AMT).³² HERA 2008 reversed this restriction and has made the LIHTC appealing to investors that may be subject to the AMT.

Finally, prior to the enactment of the Tax Reform Act of 1997 (TRA 97), an investor was able to carryback general business credits for three years and forward for 15 years. TRA 97 amended this provision to only permit investors to carryback the credits for one year but allowed investors to carry them forward for 20 years. In simple terms, if an investor were unable to use the credits allocated to it in 2009 but would have been able to use them in 2008 due to excess income, that investor could "carryback" the credits to offset its income, as long as it does not

³² The AMT was created to prevent taxpayers from using various provisions in the law to avoid paying their fair share of taxes. A taxpayer is required to pay the excess of the "tentative AMT" over the regular income taxes owed.

exceed its credit allocation, in 2008. Likewise, if the investor has income in any of the years from 2010 to 2029 (2009 + 20 years), it can “carry forward” the unused credits to those years.

The final point that investors must be noted is a rule that requires investors to have a proper profit motive in the deal for them to be able to deduct the property’s tax losses. IRC 183 requires that taxpayers cannot deduct losses without an economic interest in the transaction, which could be construed as an interest in the property’s cash flow and gain on sale. However, after conversations with multiple tax and syndication attorneys, they believe there does not need to be a profit motive for investors in LIHTC transactions other than the receipt of the tax credits.

Eligible Basis

Overview

Determining Eligible Basis is the first step toward calculating the amount of LIHTCs for which a proposed project will qualify. Eligible Basis is multiplied by the Applicable Fraction and the Applicable Percentage to determine a project’s annual credits.³³ Eligible Basis is defined as “depreciable costs including all "hard" costs, such as construction costs, and most depreciable "soft" costs, such as architectural and engineering costs, soil tests, and utility connection fees.”³⁴ An additional definition is that it is equal to the “adjusted basis of the building, excluding land but including most amenities and common areas.”³⁵ Please refer to the example on page 19 regarding the application of Eligible Basis in the LIHTC calculation. All costs included in Eligible Basis are depreciable, but not all depreciable costs are included in Eligible Basis. In addition, all costs that are incurred through the first year of the credit period are included in Eligible Basis. This is quite beneficial as it allows developers to obtain a certificate of occupancy

³³ The annual credit allocation must be multiplied by 10 years to determine the actual amount of LIHTCs the investor will receive.

³⁴ "Calculating the Qualified Basis." U.S. Department of Housing and Urban Development. Web.

<<http://www.hud.gov/offices/cpd/affordablehousing/training/web/lihtc/calculating/qualifiedbasis.cfm>>.

³⁵ Novogradac, pg. 1622.

for a development and later incur costs for items such as landscaping, common areas, etc. and still include those costs in Eligible Basis.

In general, most construction costs, personal property, many soft costs, and developer fee are included in Eligible Basis. There are a number of costs that must be excluded from Eligible Basis, such as costs “inextricably associated with the land”³⁶ and are therefore not depreciable.

Examples of costs in this category that are sometimes not included in Eligible Basis are earthmoving and grading. These costs are sometimes inextricably associated with the land. However, earthmoving costs that are required for pouring a foundation are inextricably associated with the building, considered depreciable, and are therefore included in Eligible Basis.

Other costs that are excluded from Eligible Basis include: marketing and lease-up costs, syndication expenses in relation to selling LIHTCs; tax credit application fees; land costs; legal costs and developer fees specifically related to (1) the acquisition of land (those associated with the acquisition of the building are included in Eligible Basis), (2) syndication of the LIHTCs, and (3) permanent loan; permanent loan fees; any and all reserves (operating, replacement, etc.); and organizational costs. Common area costs, as long as any resident in the development can use them without incurring an additional charge or a property manager’s unit, are included in Eligible Basis. Treasury Regulation § 1.103-8(b)(4)(iii) stipulates that costs attributable to “facilities for use by the tenants, for example, swimming pools, other recreational facilities, parking areas, and other facilities that are reasonably required for the project, for example, heating and cooling equipment, trash disposal equipment or units for residential managers or maintenance personnel” must be provided without charge and are included in Eligible Basis. Note that it is generally accepted that residents must be the primary users of these facilities, but that it is reasonable to construe that guests will also use them from time to time.³⁷ It is important to note that the treatment of costs is convoluted and requires a careful review by a

³⁶ United States. Department of the Treasury. Internal Revenue Service. *Revenue Ruling 65-265, 1965-2 CB 52.*
Print.

³⁷ Novogradac, pg. 109.

tax counsel. Tax counsel will provide a tax opinion at the financing closing that the proposed transaction complies with all LIHTC program rules as well as all relevant tax law.

Reductions and Increases in Eligible Basis

A number of owners of LIHTC properties choose to exclude certain costs from Eligible Basis so that they can charge an additional fee for areas attributable to those costs. For example, an owner may want to charge an additional fee for the use of storage bins in the building's basement. As long as the owner does not include the costs of the storage bins, and all associated costs (lighting, framing, etc.) in Eligible Basis, that owner can charge a separate fee for the storage bins. In addition, if an LIHTC property includes commercial space, the developer must ensure that the commercial space costs are not included in Eligible Basis. Finally, if a development includes a Community Service Facility that serves non-residents, HERA 2008 prohibits including in Eligible Basis costs that exceed more than 25% of the first \$15M of Eligible Basis and 10% above \$15M. In addition, the Community Service Facility must be properly defined and be in certain low income areas.

Prior to HERA 2008, if a development were "federally subsidized", then only the 4% Credit could be utilized.³⁸ The historic definition of "federally subsidized" was a loan that included federal proceeds and was below-market (i.e. below the Applicable Federal Rate (AFR)). HERA 2008 redefined "federally subsidized" to a much more narrow interpretation by only deeming tax-exempt bond financing as "federally subsidized". Under this definition of federally subsidized, owners who desired 9% Credits could reduce Eligible Basis by the amount of the federally subsidized loan and still apply for 9% Credits. However, this recent change liberalizing the definition of "federally subsidized" will significantly increase competition for 9% Credit deals.

Eligible Basis is also reduced by certain additional financing utilized as a source for the development pro forma (or budget). All federal grants reduce Eligible Basis by the amount of

³⁸ The Revenue Reconciliation Act of 1993 classified below-market HOME Investment Partnership Act (HOME) loans as "non-federally subsidized" and therefore projects utilizing below-market HOME loans could still be eligible for the 9% Credit.

the grant, and in addition, because they are grants, also may be treated as taxable income to the recipient.³⁹ In addition, an owner that utilizes federal rehabilitation (historic) tax credits is also required to reduce Eligible Basis by the amount of the federal rehabilitation tax credits the development receives. These rules are in place to prevent “double dipping” of federal subsidies.

After the initial determination and 8609 (the project’s final certification once it is constructed, to be discussed later) is issued by the state, in only one instance can Eligible Basis be increased to permit the project to earn additional LIHTCs. The only opportunity to increase a building’s Qualified Basis (defined as the Eligible Basis multiplied by the Applicable Fraction, to be discussed in detail later) is if the Applicable Fraction, as previously computed, increases after the 8609 filing. Otherwise, an increase in Eligible Basis this late in the process without meeting these corresponding factors would not result in additional LIHTCs.

Acquisition of Existing Buildings

In order to include the cost of acquiring an existing building in Eligible Basis, one must follow a series of rules. In 9% Credit deals only the 4% Applicable Percentage can be applied to the building’s acquisition cost.⁴⁰ In order to prevent related party issues and a property owner’s realization of the acquisition credit without actually transferring the property, there are a number of rules that apply to ensure there is no abuse. For example, the seller could not have owned more than 10% of the property if that seller were also going to own 10% of the capital or profits of the new owner. HERA 2008 significantly relaxed this related party rule by raising these limits to 50%. There are a number of other rules not outlined here but that should be considered if undertaking development of an existing building. The various rules were enacted to ensure the acquisition credit is only provided to a new group of individuals or entities acquiring a property.

³⁹ Most developers would prefer to accept below-market, fully interest deferred loans so that there is no tax liability created.

⁴⁰ Remember that only the cost of the building can be included in Eligible Basis, land is excluded.

An important regulation regarding the ability to utilize the acquisition credit requires that the acquisition date be at least 10 years following the last placed in service date.⁴¹ The last placed in service date is typically the last transfer of the property between parties and is not tied to when the property is converted to rental housing. There are a few exceptions to this rule. First, gifts of property and nontaxable contributions of property to a partnership, as well as potentially partial, but not full, liquidations, do not generate a new 10-year hold period. Second, inheritances are excluded from triggering a new 10-year hold. Third, if a government unit or not-for-profit organization engaged in housing activities purchases a property, then the 10 year hold period generally does not restart. Fourth, if a property is acquired through foreclosure, as long as certain rules are followed, including a 12-month mandatory resale provision, the 10 year hold is not applicable.⁴² Finally, the 10 year hold is not applicable for owner occupied properties of single family homes.

HERA 2008 eliminated the 10-year hold requirement for certain buildings that are federally or state assisted, such as those that receive Project Based Section 8 operating subsidies, and placed in service after July 30, 2008. Purchasers of federally or state assisted buildings⁴³ placed in service on or before July 30, 2008 can apply for a waiver to the 10 year hold rule by filing an application with the IRS within one year of the acquisition or upon execution of a purchase agreement.

Finally, in order to be eligible to receive the acquisition credit for an existing building, certain rehabilitation expenditures must be met. The IRS requires that rehabilitation expenditures exceed the greater of: (1) \$6,000 per low-income unit, or (2) 20% of the adjusted basis of the building.⁴⁴ The rehabilitation expenditures must be incurred within a 24-month period and are

⁴¹ Prior to HERA 2008, this rule required the purchase date to be 10 years from the placed in service date.

⁴² There are a number of interpretations and rules governing foreclosures that are not covered herein but should be reviewed before assuming the 10 year hold requirement has been met.

⁴³ See the relevant sections of OBRA '89 § 7108(r)(4) and (f) and IRC § 42(d)(6) for eligibility standards.

⁴⁴ HERA 2008 created these new limits, previously the requirements were \$3,000 or 10%. An exception to this rule permits the application of only the \$6,000 per low-income unit rule if a property is acquired from a governmental unit, in which case only the 4% Credit can be utilized for rehabilitation expenditures.

determined at the end of the first year of the credit period.⁴⁵ The \$6,000 per unit requirement will be increased annually from the 2008 base year by the cost-of-living adjustment prescribed by IRC § 1(f)(3) rounded up to the nearest \$100. In addition, a developer-friendly interpretation of the rules governing acquisitions of existing, occupied buildings permits a property to be “placed in service in December (for tax credit purposes) of a given year, but still receive a full year’s credit if the existing building (had been acquired prior to the start of the year and) were occupied by qualified tenants for the full year.”⁴⁶

Qualified Basis

Overview

The Qualified Basis is the product of the Eligible Basis multiplied by the Applicable Fraction multiplied by 130% (if applicable, see *DDA and QCT* section below regarding more details). In short, Qualified Basis is the Eligible Basis lowered to reflect market rate units and raised to reflect areas with high construction costs and/or lower incomes. The 130% increase in Eligible Basis will be due to the project being located in either a Difficult to Develop Area (DDA) and/or in a Qualified Census Tract (QCT).

DDA and QCT

A DDA is defined as “any area designated by the Secretary of Housing and Urban Development as an area which has high construction, land, and utility costs relative to area median gross income” and is updated by HUD annually.⁴⁷ DDAs are typically determined on a town, city or county basis. A QCT is defined as “any census tract which is designated by the Secretary of Housing and Urban Development and, for the most recent year for which census data are available on household income in such tract, either in which 50 percent or more of the

⁴⁵ IRC § 42(e)(3)(A)(ii) and IRC § 42(e)(3)(C).

⁴⁶ Novogradac, pg. 139.

⁴⁷ IRC § 42(d)(5)(C)(iii)(I).

households have an income which is less than 60 percent of the area median gross income for such year or which has a poverty rate of at least 25 percent.”⁴⁸

QCT’s are typically updated by HUD every ten years to coincide with the decennial census. For both DDAs and QCTs, the total population in DDAs in a defined area (town, city or county) cannot exceed 20% of the total population in that defined area. The 130% boost in Eligible Basis can substantially impact the amount of LIHTCs a development can receive and therefore a developer should carefully determine whether or his or her project lies in a QCT or DDA. Note however that the acquisition credit is not eligible for the 130% basis boost. The following website allows a user to input an address to determine if a project is in a QCT:

<http://qct.huduser.org/QCTGIS/USMainLand/Map.aspx>

The following website allows a user to determine the DDA status of his or her project’s location:

<http://qct.huduser.org/tables/ddatables.odb>

HERA 2008 also permitted a state housing credit agency to designate, at its discretion and based on financial need, any building that requires a 130% boost, to be considered located in a DDA. A state’s QAP must provide criteria that projects shall meet in order to receive this state designation. The HOME loan rules previously discussed also apply to the state designation.⁴⁹ In order for a project to receive DDA or QCT status, it must be located in a DDA or QCT in the year an allocation of credit is received.⁵⁰ In 2004, HUD enacted a rule that permitted the 130% boost if the credit allocation from the state occurs no later than 365 days after the application for a credit allocation is submitted and during that period the project were located in a DDA or QCT. For tax-exempt bond projects, rather than tying the date to the application for credit allocation, it is tied to an application for bond issuance.⁵¹

⁴⁸ IRC § 42 (d)(5)C(ii)(I).

⁴⁹ A HOME loan will not be considered a federal subsidy if it is at or above AFR. If it is below AFR and receives the state designation, at least 40% of the units shall be rented to households at or below 50% AMI.

⁵⁰ Novogradac, pg. 95. Projects utilizing tax exempt bonds must be located in a DDA or QCT on the occurrence of the earlier of the bonds being issued or the building being placed in service.

⁵¹ Novogradac, pg. 95.

The previous example is included below for reference purposes, but is updated to now assume the following: (1) an existing building was purchased for \$100,000 and the related party and 10-year hold requirements were met and (2) \$900,000 of rehabilitation expenditures were realized to improve the building. The developer confirmed the project is located in a QCT and therefore is eligible for the 130% rehabilitation basis boost. Recall that the acquisition does not qualify for the 130% Eligible Basis increase and so it is tracked separately below.

| | Acquisition Credit | Rehabilitation Credit |
|---|----------------------|-----------------------|
| [1] Eligible Basis: | \$100,000 | \$900,000 |
| [2] Applicable Fraction: | 40% | 40% |
| [3] Qualified Census Tract: | 100% | 130% |
| [4] Qualified Basis of Low Income Building: | \$40,000 [1]*[2]*[3] | \$468,000 [1]*[2]*[3] |

Qualified Credit Allocation

Once the Qualified Basis is determined, the final step toward determining the maximum credit allocation is to multiply the Qualified Basis by the Applicable Percentage. Recall that the Applicable Percentage is directly correlated with the allocation of either 4% Credits or 9% Credits. One would think that the Applicable Percentage for 4% Credits would be 4% and for 9% Credits it would be 9%; however, like most LIHTC provisions, it is much more complicated.

Applicable Percentage

Remember from previous sections that the Applicable Percentage is the percentage that corresponds with either the 4% or 9% Credit. As previously discussed, prior to July 30, 2008 and the enactment of HERA 2008, if a project were “federally subsidized” and it did not back out that federal subsidy from Eligible Basis, then it was required to use the 4% Credit. Since the definition of “federally subsidized” was changed to only include projects financed with tax exempt bonds, many projects receiving below-market federal loans are now eligible for the 9% Credit without having to back the federal subsidy out of Eligible Basis. HERA 2008 also fixed the

9% Credit for non-federally subsidized buildings at not less than 9%. This is effective through December 31, 2013.

The 4% Credit calculation did not change with the recent legislation and the actual percentage is typically less than 4%, fluctuating monthly. The 4% Credit is calculated monthly to derive an after tax present value of 30% of the Qualified Basis. The monthly Applicable Percentage is calculated by an extremely complex formula that utilizes the long-term Applicable Federal Rate (AFR) and mid-term AFR to obtain an after tax discount rate. The most recent 4% Credit Applicable Percentage can be found at the following website:

http://www.novoco.com/low_income_housing/index.php

For projects that do not require a credit allocation (4% Credit deals with tax-exempt bond financing), the Applicable Percentage election “must be made no later than the fifth day after the close of the month during which the tax exempt bonds are issued.”⁵² The election is irrevocable and the building must not have been placed in service previously.⁵³ If the owner does not fix the Applicable Percentage as per above, then the owner must fix the Applicable Percentage the month the project is placed in service. In order to eliminate the uncertainty of fluctuating Applicable Percentages, owners typically fix the Applicable Percentage at the earliest possible date. However, sometimes the Applicable Percentage may be trending upwards or some owners do not know the precise date the state issued its bonds, so owners may need to wait until the placed in service date.

The below example now incorporates the Applicable Percentage to complete the calculation for the maximum number of LIHTCs for which the project is eligible. It is assumed that the example does not include any federal grants that would need to be removed from Eligible Basis.

⁵² United States. Department of the Treasury. Internal Revenue Service. *Notice 89-1, 1989-1 CB 620--IRC Sec(s).42.* 1989. Print.; United States.

United States. Department of the Treasury. Internal Revenue Service. *Private Letter Ruling 8941035, IRC Section 42.* 1989. Print.

⁵³ Ibid.

| | Acquisition Credit | Rehabilitation Credit |
|---|----------------------|-----------------------|
| [1] Eligible Basis: | \$100,000 | \$900,000 |
| [2] Applicable Fraction: | 40% | 40% |
| [3] Qualified Census Tract: | 100% | 130% |
| [4] Qualified Basis of Low Income Building: | \$40,000 [1]*[2]*[3] | \$468,000 [1]*[2]*[3] |
| [5] Applicable Percentage | 3.35% ⁵⁴ | 9% |
| [6] Maximum Qualified Annual Credits | \$1,340 [4]*[5] | \$42,120 [4]*[5] |
| Total Maximum LIHTCs (10 Years) | \$13,400 [6]*10 | \$421,200 [6]*10 |

Based on the above example, if the state housing credit agency allocated the full \$434,600 (\$421,200+\$13,400) to the above deal, then the developer could sell those credits to an investor. If the investor were willing to pay \$0.80 per \$1 of credit, then the LIHTCs could generate \$347,680 (\$434,600*\$0.80) of equity for the development.

Gross Rent

Gross Rent Definition and Utilities

LIHTC regulations strictly govern the maximum rent that can be charged to an Eligible Household and there are a number of rules that must be adhered to in order to ensure a property remains in compliance with LIHTC rules. The maximum Gross Rent that a landlord can charge is defined as the total tenant payments for all *non-optional* services plus utilities. As previously discussed, additional fees cannot be charged to tenants for the use of facilities – such as a fitness center, storage, etc. – that were included in Eligible Basis. Utilities such as heat, water and sewer, domestic electricity, etc. that are separately metered to the tenant are included in Gross Rent. For example, if the Gross Rent is \$800 but the tenant pays \$200 in allowable utilities, then the tenant will pay the landlord \$600 in rent. Note that cable, internet and telephone are specifically excluded from the definition of “utility” for these purposes. The aggregate cost of utilities is termed the Utility Allowance. As referenced above, a Utility

⁵⁴ July 2009 Applicable Percentage.

Allowance includes all non-optional payments. Therefore, if a tenant's lease requires that the tenant obtain renter's insurance, the renter's insurance should be included as part of the Utility Allowance.

Historically, utilities were calculated by an owner referencing fixed utility costs indicated on a Utility Allowance Matrix, which is published annually by Public Housing Authorities, HUD, and non-profit administrators of Section 8 units. If an owner incorporated high efficiency HVAC units, low flow water fixtures, or Energy Star appliances, it was extremely difficult to receive authorization to reduce the Utility Allowances as indicated by the Utility Allowance Matrix. In 2008, recognizing the environmentally friendly movement in the US, Treasury updated and expanded its regulations to permit owners to use an estimate from a local utility company, a state agency, or to retain an engineer to assist with a HUD Utility Schedule Model or Energy Consumption Model. This expanded regulation now permits utility allowances to better reflect actual utilities incurred by the tenant and rewards owners that integrate energy efficient measures into their buildings.

Gross Rent Calculation

Gross Rent is determined by first obtaining the AMGI.⁵⁵ The AMGI is based on decennial census data that is then updated with the Bureau of the Census P-60 income data and the Department of Commerce County Business Patterns employment and earnings data.⁵⁶ HUD defines 80% of AMGI as Low Income, 50% of AMGI as Very Low Income, and 30% of AMGI as 30% of median (commonly known as "extremely low income"). AMGI is calculated on a county by county basis and by family size.

Under LIHTC regulations, Gross Rent for a particular unit is based on unit size and a fixed imputed number of individuals per bedroom, regardless of the actual number of individuals that reside in a unit. LIHTC regulations specify that a Single Room Occupancy (SRO) unit is deemed to have one individual occupying that unit. For all other unit types, LIHTC regulations

⁵⁵ AMGI is the "Area Median Gross Income".

⁵⁶ Novogradac, pg. 349.

stipulate that 1.5 people per bedroom reside in a unit. For example, a two-bedroom unit's Gross Rent would be calculated off of the AMGI for a 3 person household (2 bedrooms*1.5 individuals per bedroom).

Gross Rent is calculated as 30% of the minimum set-aside income requirement. For example, if the minimum set-aside is 20% of the units at 50% AMGI, and 50% AMGI for a 3 person household is \$50,000, then a two-bedroom (assumed to contain 3 individuals: 1.5*2 individuals) unit's annual Gross Rent would equal 30% of \$50,000, or \$15,000 a year or \$1,250 per month. In this particular example, the Gross Rent for a two-bedroom unit in a particular building could not exceed \$1,250 per month. An excellent source for easily locating AMGIs and LIHTC rents for a specific building location is Novogradac's Rent and Income calculator at:

<http://calc.novoco.com/rentincome/z1.jsp>.

Typically AMGIs increase year after year. However, in recessionary times it is possible for AMGIs to fall, thereby resulting in rent decreases from one year to the next. In 2008, Congress recognized that if AMGIs fell from one year to the next, a property could experience significant financial distress, especially since operating expenses tend to trend upward despite a down economy and debt service payments are typically fixed. Therefore, HERA 2008 prohibited AMGI from falling from one year to the next. This AMGI "floor" is intended to protect owners from declining incomes and corresponding decreasing rents. The initial Gross Rent is determined, at the owner's discretion, as of the date the credits are initially allocated⁵⁷ or as of the date the project is placed in service. In addition, HERA 2008 set rural areas' (as defined by the 1949 Housing Act) AMGIs as the greater of a state's non-rural AMGI or the national non-rural AMGI.

There is one exception to the rule prohibiting an owner from exceeding the LIHTC maximum Gross Rent. If a unit has either a Section 8 Project Based Voucher or is occupied by an Eligible Household that has a Section 8 Mobile Voucher, then the owner can receive the Section 8 Fair Market Rent (FMR) in lieu of the LIHTC maximum rent. The FMR is typically higher than the

⁵⁷ For tax-exempt bond financed deals, it is the date of the initial determination letter or the placed in service date per the owner's discretion.

LIHTC rent as it is intended to reflect the market value of the unit rather than a the lower income restricted rent.

Eligible Households

While Gross Rent is calculated on a predetermined number of individuals per bedroom regardless of the actual number of individuals in a unit, an Eligible Household (a household that has an income eligible to occupy a low income unit) is determined by the number of individuals in the household and that household's corresponding AMGI. For example, if a couple and two children applied to move into a two bedroom unit, then the maximum rent for that unit, per the above example, would be \$1,250. However, whereas in the above example the 3 person household moving into the unit could earn up to \$50,000, this new 4 person household could earn up to the 4 person AMGI (assume the 4 person AMGI is \$60,000). Therefore, as long as the 4 person household earned no more than \$60,000, that household would be eligible for the two bedroom unit at \$1,250 per month in Gross Rent.

There are a number of rules that govern the definition of an Eligible Household. First, family size includes all occupants and does not require a marital relationship.⁵⁸ Second, a unit containing all student occupants is not permitted to be an Eligible Household. There are a number of exceptions to this rule, including but not limited to students that were previously in foster care, single parent students with child dependents, and married students, where one party is not a student, that file a joint tax return.⁵⁹ Finally, when calculating the income of a household, a property manager must also look at the assets of the household. If the net family assets are greater than \$5,000, then the income from those assets must be included in the income determination for that household. If no income is generated from the assets, then an interest rate specified by HUD (currently 2%) is applied against the assets to derive income from those assets. Each Eligible Household must be recertified annually by the property manager or other

⁵⁸ United States. Department of Housing and Urban Development. *HUD Handbook 4350.3: Occupancy Requirements of Subsidized Multifamily Housing Programs*. (3-6)(E)(3) and (3-6)(E)(4)Print.

⁵⁹ IRC § 42(i)(3)(D) and HERA 2008.

owner designate. HERA 2008 created an exclusion to this requirement that permits 100% low-income buildings to not annually recertify existing tenants.

Over-Income Units

If a tenant's income exceeds 140% of the AMGI set aside for that unit, then the unit is considered "over income" and the Next Available Unit Rule is triggered. The Next Available Unit Rule requires that the next available unit of equal or smaller size that becomes available must be rented to an Eligible Household. The over income household's unit will still be considered a low-income unit until the next available unit is rented. However, if the next available unit that is equal or smaller in size to the over income unit is accidentally rented to a market rate household, then all the building's over income households currently counting as low-income households will lose their eligibility. For example, assume there are 100 units in a building, 40 of which are low-income units occupied by Eligible Households. Three Eligible Households get salary increases in their jobs so that they exceed 140% of the minimum set aside income requirements. The three units will still count as low-income units. However, if the property manager rents the next available unit of equal or smaller size to a market rate household, then all three units will lose their low income status. In contrast, if the property manager complies with the Next Available Unit Rule and rents out the next available unit to an Eligible Household, then the remaining two over income units will still count as low income units. In addition, the property owner can increase the one over-income unit's Gross Rent to market rent. The property manager must complete the same procedure for the other two units as well in order to remain in compliance.

Multiple Buildings and Minimum Set-Aside

In a development with multiple buildings, the owner can elect to either have the minimum set-aside pertain to each individual building or to the entire project as a whole. For example, assume a new Qualified Low Income Housing Project has four garden style buildings, labeled 1-4, each containing 50 units for a total of 200 units. The owner has elected to meet the 40/60 set aside where 80 units (40%) will be eligible to households earning at or below 60% AMGI. If

building 1 were placed in service on January 1, 2009 and the other buildings were placed in service before the end of building 1's first credit period (December 31, 2009) and the project as a whole could meet the minimum set-aside test by December 31, 2009, then the minimum set-aside could be met on a project-wide basis.

The above example would not work if the buildings are not constructed almost concurrently as they are placed in service and minimum set-aside requirements could not be met due to the length of time required to lease a building. Therefore, most owners meet the minimum set-aside test on a building by building basis. If a project-wide minimum set-aside is selected, then all the units in all the buildings will have to be of similar character (i.e. the market rate buildings cannot have granite counters, and hardwood floors while the low-income buildings have laminate counters and carpeting). In addition, the buildings have to be on the same tract of land, owned by the same entity, and have common financing. Finally, Eligible Basis, Applicable Percentage, and the Applicable Fraction are determined on a building by building basis no matter which minimum set-aside election is selected.

Recapture and Sale

Recapture

A recapture, or taking back, of LIHTCs occurs when a project violates the various requirements of the LIHTC program. Typical recapture occurs when the project fails to meet the minimum set-aside requirements by the end of each taxable year. This can occur if the project or building fails to meet the requirements in the first, or subsequent, tax credit periods. A partial recapture can occur when there is a decrease in Eligible Basis or the low income occupancy percentage decreases (Applicable Fraction). However, if the Applicable Fraction decreases below the minimum set-aside (40/60 or 20/50), then a full recapture event will occur. Once a property fails the required minimum set-aside test, then it no longer qualifies for LIHTCs even if it meets the test in subsequent years.

If recapture occurs between years 2-11, one third of previously claimed LIHTC's are recaptured. During year 12, 4/15 are subject to recapture, in year 13 3/15 are subject to recapture, and so on and so forth through year 15. In addition, the owner is subject to an interest charge on the recaptured tax credits that equals the overpayment rate established under IRC 6621.

A recapture event is a serious occurrence that can financially destroy a project. The owner's inability to deliver the promised LIHTCs to its investors can trigger owner syndication guarantees to make the investors whole. LIHTCs are typically a significant portion of a development's financing; therefore, the inability to utilize the credits are catastrophic to the project's financing assumptions. In addition to the above events that can trigger recapture, an improper sale can also activate recapture.

Sale

HERA 2008 made it significantly easier for an owner of an LIHTC property to dispose of the asset during the 15 year Compliance Period. Section 3004(c) of HERA 2008 states that recapture "shall not apply solely by reason of the disposition of a building (or an interest therein) if it is reasonably expected that such building will continue to be operated as a qualified low-income building for the remaining compliance period with respect to such building." Therefore, as long as the buyer agrees to maintain the affordability restrictions imposed by the LIHTC program, a recapture event will not occur.

When a sale transpires during the 15 year Compliance Period, it is the seller's responsibility to ensure that the property remains in compliance throughout the 15 year period. The new owner is not allowed to assume the liability for recapture. However, with some leverage, a sophisticated seller will require the property's conveyance documents to require the buyer to maintain the affordability requirements and provide adequate recourse to the buyer if the property is non-compliant in the future. It is also important to note that a 1031 "Like Kind" Exchange will trigger a recapture event.

After year 15, an investor typically desires to exit from the transaction. The investor has received the tax credits and the accumulated tax credits, losses and depreciation begin to push the investor's capital account negative. In order to prevent the investor from incurring phantom income and to ensure the property can initiate much needed capital improvements, a refinancing event or sale is required. After the initial Compliance Period there is no potential for a recapture event; therefore, an investor may want to extricate itself from the ownership so that it is not obligated to continue monitoring low income compliance. While many LIHTC deals do not realize material profit on sale, mixed income deals that may have a significant percentage of market rate units could realize a substantial gain for the seller. A sophisticated developer/sponsor will attempt to limit the investor's profit on sale. A developer/sponsor may try to limit an investor's profit by explicitly capping it in the initial Operating Agreement governing the ownership entity.

Regulatory Process

The purpose of the previous sections was to cover in detail the fundamentals of the LIHTC so that the reader would be provided sufficient background to understand the in-depth analysis of LIHTC in subsequent chapters. This final section will discuss the process by which an owner can obtain 9% Credit LIHTCs and the procedures for ensuring compliance during the Compliance Period. Recall that 4% Credits, not part of the acquisition credit for a 9% Credit deal, automatically are coupled with tax-exempt bond financing; therefore, a 4% Credit deal is required to follow tax-exempt bond rules regarding bond allocations and credit authority rather than individually applying for an LIHTC allocation.

This section will not cover 4% Credit deals as they are not subject to credit allocation rules. However, in many states, the sponsor's application for 4% Credits and tax-exempt financing are handled by the same application and agencies as for 9% Credit deals. One important consideration with 4% Credit deals is that if 50% or more of bond eligible costs are financed with tax-exempt bond proceeds, then the then full LIHTC Qualified Basis is eligible for 4% Credits. However, if the 50% floor is not realized, then only the portion of the Qualified Basis

that is financed with tax-exempt bond proceeds is eligible for 4% Credits. For example, if a project's total development cost is \$1,000,000, \$500,000 (50%) is financed with bond costs, and the LIHTC Qualified Basis is \$400,000, then the owner is eligible for 4% Credits on the \$400,000 of Qualified Basis. However, if \$490,000 (49%) is financed with tax-exempt bond proceeds, then the owner is only eligible for 4% Credits on \$196,000 (49% x \$400,000) of LIHTC Qualified Basis. Therefore, most developers are careful to ensure they meet the 50% test so as to maximize their 4% Credits. .

The first step in receiving a 9% Credit allocation is to apply to the designated state housing credit agency. There are typically only one or two application rounds per year; therefore, there is considerable lead time required for LIHTC transactions. Many states allocate 9% Credits only after one or two applications are submitted, which can result in a 1-2 year delay before a project will receive a 9% Credit allocation. In addition to the previously enumerated Treasury requirements for each state's QAP, many states also require the owner to demonstrate his or her readiness to proceed. Therefore, before a project can apply for a credit allocation, it must be well positioned regarding its financing (loan, syndication, etc.) commitments, permitting, and must be able to demonstrate legal site control. A typical LIHTC transaction in a state such as Massachusetts requires the owner to have site control for at least 2-3 years due to the extraordinarily long lead times in order to secure a LIHTC allocation.

A state housing credit agency makes a 9% Credit award to a proposed development either through a Conditional Reservation or a Binding Commitment. A Conditional Reservation typically precedes the issuance of a Binding Commitment in that it stipulates a number of requirements that the owner must fulfill. Once those requirements are fulfilled, the state will issue a Binding Commitment that obligates the state to commit the specified amount of LIHTCs to a proposed project. However, a state can issue a Binding Commitment without having issued a Conditional Reservation. The Conditional Reservation and/or Binding Commitment stipulates the year in which the first LIHTCs can be assumed by an investor. For example, a developer could have applied to a state housing credit agency in March 2005 and receive a Conditional Reservation in July 2005 for 2005 LIHTCs. Since it is virtually impossible for a new construction

development to be placed in service by the end of 2005, as it most likely had not closed on its financing and began construction, states are permitted to issue Forward Binding Commitments for LIHTCs for future years. States recognize this, and a proposed development that applies for LIHTCs in 2005 may receive a Forward Binding Commitment for either 2006 or 2007 LIHTCs.

A developer that receives an allocation of LIHTCs in the year in which it applied for a credit allocation and therefore cannot use that allocation can apply to the state housing credit agency for a Carryover Allocation. If the requirements of a Carryover Allocation are met within one year⁶⁰ of receiving a Conditional Reservation or Binding Commitment, then the owner is granted an extension and must ensure the building is placed in service not later than the close of the second calendar year following the calendar year in which the credit allocation is made. The most significant Carryover Allocation requirement is termed the 10% Test.

The 10% Test requires that 10% of the owner's reasonably expected basis⁶¹ - not limited to Eligible Basis - is incurred prior to one year after the credit allocation. Projects that contain multiple buildings can satisfy the test on an individual or aggregate basis.⁶² Only costs related to the project (building, related personal property, and land) are included in the 10% Test.⁶³ It is crucial that the entity that meets the 10% Test is also the entity that was named on the Conditional Reservation or Binding Commitment for the 9% Credit allocation from the state housing credit agency.⁶⁴ An owner of any sizable development typically meets the 10% Test by purchasing the property within one year of the 9% Credit allocation. Funds must be expended in order to be included in the 10% Test and Owners are typically required to submit an opinion from an attorney or an accountant verifying that the ownership entity has met the 10% Test by the prescribed date. Note that the 10% Test is not required for 4% Credit allocations.

⁶⁰ HERA 2008 liberalized this requirement to a year rather than a more stringent end of calendar year or six months from a Binding Commitment or Conditional Reservation.

⁶¹ Reasonably expected basis is defined as the end of the second calendar year after which the credit allocation is received, IRC § 42(h)(1)(E)(ii).

⁶² IRC § 42(h)(1)(F).

⁶³ Therefore, costs such as marketing, syndication and permanent loan fees, required reserves, etc. are not includable in the 10% test.

⁶⁴ Novogradac, pg. 196.

After the project is placed in service (typically the date the building(s) receive the certificate(s) of occupancy), the taxpayer must file IRS Form 8609 with its first tax return of the credit period. Form 8609 is filled out by the taxpayer and is executed by the state housing credit agency. It is accompanied by a Cost Certification that is audited by a certified public accountant. Information detailed on the Form 8609 includes, but is not limited to, items such as the project's Eligible Basis as of the close of the first year of the credit period, Qualified Basis, Applicable Percentage, each building's BIN,⁶⁵ Minimum Set Aside election, and election of project to be treated as multiple buildings or on a building by building basis. IRS Form 8586, that allows the investor to take the LIHTCs annually and certifies from the owner that the building is in compliance, is also required the first year as well as all subsequent years. Note that Form 8609 is only required with the first year's tax return. Finally, a Tax Credit Regulatory Agreement, executed by the owner and the housing credit agency, that specifically outlines the owner's commitment to a minimum affordability term of 30 years⁶⁶, the minimum set aside, any additional affordability restrictions, and recourse for violating the Regulatory Agreement's provisions. The Regulatory Agreement is typically recorded at the local registry and is a housing credit agency typically requires confirmation of recording prior to executing Form 8609.

Once the property is fully leased and has met the minimum set aside, state housing credit agencies are required to monitor each development and report non-compliance. Fees and other pertinent information for this mandatory oversight are outlined in the QAP. States report non-compliance on IRS Form 8823 – Low Income Housing Credit Agencies Report of Noncompliance and must file Form 8610 each year that demonstrates that the state has not exceeded its annual credit allocations. Owners must adhere to strict recordkeeping requirements and housing credit agencies can conduct onsite inspections of those records and physical inspections of individual properties. For mixed income properties, property

⁶⁵ The acronym "BIN" stands for "Building Information Number" and enables the IRS and states to track each LIHTC building. BINs are assigned by state housing credit agencies.

⁶⁶ Some state QAPs award "points" for applicants that agree to longer affordability terms (until perpetuity); therefore, many Regulatory Agreements are effective for much longer than the 30 year minimum requirement.

owners/management companies are required to annually⁶⁷ income certify each Eligible Household to ensure that the Eligible Household is still considered Eligible. HERA 2008 removed annual income certifications for 100% low-income buildings.

Conclusion

This chapter was intended to provide an overview of the LIHTC program for policy makers and others interested in the LIHTC. There are few, if any, detailed descriptions of the LIHTC program that are comprehensible for those who are not tax professionals, syndication attorneys, or finance gurus. This chapter can also serve as a simple reference for developers, syndicators, housing credit agencies, and others that frequently utilize the LIHTC. The following chapters will focus on policy analysis rather than providing background facts. Chapter 2 will present and analyze recent legislation that significantly impacted the LIHTC program. Finally, Chapter 3 will propose additional changes to the LIHTC program that could inform future Congressional legislation.

⁶⁷ This must occur once every 12 months; therefore, a tenant that executes a lease on August 1, 2009 must be income certified by July 31, 2010.

Chapter 2: HERA 2008 and ARRA – An Analysis

Two major legislative initiatives, the Housing and Economic Recovery Act of 2008 (HERA 2008) and the American Recovery and Reinvestment Act of 2009 (ARRA) have recently and significantly altered the LIHTC landscape. HERA 2008 was enacted in response to the burgeoning subprime mortgage crisis. It provided mortgage relief to numerous homeowners, provided liquidity to, and oversight of, Fannie Mae and Freddie Mac, allocated \$4B to states and municipalities to revitalize foreclosed properties, and created a first time homebuyer refundable tax credit. In addition, HERA 2008 included 23 changes to the LIHTC program, many of which had been advocated by the affordable housing community for many years. The CBO and JCT estimated the net cost of HERA 2008 would be \$25B in total for the ten year period from 2008-2018.⁶⁸

ARRA (H.R. 1), also commonly known as the “stimulus” plan, at \$787B was the most expensive bill ever passed by the U.S. Congress. Its sweeping reform package included almost all sectors of the U.S. economy, including but not limited to healthcare, tax relief, housing, transportation, education, infrastructure and science, and energy. The bill stressed rapid spending to improve the U.S.’s crumbling infrastructure, to create renewable energy resources, as aid to cities and states to alleviate potential job cuts, and to provide almost \$290B in tax cuts for companies and individuals. ARRA also allocated \$12.7B in funding for housing, including \$4B for public housing authorities (PHAs). ARRA also provided \$2.25B in grant funding for LIHTC transactions called the Tax Credit Assistance Program (TCAP) and provided for certain proposed LIHTC developments to exchange their awarded LIHTCs for grants called the Tax Credit Exchange Program (TCEP). These two programs were intended to revitalize stalled LIHTC proposed developments and temporarily reinvigorate affordable housing production until the economy rebounded.

In contrast to the last chapter, this chapter will not delve into the same level of detail regarding HERA 2008 and ARRA. A number of excellent industry memorandums have been written that

⁶⁸ United States. Congressional Budget Office. *Congressional Budget Office Cost Estimate: H.R. 3221 Housing and Economic Recovery Act of 2008 As passed by the Senate on July 11, 2008, with an amendment transmitted to CBO on July 22, 2008*. 2008. Print.

explain in detail the LIHTC provisions contained in HERA 2008 as well as detail the rules regarding TCEP and TCAP. Three memorandums authored by Anthony S. Freedman, a partner in the law firm of Holland & Knight's syndication group, are an excellent source of information for those readers that desire a greater level of detail on TCAP and TCEP than this chapter will provide.⁶⁹ In addition, Robert Rozen, one of the primary architects of the original LIHTC provisions in TRA 86, wrote a summary article in *Avenues to Affordability* regarding the LIHTC amendments contained in HERA 2008.⁷⁰ This chapter relies both on Mr. Freedman's and Mr. Rozen's analysis, as well as other sources of information.

Tax Credit Exchange Program (TCEP)

Background

The Tax Credit Exchange Program (TCEP) was enacted as Section 1602 of ARRA in order to salvage stalled LIHTC projects and to ensure continued affordable housing production. This is due to the current financial crisis articulated in Chapter 1 that collapsed the LIHTC syndication markets. TCEP allows sponsors that were allocated 2008 tax credit authority to exchange those tax credits, through a state housing credit agency, with Treasury for a grant of \$0.85 per \$1.00 of LIHTC tax credit. States may also permit up to 40% of their 2009 credit ceiling to be exchanged under TCEP. TCEP is administered by the Treasury department and therefore the compliance requirements are very similar to IRC Section 42 (the LIHTC regulations).

TCEP provides significant discretionary authority to the state housing credit agencies in terms of allocating this resource. Funds are allocated to the state housing credit agency, which then makes subawards to Qualified Low Income Buildings. State housing credit agencies must make subawards "in the same manner and shall be subject to the same limitations (including rent, income, and use restrictions on such building) as an allocation of housing credit dollar amount

⁶⁹ Mr. Freedman's memorandums can be found at the following websites:

<http://www.ncsha.org/uploads/Tax%20Credit%20Assistance%20Program%20May%2012%2009.pdf>,

<http://www.ncsha.org/uploads/Tax%20Credit%20Exchange%20Program%20March%2012%2009.pdf>

⁷⁰ Mr. Rozen's article can be found at the following website:

http://capfund.net/Portals/_Rainbow/Documents/CongressChangesLIHTCProg.pdf

allocated by such State housing credit agency.”⁷¹ In addition to complying with LIHTC rent and income restrictions, sponsors must demonstrate that they actively sought out equity investors for the LIHTCs that were originally allocated to them but were unsuccessful or only partially successful in receiving an equity installment. If sponsors are able to locate an LIHTC investor, but that investor is not able to invest \$0.85 per \$1.00 provided under TCEP due to its equity yield requirements, then the investor can co-invest its equity with the TCEP program to generate an appropriate yield for the investor.

The subaward amount may or may not correspond to an individual project’s allocated LIHTCs. For example, if a project was allocated \$100,000 of 2008 credit authority, then one might presume that it would receive \$8,500,000 ($\$100,000 \times 10 \text{ years} \times \0.85) in TCEP grants. However, the state could decide to only allocate \$7,000,000 in a subaward to the project if it believes that the project is financially feasible with the lower amount.

TCEP is only available to 9% Credit transactions, so it therefore does not benefit the many 4% Credit transactions that typically struggle for LIHTC equity even in strong economic times. Tax-exempt bond projects that were allocated 4% Credits are eligible for TCEP funds, but the 4% Credits generated by the tax-exempt bonds are not eligible. In contrast to all other federal grants, Treasury specifically excluded TCEP from reducing Eligible Basis and TCEP grants do not generate taxable income to the recipient. If Treasury had not included these two exclusions, the TCEP program would not have been able to properly function.

TCEP funds must be allocated to subawardees no later than December 31, 2010 and TCEP can be used in conjunction with investor equity and TCAP (to be described below). Since TCEP functions in a similar manner to the LIHTC program, Davis-Bacon prevailing wage laws and the National Environmental Policy Act (NEPA) are not required. These laws are typically required with all non-LIHTC federal subsidies. This is extremely beneficial to sponsors as the NEPA process can be time consuming and cause delays and Davis-Bacon can increase labor costs in some areas as much as 15-20%. Finally, TCEP includes similar recapture provisions to Section

⁷¹ H.R. 1, 111 Cong., 1602(c)(2) (2009) (enacted). Print.

42, and recapture may be enforced against the ownership entity, sponsor, and/or another party, who is considered fully indebted to the Treasury. In practice, who is subject to recourse and how recapture will be administered is still ambiguous at this point and must be clarified by Treasury.

Summary

TCEP was an important measure to salvage a number of proposed LIHTC transactions on the verge of collapse. Although it was enacted in February 2009, few TCEP transactions have closed on their financing. This is due to the significant lag time for Treasury to implement its guidelines compounded by the time state housing credit agencies required to draft their own guidelines. As of the time of this writing, a number of industry professionals indicate that they expect TCEP deals to begin closing in late August. The lag in implementing TCEP most likely adversely impacted a number of proposed LIHTC transactions due to the cost of carrying properties and other related costs.

Tax Credit Assistance Program (TCAP)

Background

Authorized under Title XII of ARRA and administered by HUD, TCAP provides \$2.25B in special HOME Investment Partnerships (HOME) Program funding to “provide funds for capital investments in Low-Income Housing Tax Credit (LIHTC) projects. HUD will award TCAP grants by formula to state housing credit agencies to facilitate development of projects that received or will receive LIHTC awards between October 1, 2006, and September 30, 2009.”⁷² TCAP funds are distributed under the HOME program; however, TCAP funds are not subject to the preexisting HOME requirements in 24 CFR Parts 91 and 92.

⁷² United States. Department of Housing and Urban Development. Community Planning and Development. *Notice CPD-09-03: Implementation of the Tax Credit Assistance Program (TCAP), Section II*. 2009. Print. (“HUD Notice”)

As opposed to extant HOME funds that are awarded to “Participating Jurisdictions”, TCAP funds are awarded to state housing credit agencies.⁷³ Section 42 requirements regarding rent and household income limitations apply to TCAP. In contrast to the TCEP funds that do not require an LIHTC award, TCAP funds must be allocated to “projects that have received or will simultaneously with TCAP funding receive a LIHTC award.”⁷⁴ TCAP funds are to be distributed to states utilizing the HOME formula rather than the LIHTC per capita formula. TCAP must be distributed in accordance with the state housing credit agencies’ existing QAP requirements; however, housing credit agencies are instructed to prioritize developments that are anticipated to be completed within three years of the ARRA’s enactment.

While TCEP funding must be provided in grant form, TCAP funding is more flexible in that it permits state housing credit agencies to either grant or loan the funds. Like TCEP, TCAP funding does not reduce Eligible Basis. However, TCAP funding as a grant would be treated as taxable income to the recipient unless that recipient were a tax-exempt entity. Therefore, it is anticipated that TCAP will most likely be provided as a low or zero percent interest loan.⁷⁵ In line with ARRA’s mission to revitalize the economy by job creation and rapid spending, housing credit agencies must adhere to the following distribution requirements:

1. Commit not less than 75 percent of its TCAP grant within one year of the enactment of the Recovery Act (i.e., by February 16, 2010);
2. Demonstrate that all project owners have expended 75 percent of the TCAP funds within two years of the enactment of the Recovery Act (i.e., by February 16, 2011); and
3. Expend 100 percent of its TCAP grant within three years of the enactment of the Recovery Act (i.e., by February 16, 2012).⁷⁶

If TCAP funds are not expended within the three year period outlined above, HUD will recapture the funds. In addition, state housing credit agency agreements with sponsors must

⁷³ Freedman, Anthony S. "Tax Credit Assistance Program - HUD Guidance." *Holland & Knight* (2009). Print. ("Freedman HUD")

⁷⁴ HUD Notice, Section IV(B)

⁷⁵ Freedman HUD.

⁷⁶ HUD Notice, Section IV(C).

specifically outline a schedule for the utilization of TCAP funds. If the sponsor does not adhere to its schedule, it risks losing TCAP funding to other projects in the state.⁷⁷

Finally, in contrast to TCEP, TCAP includes a number of requirements that could be considered onerous to a sponsor. Before TCAP funding can even be committed, HUD Notice CPD-09-03 explicitly states in bold letters **“No TCAP funds may be committed to a project before completion of the environmental review process (NEPA).”**⁷⁸ NEPA’s requirements also prohibit sponsors from performing any construction work or acquiring a property prior to NEPA approval. This will prevent a sponsor from acquiring a property and/or completing such items as preconstruction demolition and site work that significantly reduce the construction period. In addition, all other federal grant requirements must be adhered to including Davis-Bacon.

Summary

TCAP is simply a soft subsidy program that does not involve private sector oversight. However, TCAP could be used in conjunction with TCEP, so private sector involvement would be incorporated through utilizing both subsidies. In addition, it is assumed that TCAP will be provided as loans that will eventually need to be discharged during a refinancing or disposition event. This will erode sponsors’ and investors’ profits and could reduce the price an investor would pay for LIHTCs.

TCAP’s federal requirements could harm a proposed LIHTC development that requires TCAP funding to expeditiously close on its financing. First, the NEPA process can be long and arduous. All environmental reports and significant remediation must be complete before the sponsor can even apply for NEPA review. This is costly to the sponsor and must be funded by either a predevelopment loan or its own equity capital. Many state housing credit agencies only have one or two individuals qualified to complete NEPA, and these individuals tend to be overextended with their existing work. NEPA reviewers must extensively review the environmental documentation, which could take weeks. After the review is complete, a public

⁷⁷ Freedman HUD.

⁷⁸ HUD Notice, Section V.

notice is published in a local newspaper that provides the public with a 14 day period to comment. If there are no negative public comments, the NEPA review will be submitted to HUD for approval.

As evidenced by the somewhat burdensome process outlined above, the NEPA process is difficult to navigate, time consuming and expensive for sponsors. The guidelines should have provided an exception to permit sponsors to receive a TCAP commitment as long the sponsor had submitted its NEPA application. Currently under the HOME program, applicants for HOME funding are permitted to receive a HOME funding commitment from the state prior to initiating NEPA. This rule should also apply to TCAP.

While it was most likely impossible for HUD to exclude Davis-Bacon from TCAP guidelines, it will be significantly more expensive for sponsors in high cost areas to complete their developments. In non-union cities that have high costs, according to one industry construction professional, Davis-Bacon could increase construction costs by 15-20%. TCEP will therefore be the subsidy of choice for these developments' sponsors.

The Housing and Economic Recovery Act of 2008 (HERA 2008)

Background

HERA 2008 contained some of the most sweeping legislative reforms of the LIHTC since its inception in 1986. In total, 23 changes were enacted by Congress, all of which benefited the LIHTC program. The affordable housing industry, represented by a number of organizations, was extremely successful in encouraging Congress to enact these changes. Along with Congress, they deserve much of the credit for conceiving and implementing these ideas. As previously discussed, please refer to Robert Rozen's article on HERA 2008 that succinctly highlights all 23 changes. The following discussion will highlight six of the 23 changes that in my opinion are the most important.

Increase in State Allocation Volume Cap

As mentioned in Chapter 1, HERA 2008 increased the state per capital allocation volume cap to \$2.20 for 2009 and the minimum to \$2,555,000 (10% increase) for small states. This change significantly increased the credit ceiling that state housing credit agencies can distribute to LIHTC transactions. Unfortunately, because the syndication markets are currently stalled, even with utilizing TCEP, many states are likely to have excess credits that they will be unable to place and that will need to be carried until 2010.

Fix 9% Credit and Open 9% Credit Investment

Chapter 1 detailed HERA 2008's provisions that permitted the 9% Credit Applicable Percentage to be fixed at 9%. This is conditioned on a Qualified Low Income Building being placed in service after the date of HERA 2008's enactment but before December 31, 2013. In addition, HERA 2008 redefined the definition of "federal subsidy" by limiting federal subsidies to solely tax-exempt bond financing. Prior to HERA 2008, 9% Credit transactions were not permitted to utilize other federal subsidies, which included tax exempt bonds and also federally subsidized loans. By reclassifying the term "federal subsidy", HERA 2008 enabled many developments that were previously prohibited from using the 9% Credit, or had to back the federal subsidy out of Eligible Basis, to apply for an allocation of 9% Credits without any restrictions. This change created flexibility for 9% Credit transactions and enabled them to utilize 9% Credits without being penalized for using additional federal subsidies precisely when more subsidy is needed with the exception of tax-exempt financing. Fixing the 9% Credit also removed the uncertainty of Applicable Percentage fluctuations.

State Housing Credit Agency DDA Designation

HERA 2008 permits state housing credit agencies to declare a specific Qualified Low Income Building to be located in a Difficult to Develop Area (DDA). Chapter 1 outlined that if a building is located in a DDA (and/or a QCT), then the building is entitled to a 130% boost in Eligible Basis. Housing credit agency QAPs are required to outline the requirements for a sponsor to request a DDA designation. Treasury requires that the state housing credit agencies determine that the

proposed LIHTC transaction would not be financially feasible if the 130% boost were not awarded to the transaction. Only allocated (9% Credits) are eligible for this determination.

In high cost states, this change may not be beneficial. Many housing credit agencies in high cost states cap the Qualified Basis for allocated LIHTCs. The result of the cap is that many LIHTC projects have significant excess Qualified Basis, even without the 130% boost. Unless high cost states revisit their QAPs and raise or eliminate the Qualified Basis cap, this change will not have an impact on buildings located such states.

Area Median Gross Income (AMGI) Floor

As detailed in Chapter 1, HERA 2008 set the 2008 Area Median Gross Income (AMGI) as the floor for all future median income calculations. Therefore, the AMGI for all future years will be calculated as the greater of the AMGI for 2008 or the AMGI for the specific future year. Since Gross Rents are directly correlated with AMGI, this change eliminates the risk of future decreases in Gross Rents. Prior to this change, sponsors would be at risk of violating their loan covenants if Gross Rents declined, because sponsors would not be able to maintain the required debt service coverage ratios and investors and lenders could call a sponsor's operating guarantee. As with fixing the 9% Credit Applicable Percentage, this change eliminates risk for a sponsor.

Eliminated Alternative Minimum Tax (AMT) Prohibitions

Prior to HERA 2008, a number of investors were unable to invest in LIHTC transactions due to the inability to offset their Alternative Minimum Tax (AMT) liability with LIHTCs. HERA 2008 rescinded this prohibition for all LIHTC transactions placed in service after December 31, 2007. This change represented a significant victory for the affordable housing industry as it greatly increased the pool of investors that could utilize the LIHTC.

Conclusion

A number of positive legislative changes impacted the LIHTC in HERA 2008. Unfortunately, Congress could not politically incorporate all the changes advocated by the affordable housing industry into a single bill. The affordable housing industry is continuing to advocate for additional changes to LIHTC, a number of which are outlined in Chapter 3. Congress is contemplating another housing bill for either late 2009 or 2010 that should hopefully include additional positive changes to LIHTC that will aid in revitalizing the program.

Chapter 3: Proposed LIHTC Changes Beyond HERA 2008 and ARRA

The preceding chapters provided detailed background on LIHTC and presented and analyzed the most recent legislation affecting it. This final chapter will explore a proposed set of additional changes to LIHTC based both on current ideas being discussed among industry and government participants and my own conclusions. Some of these proposals are politically feasible while others are controversial. The recent collapse of the syndication markets has exposed LIHTC's vulnerabilities and the patchwork legislation enacted in 2009 is simply a band aid until, and if, LIHTC markets rebound. By incorporating the changes outlined below in future legislation, Congress can improve and hopefully mitigate many of the problems inherent in today's crisis. The changes are ordered according to the author's determination of importance, with the most important change first and the least important change last.

In the process of conducting background research for this thesis, I conducted interviews with over 15 industry professionals, LIHTC advocacy organizations and public policy makers on the state and federal level. They were generous with their time and candor, and provided invaluable perspective. All requested that they not be directly quoted or linked by name to comments or policy recommendations discussed in the pages that follow.

A number of the proposed changes included herein are those either publicly or privately proposed by industry professionals, LIHTC advocacy organizations, and policy makers and where possible, I attribute the proposals to groups who are known to be promoting the changes. A partial list of individuals interviewed is attached as Appendix 1. Some interviewees asked not to be included on the list and are therefore excluded. Also note that interviewees had differing views on all the proposed changes in this section; therefore, the opinions expressed herein should not be attributed to any of the interviewees.

Relax Passive Loss Investor Rules

Background

Since the passage of the Tax Reform Act of 1986, the restrictive passive loss rules on individual investors in LIHTC transactions have been the subject of much debate. As currently drafted, IRC Section 42 promotes corporate investment in LIHTC transactions but significantly constrains individual investors. Increasing the potential pool of investors in LIHTC deals by relaxing the passive loss rules for individual investors would increase demand for tax credit deals.

Recall from Chapter 1 that individual investors of any income level can invest in an LIHTC transaction and can realize up to an annual maximum tax loss of \$25,000 per investor. The \$25,000 cap at the 39.6% tax rate (2010) translates into approximately \$9,900 ($\$25,000 \times 39.6\%$) of actual tax savings from LIHTCs per individual investor. In addition, individual investors are permitted only to utilize the tax credits and are not able to utilize a low-income property's depreciation and other tax losses (e.g. mortgage interest) to offset their active income. This effectively means that with enough demand from companies, individuals will typically be outbid by corporate investors for tax credits. The following transactional example illustrates the infeasibility of incorporating individual investors in a LIHTC deal under current law. Assume a new construction development with 100% low-income units in a Qualified Census Tract in a wealthy urban area. The average cost per unit including land is \$250,000 and the development is modestly sized at 150 units. The resulting total development cost is therefore \$37,500,000 ($\$250,000 \times 150$). Assume conservatively that 80% of the total development cost is included in Eligible Basis. Therefore, the following calculations apply:

| | |
|---|-----------------------------------|
| [1] Eligible Basis of Low Income Building: | \$30,000,000 (80% x \$37,500,000) |
| [2] Applicable Fraction: | 100% |
| [3] Qualified Census Tract | 130% |
| [4] Qualified Basis of Low Income Building: | \$39,000,000 [1]*[2]*[3] |
| [5] Applicable Percentage: | 9% |
| [6] Maximum Qualified Annual Credits: | \$3,510,000 [4]*[5] |

Assuming that the development is awarded the maximum number of credits for which it is qualified, and that the deal is comprised only of individuals, then the sponsor would be required to admit 355 ($\$3,510,000/\$9,900$) individuals into the deal. Even if the development received only 50% of the maximum credits for which it is qualified, this would require the participation of at least 178 individuals in the deal. The identification and management of this number of individuals interested in a tax credit transaction would be difficult and an administrative nightmare that would significantly increase transaction costs relative to just a few corporate investors in a particular syndication. Boston Capital Corporation until a few years ago managed a number of LIHTC funds that contained individuals. Currently no LIHTC funds for individuals exist due to the previously enumerated high transaction costs.

Recommendation

Congress should amend IRC Section 42 to remove the \$25,000 loss cap on individual investors and allow individual investors to offset their active income with losses from LIHTC low-income properties. A number of LIHTC advocacy organizations support this measure, including the National Association of Home Builders (NAHB) and the National Council of State Housing Agencies (NCSHA). This proposed amendment is not a reversion to pre-1986 abusive tax shelters. In my opinion, it should only apply to LIHTC transactions, of which there are a finite number. 9% Credits are capped on a per capita basis and 4% Credits are capped based on available state bond volume cap. This amendment would increase demand for the LIHTC. Given the fixed supply, this change should increase the price of the tax credit or at least diversify the set of potential buyers, which is important in difficult economic times such as these.

The Congressional Budget Office (CBO) is a non-partisan Congressional agency charged with reviewing Congressional budgets. The CBO, along with Joint Committee on Taxation (JCT), assigns a score to any legislation that will have a budgetary impact. The score represents the dollar amount in which the legislation will either increase or lower the federal budget. The proposed change to extend the passive loss rules to individuals should score revenue neutral at worst with the CBO and JCT.

The increase in LIHTC pricing should actually save the government money. Many LIHTC transactions, especially those in high land and construction cost areas, often require deep additional subsidy from localities, states and the federal government. Increasing demand for the tax credit and the subsequent increase in pricing should reduce the dependence on additional subsidies. These additional subsidies could then be either entirely eliminated or scaled back resulting in government savings. Also note that the Community Reinvestment Act (CRA) drives many corporate investors to invest in LIHTC transactions. In many rural communities with few large banks that take deposits, corporations have no CRA motivation to invest. Individual investors that are not motivated by the CRA could aid in promoting investment in rural low-income communities.

Affordable Housing Industry Recommendation

On August 3, 2009, the affordable housing industry, led by the Housing Advisory Group, and sponsored by over 30 affordable housing organizations, proposed relaxing the passive investor rules for some S corporations and closely held C corporations. The industry's proposal is as follows:

Under present law, the tax code's passive loss rules restrict the pool of potential LIHTC investors. We support providing parity with C Corporations by allowing some S Corporations and closely-held C Corporations to offset revenue with LIHTC tax benefits that would otherwise be taxable when passed through to the owners of these businesses. To ensure the high standards of oversight associated with the program are maintained, we support limiting this ability to such entities that satisfy the following tests: (1) annually have at least \$10 million in gross receipts; (2) the principal purpose of forming the entity is not the avoidance or evasion of Federal income tax; and (3) there is an expectation of reasonable asset management. Such a policy change will broaden investor demand and prove particularly beneficial in rural areas where many community banks and other potential investors are currently prevented from participating in the program.⁷⁹

It explicitly does not incorporate individual investors, most likely due to the authors' understanding that there is currently little political will in Congress to relax the passive loss

⁷⁹ Housing Advisory Group. "Affordable Rental Housing Action Letter." Letter to Congress. 3 Aug. 2009. MS.

rules for individuals. While the industry's proposal is positive and likely the most pragmatic at this time, the LIHTC syndication markets would also significantly benefit from incorporating individuals, as proposed above.

Counter Arguments

Various arguments against relaxing the passive loss law cap on individuals specifically for LIHTC transactions must be addressed. First, some claim that providing this exception equates to abusive and unfair tax breaks for wealthy individuals, and violates the intent of TRA 86. However, providing a benefit to corporations over individuals in the financing of affordable housing inappropriately favors corporations when individuals may be able to better support the LIHTC program in certain instances. As opposed to pre-TRA 86 real estate tax shelters that were sometimes unregulated, numerous, and at times may have not truly served low income individuals, the post-TRA 86 environment is highly regulated and monitored. As previously enumerated, the number of LIHTC transactions is fixed by statutory formulas. There is little ability to exploit this new market as there was pre-TRA 86.

Another counter argument is that private corporate investors provide necessary oversight of each LIHTC deal. Corporate investors, typically through syndicators, have in-house expertise to analyze a transaction's viability, whereas individual investors tend to lack that experience. When creating the LIHTC program, this governance feature was appealing to Congress. For the first time private industry with expertise and a financial interest in affordable housing transactions would be overseeing a government affordable housing program. This private oversight feature placed responsibility to ensure a development's success in the hands of the private sector, which Congress believed was equipped with strong real estate financial experience that would better monitor LIHTC developments as compared with the public sector.

However, most LIHTC transactions utilize private lenders that complete significant and independent due diligence. Since illiquidity entered the markets in 2008, private lenders have significantly tightened their underwriting standards and are completing extremely thorough due diligence. In addition, private individuals will most likely be attracted to a LIHTC transaction

through a syndicator. As in their current role with corporate investors, syndicators will provide and preserve the private professional oversight that is a favorable aspect of the program.

Finally, there has been a recent surge in the creation of new types of federal tax credits. There are Energy tax credits, New Markets tax credits, and Historic tax credits, all of which are constrained by the same LIHTC passive loss rules on individuals. A concern arises that advocates for these tax credits will likely lobby to include their programs if Congress relaxes the passive loss rules for LIHTC transactions.

However, the argument can be made that the exception to TRA 86 rules should be made only in the instance of LIHTCs. Unlike Energy and Historic tax credits, the LIHTC is capped. Further opening the markets to Energy and Historic tax credits could cost the government additional tax revenue and score poorly with the CBO. The increase in demand for those tax credits will most likely lead to additional transactions whereas the finite number of LIHTCs cannot increase. Therefore, despite a potential movement to extend this exception to all tax credits, the case can be made to focus strictly on LIHTCs.

In addition to the concern about unequal treatment of various other tax credits, relaxing the passive loss rules on individual investors is also politically sensitive for other reasons. Congress is concerned that if a liberalized interpretation is provided for LIHTC transactions, then that could open Pandora's Box and eventually lead to pressure to revert back to pre-TRA 86. However, the exception to the passive loss rules for LIHTC transactions should be specific and narrow and the legislation would need to be carefully drafted so as to not be read more expansively than intended. In order to assuage the concerns of the advocates for the other enumerated tax credits, the best strategy may be for Congress to acknowledge it is first considering changing the passive laws for only LIHTC transactions and then will reassess extending the broader limitations to other tax credits in the future.

Accelerate the LIHTC

Background

Recall from Chapter 1 that the LIHTC is delivered to investors basically proportionately over ten years. This is in significant contrast to the Renewable Energy and Historic tax credits that are fully realized in the first year and the New Markets tax credit that is received over seven years. The LIHTC program requires an investor to predict its tax liability ten years out, which can be extremely difficult, if not impossible, for most investors. The result is currently a significant discount applied to the LIHTC as compared with the other tax credits.

For example, the Reznick Group, one of the U.S.'s largest LIHTC accounting firms, speculated in December 2008 that median pricing for LIHTCs in 2009 would be \$0.78 for \$1.00 of LIHTC tax credit.⁸⁰ However, according to Aaron Stevens, Director at Centerline Capital Group, one of the nation's largest LIHTC syndicators, current LIHTC pricing is approximately \$0.65 per \$1.00 with a \$0.05-\$0.07 premium for CRA investors. In contrast, federal Historic tax credits are currently being priced at \$0.90 - \$0.95 per \$1.00 of tax credit, according to Paul Hoffman, Managing Partner of CityScape Capital Group, one of the country's leading syndicators of federal Historic tax credits. This pricing comparison represents a 46% high price for the federal Historic tax credit as compared with the LIHTC, and further emphasizes the need to accelerate the LIHTC.

Recommendation

A provision heavily debated, but ultimately excluded from ARRA, likely because Congress was consumed with drafting temporary legislation for two new subsidies programs (described further in Chapter 2), was an amendment permitting investors to accelerate a high percentage of LIHTCs in the first three years. The amendment was originally supported by the Affordable Housing Tax Credit Coalition and NAHB. This amendment would have significantly reduced the risk of unpredictable future tax liability for LIHTC investors. In order to make the LIHTC more

⁸⁰ Kimmura, Donna. "Bracing for 2009: Turmoil in the LIHTC Market Expected to Continue into the New Year." *Affordable Housing Finance* (Dec. 2008). Print.

competitive with the other enumerated tax credits, Congress should revisit the acceleration provision for LIHTC.

At a minimum, the LIHTC should be competitive with the New Markets tax credit and federal Historic tax credit. A plausible proposal could be a seven year LIHTC credit period where the LIHTC credits could be drawn down at 20% for each of the first three years and the remaining 40% could be drawn down at 10% per year for the remaining four years. As opposed to LIHTC transactions that have significantly stalled, New Markets and Historic transactions continue to receive financing, which is a testament to investors' ability to envision a five year horizon.

Currently, Freddie Mac is about to liquidate an over \$3B portfolio of LIHTC properties. In packaging the deal, among other things, Freddie Mac accelerated the LIHTC credits to five years. Investors have been attracted to the transaction despite the current economic crisis, and some attribute this successful syndication to the acceleration clause. If the syndication consummates, it will bolster this acceleration proposal.

Counter Arguments

Accelerating the LIHTC over five years will result in investors utilizing twice as many LIHTCs per year, thereby increasing the near-term cost to Treasury, due to the time value of money principle, as compared with the current formula. However, the acceleration should increase the price of the tax credits so that the program can impact more housing units. In addition, as with fixing the 4% credit, raising the price of the tax credit will relieve reliance on other federal funding sources. Finally, some may claim that reducing the credit period to five years will encourage investors to lose interest in their LIHTC investments during the remainder of the 15 year compliance period. However, if sufficient recapture provisions are instituted, a non-compliant property could adversely impact the investor between years 8-15. Therefore, the existing timing of the LIHTC recapture provisions, as described in Chapter 1, should remain in effect to ensure the investor remains engaged.

Carryback LIHTC 5 Years

Background

Chapter 1 explained that LIHTC investors are permitted to carryback LIHTCs and property losses for one year and forward for twenty years. Since the economic collapse in 2008, companies have sustained significant net operating losses (NOLs). Their inability to carryback losses and LIHTCs beyond a year has dimmed the prospect of future LIHTC investment even if corporate earnings once again rise. This is due to corporations being able to carry forward their NOLs from 2008-2009 to offset future profitable years.

For example, if Company X earned \$3,000,000 annually from 2005-2007, then lost \$4,000,000 annually in 2008-2009, then earned \$2,000,000 annually in 2010-2011, it could offset \$3,000,000 of its \$3,000,000 2007 earnings with its 2008 loss. The remaining \$5,000,000 ($\$4,000,000 \times 2 \text{ years} - \$3,000,000$) of NOLs could be used to offset its entire \$2,000,000 income for 2010 and 2011 with another \$1,000,000 remaining for future losses. Therefore, even though the economy rebounded in 2010 and Company X had positive earnings, it used its 2008-2009 NOLs to fully offset those earnings. Company X may have ordinarily been a LIHTC investor; however, because it cannot carryback NOLs and LIHTCs to its higher earning years, it would not consider an LIHTC investment for many years despite a positive economy because it will be carrying forward NOLs.

Recommendation

The affordable housing industry has rallied in support of permitting a five year carryback of NOLs and LIHTCs rather than the current one year carryback. The industry's proposal would require investors to reinvest in new LIHTC transactions in an amount equal to the entire refund they would receive from Treasury for the extended carryback period. In addition, new LIHTC investments would also be permitted to carryback tax credits and losses for five years. Finally, the LIHTCs carried back would be permitted to be used against the alternative minimum tax.

This recommendation has tremendous support, including from the powerful NAHB, the Affordable Housing Investors Council, the Affordable Housing Tax Credit Coalition, Enterprise Community Partners, Housing Affairs Group, LISC, National Affordable Housing Trust, the National Leased Housing Association, and the Stewards of Affordable Housing for the Future. In April 2009 Senator Olympia Snowe filed the Net Operating Loss (NOL) Carryback Act that would permit businesses to carryback 2008 and 2009 NOLs for up to five years. Representatives Richard Neal and Patrick Tiberi also filed a companion bill in the House of Representatives. Although this bill may appear positive for the LIHTC industry, a clause in both proposals excludes any company that received funding under the Troubled Asset Relief Program (TARP) from claiming the extended five year carryback benefit. Since a significant number of LIHTC investors are banks that are also TARP recipients, this exclusion would offset the benefit to many in the LIHTC industry.⁸¹ Therefore, it is recommended that these bills be amended to include TARP recipients; however, it should specifically only govern investments in LIHTC transactions.

Counter Arguments

The LIHTC carryback proposal would be extremely expensive to Treasury and the federal budget. Permitting existing and new investors to carryback their losses for five years will result in Treasury issuing significant tax refunds. Assuming approximately \$600,000,000 of LIHTCs was issued in each of the past few years, Treasury could be writing checks into the billions of dollars. Although the industry's proposal requires that these funds be reinvested in new LIHTC transactions, in essence the proposal is simply giving tax refunds to corporations and then supporting new tax breaks through LIHTC reinvestment.

For example, assume Corporation Y invested in a LIHTC transaction that was placed in service in 2007 and it received \$100 in total LIHTCs (\$10 in LIHTCs per year for 10 years). The Corporation originally anticipated utilizing the LIHTCs over the 10 years. However, this section's proposed change would permit Corporation Y to use the entire \$100 in LIHTCs against its earnings from

⁸¹ *Novogradac Journal of Tax Credit Housing* II.VII (2009). Print.

2002-2007. Since Corporation Y previously paid its taxes for that time period, if Corporation Y were able to fully utilize the \$100 to offset its taxes paid during that period of time, Treasury would be required to write a check to Corporation Y equal to \$100. However, instead of pocketing the \$100 check, Corporation Y would then be required to reinvest the entire \$100 in a new LIHTC transaction. However, this proposal could unduly profit Corporation Y if it reinvests the proceeds at an unreasonable yield. Therefore, the industry's proposal should set a floor price for LIHTCs or a maximum investor yield. This would prevent corporations from extracting unreasonable profits from both carrying back their losses as full tax refunds as well as receiving high yields on new LIHTC investments that would be funded by Treasury's refund.

Encourage Concurrent State Low Income Housing Tax Credit Investment

Background

A number of states have funded state low income housing tax credits (state LIHTC). A state low income housing tax credit functions in a similar manner to the federal LIHTC, except that a state LIHTC can be used to offset state tax liability rather than federal tax liability. Many states' regulations mirror the federal LIHTC regulations and utilize similar allocation procedures. Whereas the federal LIHTC investor must be admitted as a member/partner into the ownership entity, some states allow state LIHTCs to be transferred to entities that are not members/partners. In addition, the credit period varies from state to state and does not necessarily mirror the 10 year federal LIHTC credit period.

In order to understand some complexities regarding state credits, it is necessary to understand that state tax payments are deductible against a taxpayer's federal tax liability. For example, if a corporation has profits of \$100 in 2009 and pays \$5 in state taxes, then the corporation's federal taxable income is \$95 (\$100-\$5) because the corporation is allowed to deduct the \$5 it paid in state taxes. The IRS has issued three private letter rulings regarding state LIHTCs and the treatment of both transferrable and nontransferable state LIHTCs with respect to this

deductibility aspect.⁸² The IRS has ruled that for nontransferable state LIHTCs (i.e., where the state LIHTC investor makes a capital contribution to the owner entity in the typical investment method used for federal credits), the IRS has determined that the investor's use of the state LIHTCs is not equivalent to paying state taxes. Therefore, the investor cannot take the state tax deduction on its federal return. For example, if the same corporation is an investor in a state LIHTC transaction and utilizes \$5 in state LIHTCs, its taxable income for federal income tax purposes would be \$100. Therefore, this ruling effectively reduced the value of state LIHTCs by the value of the LIHTCs multiplied by the taxpayer's federal tax rate (typically reducing the state LIHTCs by the 35% corporate tax rate).

However, for transferable state LIHTCs, the IRS has ruled that a different tax treatment is applicable. In the case of transferable credits which are evidenced by a "certificate," the state LIHTC investor is purchasing "property...rather than a factor in the calculation of [the investor's] tax due" and is therefore eligible to take the state tax deduction on its federal tax return.⁸³ However, because the owner has no cost basis in the state LIHTCs, the owner incurs tax liability in connection with the sale of the state LIHTCs. This effectively reduces the value of the state LIHTCs to the owner by the owner's tax rate and creates the same net effect as described with nontransferable state LIHTCs.

Sophisticated tax attorneys have developed convoluted ways around the tax liability issue associated with the transferable credit. One structure sometimes used involves the ownership entity specially allocating the state LIHTCs to a charity that is a member of the ownership entity. The charity then agrees to transfer/sell the credits to a purchaser in exchange for cash payments. The transfer to the LIHTC purchaser is evidenced by a filing transfer forms with the state agency, which in effect becomes the "certificated" credit documentation. By converting the state LIHTCs to certificates, the LIHTCs have been converted to "property," as described above. The charity then loans, or contributes as equity, the proceeds it receives from the state LIHTC purchaser to the ownership entity. If it is a loan, it is typically structured at 0% interest,

⁸² See the following IRS PLRs: 200348002, 200445046, and 122091-03.

⁸³ IRS PLR 200348002 11/28/2003.

fully deferred with a term longer than all senior and subordinate financing. This method, although cumbersome and costly, is a creative method to maximize the value of state LIHTCs and provide significant value to affordable housing transactions.

Recommendation

The IRC should permit an investor to purchase both nontransferable and transferable state LIHTCs and then subsequently reduce its federal tax liability by the amount of the investor's state LIHTCs with no adverse tax impact to either the investor or property owner. This would eliminate the cumbersome and diversionary process described above, increase the price of nontransferable state LIHTCs, and further streamline the affordable housing development process. Although this recommendation does not directly impact the federal LIHTC, it is important as it pertains to the subject matter and many federal LIHTC transactions also incorporate state LIHTCs.

Counter Arguments

There do not appear to be any counter arguments in permitting investors to deduct nontransferable state LIHTCs on their federal tax returns and excepting owners in transferable state LIHTC transactions from paying taxes on the gain from the sale of state LIHTCs. If the taxes were owed to the state, and the state forgives those taxes to promote affordable housing, it is the state's discretion. The investor would have paid the taxes had the state LIHTC program not exist, and therefore would have been eligible for the deduction. Taxing owners on a state subsidy diminishes the value of the subsidy and adversely impacts the state as well as affordable housing development owners.

Amend the Per Capita Allocation Rules

Background

As previously enumerated, in 2009 each state received \$2.20 per capita in 9% Credits with a minimum allocation of \$2,555,000. The per capita formula does not take into account the

variations of construction costs across states or affordable housing need. For example, using RS Means construction cost data, a six story, 200,000 square foot apartment building in Cambridge, Massachusetts is priced at approximately \$33,000,000 or \$165 per square foot. RS Means estimates that an identical building in Cedar Rapids, Iowa or Jackson, Mississippi would cost approximately \$24,000,000 or \$120 per square foot. This represents a 38% reduction in costs for these areas as compared with Cambridge. However, the existing distribution formula does not account for this significant variation in construction pricing, thereby harming states that desperately need affordable housing due to the high cost of living. In addition, states that have high construction costs typically have high land costs and high transaction costs. These additional costs also filter through to additional construction loan interest as developers must finance a portion of these additional costs. States that have high costs, such as Massachusetts, cap the Qualified Basis per low-income unit due to the fact that there is a scarcity of 9% Credits compared with other states. These high cost states explicitly choose to distribute 9% Credits to more projects at a lower subsidy amount per project to demonstrate that the LIHTC impacts as many housing units as possible.

Recommendation

Rather than distributing LIHTCs on a per capita basis, a more rational approach that accounts for both rent and construction costs should be explored. The current per capita formula ignores cost differentials among states. Therefore, an expanded formula that accounts for construction costs, median rents, and population is proposed. The proposed formula would utilize U.S. Census Bureau population data and median rent per state as well as a national database of construction costs by state. In this case, the Marshall Valuation Service Construction Cost Multipliers by state is referenced. Median rent costs reflect the cost of land, construction, transaction fees, etc. in a particular state. In addition, by also including a construction cost indicator, the proposed formula separately accounts for the most expensive development cost and best reflects variations in development costs among states.

This revised formula weighs the following indicators: (1) state construction costs at 50%, and (2) median state rent versus median national rent at 50%. This combined weighting is then multiplied against the existing population in the state to derive a new population number upon which the state will receive its per capita LIHTC allocation. Finally, there is a minor adjustment that must be factored in to account for a slight variation (approximately 0.18% for 2009) in the calculation. This proposed formula is best explained in **Figure 5** on the following two pages. For example, when you refer to Figure 5, you will notice that California will receive a 25% increase in its LIHTC allocation (see “Var.” column) versus the existing per capita formula, while Nebraska will realize a 17% decline in its allocation. This is due to higher costs and rents in California and its subsequent need for additional subsidy.

Figure 5: Proposed Revised Annual 2009 Allocations By State Utilizing Proposed Formula

(Continued on next page)

| State | [1] Median Rent ¹ | [2] Pop. Projections 7/10 ² (in millions \$) | [3] 2009 Per Capita Allocation ³ (in millions \$) | [4] Median Rent Adj. Factor ⁴ | [5] Const. Costs Mult. ⁵ | [6] Adj. Pop, ⁶ (in millions) | [7] Final Adj. Pop. ⁷ (in millions) | [8] Adj. 2009 Per Capita Allocation ⁸ (in millions \$) | [9] Var. ⁹ |
|-------|------------------------------|---|--|--|-------------------------------------|--|--|---|-----------------------|
| US | 781 | \$309 | | | | | | | |
| AL | 586 | \$5 | \$10 | 75% | 0.86 | 4 | 4 | \$8 | -20% |
| AK | 898 | \$1 | \$2 | 115% | 1.33 | 1 | 1 | \$2 | 24% |
| AZ | 786 | \$7 | \$15 | 101% | 0.94 | 6 | 6 | \$14 | -3% |
| AR | 578 | \$3 | \$6 | 74% | 0.84 | 2 | 2 | \$5 | -21% |
| CA | 1,058 | \$38 | \$84 | 135% | 1.15 | 48 | 47 | \$104 | 25% |
| CO | 797 | \$5 | \$11 | 102% | 0.95 | 5 | 5 | \$10 | -2% |
| CT | 910 | \$4 | \$8 | 117% | 1.10 | 4 | 4 | \$9 | 13% |
| DE | 868 | \$1 | \$2 | 111% | 1.07 | 1 | 1 | \$2 | 9% |
| DC | 906 | \$1 | \$1 | 116% | 1.02 | 1 | 1 | \$1 | 9% |
| FL | 892 | \$19 | \$42 | 114% | 0.98 | 20 | 20 | \$45 | 6% |
| GA | 756 | \$10 | \$21 | 97% | 0.84 | 9 | 9 | \$19 | -10% |
| HI | 1,144 | \$1 | \$3 | 146% | 1.40 | 2 | 2 | \$4 | 43% |
| ID | 644 | \$2 | \$3 | 82% | 0.96 | 1 | 1 | \$3 | -11% |
| IL | 780 | \$13 | \$28 | 100% | 1.08 | 13 | 13 | \$29 | 3% |
| IN | 646 | \$6 | \$14 | 83% | 0.97 | 6 | 6 | \$13 | -11% |
| IA | 587 | \$3 | \$7 | 75% | 1.00 | 3 | 3 | \$6 | -13% |
| KS | 626 | \$3 | \$6 | 80% | 0.92 | 2 | 2 | \$5 | -14% |
| KY | 560 | \$4 | \$9 | 72% | 0.93 | 4 | 4 | \$8 | -18% |
| LA | 629 | \$5 | \$10 | 81% | 0.89 | 4 | 4 | \$9 | -16% |
| ME | 650 | \$1 | \$3 | 83% | 0.97 | 1 | 1 | \$3 | -10% |
| MD | 977 | \$6 | \$13 | 125% | 0.96 | 7 | 7 | \$14 | 10% |
| MA | 952 | \$7 | \$15 | 122% | 1.13 | 8 | 8 | \$17 | 17% |
| MI | 689 | \$10 | \$23 | 88% | 0.99 | 10 | 10 | \$21 | -7% |
| MN | 719 | \$5 | \$12 | 92% | 1.07 | 5 | 5 | \$12 | -1% |
| MS | 591 | \$3 | \$7 | 76% | 0.85 | 2 | 2 | \$5 | -20% |
| MO | 623 | \$6 | \$13 | 80% | 0.97 | 5 | 5 | \$11 | -12% |
| MT | 582 | \$1 | \$2 | 75% | 0.93 | 1 | 1 | \$2 | -16% |
| NE | 610 | \$2 | \$4 | 78% | 0.88 | 1 | 1 | \$3 | -17% |
| NV | 944 | \$3 | \$6 | 121% | 1.01 | 3 | 3 | \$7 | 10% |
| NH | 892 | \$1 | \$3 | 114% | 0.98 | 1 | 1 | \$3 | 6% |
| NJ | 1,002 | \$9 | \$20 | 128% | 1.14 | 11 | 11 | \$24 | 21% |
| NM | 630 | \$2 | \$4 | 81% | 0.91 | 2 | 2 | \$4 | -15% |

Figure 5: Proposed Revised Annual 2009 Allocations By State Utilizing Proposed Formula (continued from previous page)

| State | [1] Median Rent ¹ | [2] Pop. Projections 7/10 ² (in millions \$) | [3] 2009 Per Capita Allocation ³ (in millions \$) | [4] Median Rent Adj. Factor ⁴ | [5] Const. Costs Mult. ⁵ | [6] Adj. Pop, ⁶ (in millions) | [7] Final Adj. Pop. ⁷ (in millions) | [8] Adj. 2009 Per Capita Allocation ⁸ (in millions \$) | [9] Var. ⁹ |
|---------------|------------------------------|---|--|--|-------------------------------------|--|--|---|-----------------------|
| NY | 898 | \$19 | \$43 | 115% | 1.01 | 21 | 21 | \$46 | 8% |
| NC | 674 | \$9 | \$21 | 86% | 0.89 | 8 | 8 | \$18 | -13% |
| ND | 513 | \$1 | \$1 | 66% | 0.97 | 1 | 1 | \$1 | -19% |
| OH | 645 | \$12 | \$25 | 83% | 0.96 | 10 | 10 | \$23 | -11% |
| OK | 587 | \$4 | \$8 | 75% | 0.87 | 3 | 3 | \$6 | -19% |
| OR | 735 | \$4 | \$8 | 94% | 1.04 | 4 | 4 | \$8 | -1% |
| PA | 682 | \$13 | \$28 | 87% | 1.00 | 12 | 12 | \$26 | -7% |
| RI | 833 | \$1 | \$2 | 107% | 1.09 | 1 | 1 | \$3 | 8% |
| SC | 648 | \$4 | \$10 | 83% | 0.86 | 4 | 4 | \$8 | -16% |
| SD | 533 | \$1 | \$2 | 68% | 0.94 | 1 | 1 | \$1 | -19% |
| TN | 626 | \$6 | \$14 | 80% | 0.90 | 5 | 5 | \$12 | -15% |
| TX | 725 | \$25 | \$54 | 93% | 0.86 | 22 | 22 | \$48 | -11% |
| UT | 719 | \$3 | \$6 | 92% | 0.94 | 2 | 2 | \$5 | -7% |
| VT | 733 | \$1 | \$1 | 94% | 1.02 | 1 | 1 | \$1 | -2% |
| VA | 875 | \$8 | \$18 | 112% | 0.90 | 8 | 8 | \$18 | 1% |
| WA | 799 | \$7 | \$14 | 102% | 1.09 | 7 | 7 | \$15 | 5% |
| WV | 516 | \$2 | \$4 | 66% | 0.99 | 2 | 2 | \$3 | -18% |
| WI | 675 | \$6 | \$13 | 86% | 1.06 | 5 | 5 | \$12 | -4% |
| WY | 607 | \$1 | \$1 | 78% | 0.92 | | | \$1 | -15% |
| Totals | | \$309 | \$680 | | | 309 | 309 | \$680 | |

[9] Offset = 560,791 [7] - [6]
 Offset I = 0.0018 [9]/[6]

Footnotes

- ¹ U.S. Census Bureau, American Community Survey, 2005-2007 American Community Survey 3-Year Estimates, GCT2514. Median Monthly Housing Costs for
- ² U.S. Census Bureau, Population Division, Table A1: Interim Projections of the Total Population for the United States and States, April 1, 2000 - July 1, 2030
- ³ [2] x \$2.20 (2009 per capita allocation)
- ⁴ Specific State Median Rent/United States Median Rent (\$781)
- ⁵ Marshall Valuation Service Construction Cost Multipliers
- ⁶ [2] x ([4] + [5]) x 0.5
- ⁷ [6] x Offset Factor
- ⁸ [7] x \$2.20
- ⁹ [8]/[3]

Counter Arguments

The proposed change in the LIHTC allocation formula would not be well received by states adversely impacted by the change. Members of Congress and state delegations would oppose the redistribution of funds from their states to other states. However, Congress should accept a revised formula based on more than a simple per capita calculation. There is precedent for distribution of affordable housing subsidies based on a multitude of factors rather than population. The HOME Investment Partnerships (HOME) program relies on a number of factors, including construction costs, to determine annual HOME allocations. Congress should recognize that the current LIHTC distribution formula is inequitable and results in a greater benefit in states where construction costs, land costs, and the cost of living are lower.

The proposed revised allocation rules must be transparent and simple so that states can anticipate with certainty their annual allocation. Although HOME accounts for a number of indicators, it is overly complex and, at times, bureaucratic. The proposed formula herein is transparent, can be captured in a straightforward amendment to Section 42, and does not require an ambiguous government process. Also note the indicators and weighting used in this section could be rightfully contested as not fully representing the disparities among states. Therefore, the proposed example should be further vetted, and if other indicators are proven to better represent the inequality in costs among states, those revised indicators should be used instead.

Fix the 4% Applicable Percentage

Background

As previously discussed, the 9% Credit for non-federally subsidized buildings was fixed at 9% under HERA 2008. Historically, the Applicable Percentage was adjusted monthly so as to provide an after tax present value of 70% of the Qualified Basis, resulting in a tax credit of something less than 9%. In fixing the 9% Credit Applicable Percentage, Congress ensured that a full 9% allocation of tax credits would be awarded to 9% Credit deals thereby increasing the

LIHTC subsidy to proposed transactions. HERA 2008 removed the uncertainty for those developers, owners, and investors deciding to wait to fix the Applicable Percentage. Recall that the Applicable Percentage can be fixed when the project is placed in service or at an earlier date, depending on the financing structure. Those owners that do not desire to fix the Applicable Percentage at the earlier date, most likely due to it being lower than usual, risked further decline and a corresponding reduction in LIHTCs by waiting until the project was placed in service. Fixing the 9% Credit Applicable Percentage mitigated this risk.

Regarding 4% Credits, note they are only capped by state bond volume cap, the Applicable Percentage is typically below 4%, and credits are distributed with projects that obtain tax-exempt bond financing. If a project is issued tax-exempt bonds under the state volume cap and finances at least 50% of eligible costs with bond proceeds, then the project is eligible to receive its maximum allocation of 4% Credits. The following example refers to this Chapter’s previous example to compare the impact of utilizing the July 2009 4% Applicable Fraction of 3.35% versus a fixed 4%.

| Applicable Percentage | <u>3.35%</u> | <u>4%</u> |
|---|--------------------------|--------------|
| [1] Eligible Basis of Low Income Building: | \$30,000,000 | \$30,000,000 |
| [2] Applicable Fraction: | 100% | 100% |
| [3] Qualified Census Tract | 130% | 130% |
| [4] Qualified Basis of Low Income Building: | \$39,000,000 [1]*[2]*[3] | \$39,000,000 |
| [5] Applicable Percentage: | 3.35% | 4% |
| [6] Maximum Allocated Annual Credits: | \$1,306,500 [4]*[5] | \$1,560,000 |

In the above example, Treasury would allow \$253,500 additional LIHTCs annually over 10 years, resulting in \$2,530,000 additional LIHTCs to this transaction.

Recommendation

It is recommended that Congress fix the 4% Credit in the same manner that the 9% Credit was fixed. This will provide 4% Credit deals with additional LIHTCs, thereby mitigating the need for

obtaining additional subsidies. Although this will increase the federal budget, it will help relieve state budgets as most additional subsidies are provided by the states. It will also alleviate the risk of Applicable Percentage fluctuations that results in uncertainty and risk to owners and investors. The Affordable Housing Tax Credit Coalition is one of a number of groups supporting this recommendation. A number of LIHTC advocacy groups and individuals in Congress predict that this recommendation will be enacted in the near future. HERA 2008 was authorized so expeditiously that this recommendation was excluded from the final bill, but it remains on policy makers' radar screens as one of their legislative priorities.

Counter Arguments

The counter argument to fixing the 4% Credit is that the government will be forced to forgo additional revenue due to the issuance of additional 4% Credits. As described in the above example, fixing the 4% Credit would increase the amount of LIHTCs distributed to the transaction by almost 20%. The CBO and JCT would need to assess the budgetary impact of this recommendation.

Note that when Congress fixed the 9% Applicable Percentage in 2008, the change did not result in an additional cost to Treasury. 9% Credits, as previously discussed, are distributed to states on a fixed per capita basis. Fixing the 9% Credit will aid states that have excess 9% Credits because they will be able to allocate more credits to a proposed development. However, it will not assist states where competition for the 9% Credit is significant and states cap the number of 9% Credits a proposed transaction can receive. In contrast, fixing the 4% Credit will result in a significant increase in LIHTCs across all states because it will result in increased 4% Credits as described in the example on page 82.

Expand the Community Reinvestment Act (CRA)

Background

Remember from Chapter 1 that the CRA is a tremendous impetus for bank investors to invest in LIHTC transactions. Congress enacted CRA to ensure that banks receiving deposits from persons and businesses in low income communities also reinvest in those communities. Banks that receive poor scores under CRA are penalized and can be denied the right to merge with other banks or to open new branches. Federal regulators award banks CRA points if they invest in LIHTC transactions; therefore, prior to the 2008 economic collapse, banks were significant investors in LIHTC transactions and the CRA was a crucial tool to encourage LIHTC investment.

Recommendation

Congress should expand the CRA to include other industries that actively profit from low income communities. First, in the financial sector, CRA should be expanded to incorporate non-banks such as credit unions, hedge funds and investment managers. Second, other industries such as insurance companies, utility companies, and oil companies significantly profit from serving low income communities. These industries should be compelled to reinvest in low income communities under the CRA. Finally, a number of virtual companies on the internet, such as banks, profit from low income communities. These virtual companies should also fall under the auspices of CRA.

In March 2009, Representative Eddie Bernice Johnson submitted to the U.S. House of Representatives a bill entitled Community Reinvestment Modernization Act of 2009 (H.R. 1479). The bill proposes to expand the CRA to credit unions and non-bank industries such as insurance companies. The bill's language states:

All nonbank affiliates of any bank holding company that engage in lending or offer banking products or services, and all other nonbank financial institution affiliates of any bank holding company (including insurance companies and securities firms), shall be subject to the Community Reinvestment Act of 1977 in accordance with this paragraph and in the same manner as a regulated financial institution (as defined in such Act) and the record of any such affiliate in meeting

community credit, investment, and consumer needs shall be taken into account by the Federal regulatory agency with jurisdiction over the affiliate's bank holding company in the course of reviewing the activities of the bank holding company or any application by such affiliate.⁸⁴

Congress should support this bill as a sound first step toward expanding CRA and ensuring that industries that operate in low income communities reinvest in those communities. However, the bill is limited to “affiliates of any bank holding company”, which would exclude many insurance companies, hedge funds, utility and oil companies. The bill should be expanded to include these industries as well.

As it currently does with banks, the CRA should evaluate each company in various industries that desires to operate in a low income community. Insurance companies that apply for branch licenses, oil companies that apply for gas station licenses, and utility companies that serve low income households and businesses should be subject to the same scoring system as banks under CRA. These industries, some of which are suffering from poor publicity, should benefit greatly from the increased public perception of these investments that “give back to the community.” Since the historically strong demand for LIHTC transactions can be directly attributed to CRA, expanding CRA will increase demand for LIHTCs and result in increased LIHTC pricing.

The NCSHA and the Housing Advisory Group are also advocating that banks be allowed to invest in LIHTC transactions outside their existing geographic service area. These investments would satisfy a portion of their CRA requirements but would not fully absolve them of their requirement to invest in their own service areas. This proposal should be considered by Congress as an excellent opportunity to encourage investment in rural areas that are serviced by small banks that do not purchase LIHTCs.

⁸⁴ Community Reinvestment Modernization Act of 2009, H.R. 1479(102)(4)(A), 111 Cong. Print.

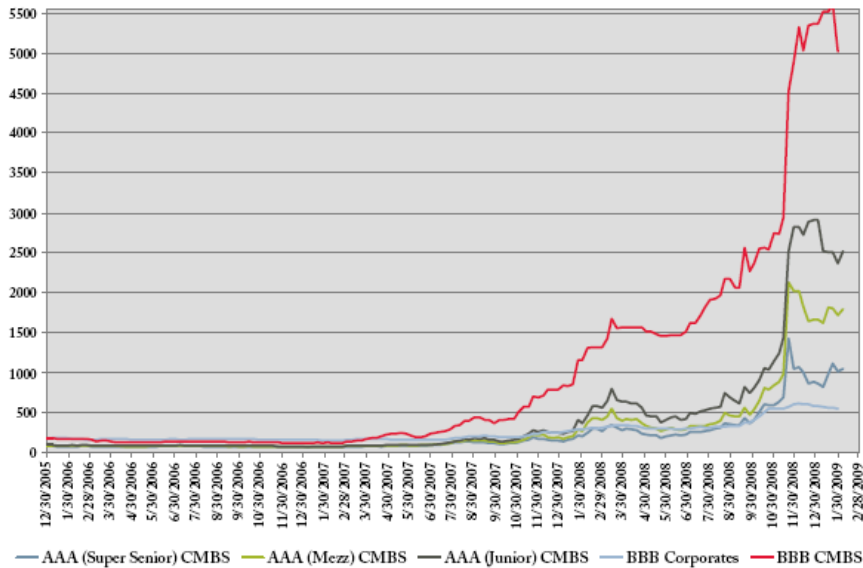
Counter Arguments

As previously discussed in Chapter 1, CRA has been the subject of much scrutiny in connection with the collapse of the subprime mortgage markets. A number of politicians claim that the CRA either caused, or greatly contributed to, the overleveraging by individuals. As discussed in Chapter 1, a number of economists refute this contention with hard data. Nonetheless, broadening the CRA at this juncture could be a difficult proposition for CRA's proponents. Representative Johnson's bill is an excellent first step toward further expanding the CRA. It has 48 cosponsors in the House, but may face stiff opposition due to the existing misconceptions of a number of politicians.

Second, some claim that the CRA over stimulated the demand for LIHTCs and encouraged imprudent investments. Prior to the 2008 economic collapse, bank investors that thrived and expanded during the economic boom had a voracious appetite for LIHTCs. In order to continue growing, banks needed additional CRA credit that they obtained through LIHTC investments. Based on a discussion with various LIHTC syndicators, a number of these LIHTC investments were poorly underwritten and underwent careless and cursory due diligence and now suffer from an inability to meet debt service obligations. Therefore, some individuals assert that the CRA forced banks to make poor investments in order to meet regulatory requirements.

This argument does not appear to be substantiated when poor LIHTC investments are compared with other real estate and non-real estate investments during the same time period. Prior to 2008, investors flocked to securitized debt obligations such as Commercial Mortgage Backed Securities (CMBS) and Residential Mortgage Backed Securities (RMBS). The following chart depicts the significant expectations regarding losses in the CMBS market, including BBB spreads moving from 100 basis points over treasuries in early 2007 to 5,500 basis points over treasuries in 2009.

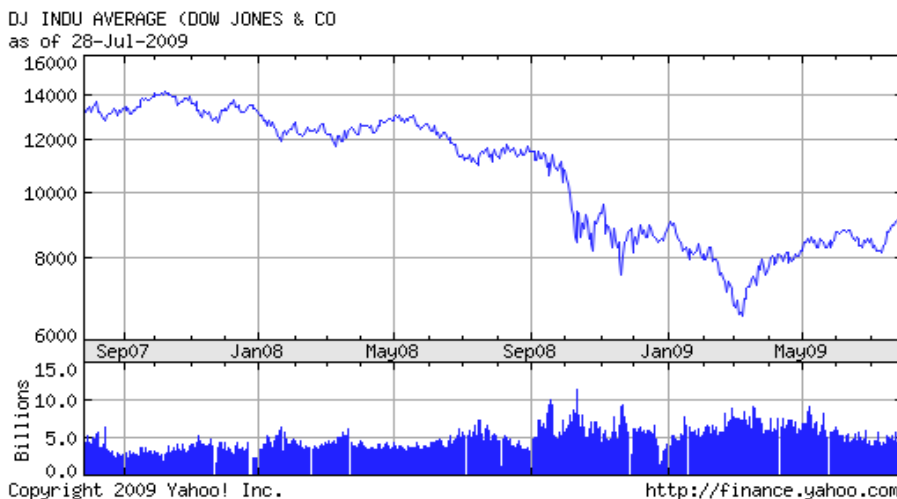
Figure 6: CMBS Spreads (December 2005 – February 2009)



Source: Bloomberg

Equity investors in the stock market also realized tremendous losses beginning in the summer of 2008. The following chart shows the precipitous drop of the Dow Jones Industrial Average from a high of over 14,000 in October 2007 to a low of approximately 6,500 in March 2009.

Figure 7: Dow Jones Industrial Average (September 2007 – July 2009)



Therefore, although unwise investments were made in some LIHTC transactions, all market segments exhibited significant losses during the same time period. It seems unlikely that the

sole fault lies with the CRA with respect to failed LIHTC transactions. It is important to note that during strong economic times when companies subject to CRA incur significant corporate earnings, the CRA's influence could be one of many factors that stress sound underwriting principles.

While banks, investment managers, and oil and utility companies are federally regulated, insurance companies are regulated by individual states. It will therefore be a challenge to enforce the proposed expanded CRA regulations to insurance companies. The federal government will need to require states to implement the proposed CRA requirements, which will result in an additional administrative burden to the states.

Finally, the CRA was established to set fair standards for banks operating in low income communities. Some may maintain that expanding CRA beyond the banking realm violates the spirit of the CRA. However, Congress amends many laws over time as necessary to meet the demands of modern society by either constricting or expanding a law's jurisdiction. Claiming that the CRA was originally established for banks as the sole reason to prevent expanding the law is not in line with existing precedent.

Incentivize Cost Savings

Background

Once a developer completes its pro forma (budget) and is approved by the housing credit agency, a developer has few incentives to manage the project under budget. As previously discussed, LIHTCs are allocated based on Eligible Basis. If a developer saves costs, and Eligible Basis declines, then the developer's project could receive fewer LIHTCs than originally anticipated if there is no excess Eligible Basis. This could create multiple adverse problems for the developer.

First, in 9% Credit deals where LIHTCs are competitively awarded, it will appear to the housing credit agency that the developer requested more 9% Credits than were necessary. This could harm the reputation of the developer and reduce the likelihood of the developer receiving

LIHTCs for future projects. In addition, such a scenario could also negatively affect the state. Chapter 1 highlighted that unused 9% Credits must be returned to the national pool. States cannot simply reallocate returned LIHTCs to other in-state projects and must send them to the national pool.

Second, maximum permissible developer fees are typically calculated as a percentage of either total development costs or Eligible Basis. A reduction in project costs could compel the housing credit agency to force the developer to reduce its developer fee. Since a significant factor in a LIHTC transaction's return metric is developer fee, developers subject to a fee reduction due to cost savings have a disincentive to reduce costs.

Third, equity investors anticipate receiving a certain number of LIHTCs in their investment calculations. Syndicators typically incur the cost of their due diligence and attorneys fees and rely on economies of scale to distribute those costs. If fewer LIHTCs are received, each LIHTC must bear a proportionately greater percentage of syndicator's fixed transaction costs. Syndicators mitigate against the delivery of fewer credits by having downward adjusters that reduce their capital contributions by amounts in excess of the original purchase price if fewer LIHTCs are delivered. Thus, the cost savings results in an even greater reduction of equity proceeds to the owner. However, the adjusters preserve an investor's yield in case of LIHTCs delivered to the investor are less than originally promised.

Recommendation

Developers should be rewarded for saving costs on an LIHTC transaction. One incentive could be to permit a developer to retain 50% of the savings as an additional developer fee. In Massachusetts, the Massachusetts Housing Finance Agency's Priority Development Fund contains a provision that permits a developer to split cost savings with the state. If this change were implemented, developers would be incentivized to save costs because they would personally benefit from the savings.

Second, any credits that are returned to a state through this cost savings program should not be required to be returned to the national pool. As indicated in Chapter 1, states are required to return unused LIHTCs to the national pool if they have not allocated them within one year. Projects that realize cost savings will most likely be returning LIHTCs after that one year period. Therefore, states should be permitted to retain returned credits for at least one additional year so the states can redistribute them to other affordable housing developments in the state.

Counter Arguments

Some argue that developers may intentionally over estimate costs in their initial application to the housing credit agency. By overestimating costs, developers can then benefit from cost savings by realizing an increased developer fee under the proposed cost savings program. However, if the housing credit agency completes thorough due diligence on a proposed project to ensure costs are reasonable at the outset, regulatory oversight should ensure the system is not abused. Housing credit agencies typically finance numerous developments of similar character throughout the state. They are able to draw on their database of costs from other developments as a comparison to protect against a developer manipulating the system.

The issue of preserving an investor's return expectations if fewer LIHTCs are delivered due to cost savings is addressed through adjusters. Syndicators set the adjusters so that if fewer LIHTCs are delivered to an investor, the "adjusted" LIHTC price will compensate the syndicator for its overhead. The adjustment will also maintain the investor's return requirements.

Housing Credit Agency Costs Surveying and Sponsor Competency Review

Background

Housing credit agencies tend to have a highly trained workforce, but many agencies are understaffed and overworked. They typically schedule only one or two funding rounds annually for 9% Credits and receive dozens of applications which they need to review. They may hire consultants to review construction costs and plans and specifications and provide feedback. Their ability to complete thorough due diligence is very limited, and in order to prevent any

sense of impropriety, there is typically little interaction between the developer and the housing credit agency once the application is submitted. Construction and soft costs also vary significantly between properties in the same community and the viability of a transaction can be difficult to determine. Housing credit agencies may not have the expertise on staff to understand those variances and underwriting complexities. In addition to their responsibility in allocating LIHTCs, housing credit agencies must monitor all of the properties that have received LIHTCs, which further stresses their capacity.

Recommendation

A system that incorporates better cost monitoring should be established to enable housing credit agencies to better assess the viability of a proposed development. This could include maintaining a statewide database segregated into nationally standardized, individual budget line items. In addition, states should be required to submit their databases to a national database of costs so that each state can compare their costs with other states, especially those that best mirror their own state. A national database would also enable Congress to better assess the LIHTC program. Congress should explicitly not use the data to punish high cost states, especially if Congress mistakenly compares them to low cost states. Instead, Congress could use it to compare high cost states against each other (and low cost states against each other) to encourage improved cost control. This proposed change would also bolster the previous recommendation regarding monitoring costs and incentivizing savings.

In addition, housing credit agencies should receive funding to retain additional engineering, design, construction, and finance professionals as staff members to assist in ensuring costs are reasonable. It is important that these professionals are hired on the staff level rather than as consultants. As staff members, these individuals will more likely retain ownership over their decisions and follow the project through completion, rather than simply collecting a fixed fee for specific consulting services. These staff members can also work with the developer and contractor to formulate cost saving strategies that will result in the state ultimately being able to allocate LIHTCs to more projects.

Finally, states need to better identify credit worthy and experienced sponsors before allocating LIHTCs. A number of for-profit and non-profit sponsors were awarded LIHTCs prior to 2008 that did not have the capacity to construct and manage a feasible LIHTC development. This represented a failure of the entire LIHTC system as overly aggressive investors eager for LIHTCs also invested in these transactions. As much as the investors were at fault for questionable due diligence by investing in these transactions, states were also at fault for allocating LIHTCs to these deals. Utilizing staff finance professionals, state housing credit agencies should be better equipped to assess a sponsor's strength and a proposed deal's viability. Like Fannie Mae and Freddie Mac's staffers, the LIHTC program should assist state housing credit agencies with funding to retain professionals at salaries competitive with the market.

Counter Arguments

These additional measures will increase the cost to monitor the LIHTC program. Retaining additional professionals and establishing a database is time intensive and will initially require time and effort. However, the reduction in costs afforded by this program should offset any additional overhead. Due to the current economic climate where the federal deficit is soaring and states are eliminating numerous programs, it is likely that Congress may want to wait for the economy to rebound before implementing this recommendation.

Require Syndicator Disclosure

Background

Syndicators serve an enormously important purpose in the LIHTC program. The program is extremely complex and can be navigated only by the most sophisticated professionals. Syndicators understand LIHTC's intricacies, possess a legal framework for completing transactions, and can professionally assess proposed transactions from a real estate perspective. Although corporations can directly invest with LIHTC developers, the majority of LIHTC transactions are consummated through syndicators.

The LIHTC is a very well regulated program that establishes maximum developer fees and dictates that costs must be reasonable. Housing credit agencies carefully review all costs prior to allocating LIHTCs. Once a development is complete, certified public accountants meticulously review each invoice to ensure that expenditures comply with LIHTC program requirements. Despite the strict regulations governing costs and developer profits, there are no regulations to ensure that syndicator profits are reasonable.

Recommendation

Treasury should require syndicators to disclose both gross and net profits in a publicly available document. This proposed regulation would function in a similar manner to the Securities and Exchange Commission's (SEC) requirements for the mutual fund industry. The SEC mandates that all mutual funds disclose their load (fees, etc.) to prospective investors so that the investor can evaluate the reasonableness of the fund's profits.

Requiring syndicators to provide this information will enable Congress, Treasury and potential investors and developers to evaluate syndicator profits. Many in the LIHTC industry believe syndicator profits are well controlled by their investors; therefore, capping profits at this juncture is unnecessary. However, since there are no publicly available data to reinforce this assertion, mandating that syndicators provide the information will permit policy makers to appraise the reasonableness of syndicator profits.

While it is likely that syndicators' profits are not unreasonable, the fact that so few syndicators exist in the market is concerning. According to FannieMae, there are only 10 registered syndicators of LIHTC transactions.⁸⁵ This is contrast to nearly 700 investment management firms operating in the US that represent 16,262 investment funds.⁸⁶ Assuming the LIHTC industry syndicates \$3.3B of equity annually, it results in an average of \$330M of equity

⁸⁵ *Equity Syndicators*. EFannieMae.com. Web.

<<https://www.efanniemae.com/mf/refmaterials/lenderinfo/equitysyn.jsp>>.

⁸⁶ *2009 Investment Company Fact Book 49th edition A Review of Trends and Activity in the Investment Company Industry*. Rep. 49th ed. Washington: Investment Company Institute, 2009. pgs. 12 and 15. Print.

investment per syndicator.⁸⁷ In contrast, in 2008 investment companies managed \$10.349T of equity investment resulting in an average of less than \$15M per investment company.

Therefore, on a per company basis, LIHTC syndicators are controlling approximately 22 times the amount of capital that an average investment company controls. This indicates that there may be too few LIHTC syndicators in the market and that a potential monopoly may exist that could exploit the LIHTC market.

Counter Arguments

Some industry professionals claim that corporate investors that typically invest with syndicators understand the market value of LIHTCs and make certain that syndicators' profits are not excessive. The corporations or banks typically invest with multiple syndicators or on their own account and therefore are well versed in LIHTC pricing. However, it is unclear as to the benefit afforded to an investor that stringently negotiates with a syndicator. For example, assume an investor purchases \$100 of tax credits for \$90 and the syndicator takes a \$10 fee resulting in a net \$80 equity contribution in the LIHTC transaction.

In many cases, LIHTC generated equity represents the only equity in the transaction since hard and soft debt sources make up the difference of the development budget. The investor receives \$100 in tax credits and its percentage interest in the losses. If the syndicator took a higher or lower fee, the investor would still retain the same \$100 of tax credits and most likely the same percentage interest in the losses. Therefore, it is unclear as to whether the investors possess a strong motivation to contain a syndicator's profit. Therefore, under the current syndicator – investor – sponsor structure, the sponsor would have to be the motivated party to ensure that the syndicator is not unreasonably profiting. During strong economic times this is more feasible

⁸⁷ The estimate of \$3.3B was calculated by using the 2008 Mid-Year Tax Credit Update chart "1st Half 2008" included in Donna Kimura's *Affordable Housing Finance Article* entitled Syndicators "Predict Better But Still Restrained Second Half", October 2008. The calculation totaled the 1st Half 2008 equity raise and multiplied it by 2 to estimate the annual raise. The author acknowledges this is an estimate as a syndicator's capital does not necessarily correlate with invested equity. However, it represents the best estimate available at the time of writing and is likely close to the actual amount invested.

as competition among syndicators is strong, while during weak economic times it could be virtually impossible for a sponsor to enforce syndicator profit limitations.

Second, some suggest that if syndicator profits are capped then the few remaining syndicators in the LIHTC market will exit. This may be a valid concern, which is why the suggested proposal herein only requires syndicators to disclose profits rather than capping profits. However, under the LIHTC program, developer fees are capped and there are numerous developers engaged in LIHTC transactions. The capping of fees has not deterred developers from entering the LIHTC market. If syndicator fees are eventually equitably regulated, this hopefully should not deter syndicators from engaging in the LIHTC market.

It is important to note that syndicators represent a strong lobbying effort in the LIHTC community. Syndicators, along with attorneys, consultants and others that represent them, are well funded and excel at lobbying Congress on behalf of the entire industry. The changes implemented as a result of their diligent work have been overwhelmingly positive and cost effective for Treasury. That being said, any changes to the LIHTC regulations that could infringe on syndicators' profits would be aggressively challenged by this lobbying force.

Consolidate Transaction Costs and Legal Documentation

Background

Under the existing affordable housing subsidy system, there are multiple subsidies, each with their own set of legal documents, transaction costs, and fees. For example, there are separate application fees to apply for HOME funding, state LIHTCs, federal LIHTCs, bond financing, etc. There are separate issuance fees for each of these subsidies as well that can range upwards of \$100,000 for a bond issuance. In addition, each subsidy has its own set of legal documents that must be negotiated separately with different sets of attorneys that charge significant fees and cost the developer considerable time and overhead. Finally, each subsidy program has its own monitoring fees once the property is operational that must be paid annually to each regulatory authority that oversees the particular subsidy.

Recommendation

Rather than having multiple application fees, monitoring fees, etc., there should be a single application and issuance fee that is reasonable and that accommodates the necessary overhead of the state agencies. State agencies should be required annually to justify the application fee amounts through a public disclosure process to ensure that the fees do not exceed reasonable standards. In addition, with LIHTC properties that have multiple subsidies, only one state agency should be required to monitor the property for compliance and only one monitoring fee should be required. By consolidating these tasks and fees, the LIHTC program can reduce development costs and can more effectively spread resources.

In addition to the duplicative fees described above, transaction costs for multiple sets of legal documents are excessive. States should be encouraged to develop one set of legal documents for transactions that incorporate multiple subsidies. Although most syndicators and investors will likely still require their own set of legal documents, the ability to consolidate all other subsidy and loan documents will reduce the amount of review by all parties. The Massachusetts Housing Partnership's MassDocs (<http://www.massdocs.com>) program is an excellent example of an agency consolidating legal documents. MassDocs consolidates 11 of Massachusetts's state and local funding sources into a single set of documents.

Counter Arguments

Requiring state agencies to justify their fees is an administrative burden that will cost time and money. However, better regulation of fees will preserve scant subsidy dollars for their intended purpose – affordable housing investment. Consolidating monitoring duties to a single agency could be complicated, as different subsidies have different monitoring requirements. This can be alleviated by establishing a central monitoring agency knowledgeable about all subsidies. This will relieve subsidy allocating agencies of their monitoring responsibilities and will avail them more time to focus on selecting viable deals. It will also permit property owners to pay one fee to a single monitoring agency that will save costs and facilitate better resource allocation.

Replace LIHTC Program with a Grant Program

A number of policy makers and industry professionals believe the LIHTC program is inefficient and should be replaced by a grant program. They argue that there is a breakeven point where it would be more efficient for Treasury to issue direct grants instead of tax credits to fund affordable housing. The issuance of grants in lieu of LIHTCs would eliminate inefficiencies and high transaction costs inherent in LIHTC transactions that have been described herein.

An estimate of the breakeven point for Treasury can be conducted utilizing a simple net present value (NPV) calculation. One can utilize the current 10 year Treasury note yield and \$1 of LIHTC investment that will be distributed proportionately over ten years. This analysis assumes that Treasury could either allocate the credits to investors or that it could borrow the \$1,000,000 at the 10 year yield and immediately distribute the LIHTCs to a developer as a grant. The analysis can be summarized in the following chart:

Figure 8: Net Present Value Analysis to Determine Treasury LIHTC Breakeven

| | |
|---|-----------|
| 10 Year Treasury Note Yield (as of 7/30/09) | 3.60% |
| Investment Amount | \$ 1.00 |
| Year 1 | \$ (0.10) |
| Year 2 | \$ (0.10) |
| Year 3 | \$ (0.10) |
| Year 4 | \$ (0.10) |
| Year 5 | \$ (0.10) |
| Year 6 | \$ (0.10) |
| Year 7 | \$ (0.10) |
| Year 8 | \$ (0.10) |
| Year 9 | \$ (0.10) |
| Year 10 | \$ (0.10) |
| Net Present Value (NPV) | \$ (0.83) |

The above analysis concludes that currently an LIHTC price below \$0.83 per \$1 tax credit results in the Treasury losing money in the program. In 2007, when some LIHTCs were selling upwards of \$1, the 10 year Treasury note yields were in the 5% range, resulting in a breakeven of \$0.77 and the program generating a significant benefit. Although many argue that the LIHTC program

should be eliminated in favor of a direct subsidy program, there appears to be no appetite in Congress for such a program. Both political parties favor the LIHTC subsidy as it is an indirect subsidy that funds affordable housing.

It is ironic that on the one hand affordable housing is in tremendous demand in the United States, but on the other hand the LIHTC program and other affordable housing subsidies have incredibly high barriers to entry. Developers must have in-depth knowledge to navigate the subsidy programs in order to successfully complete a development. A developer must also be sophisticated, well financed and patient in order to survive the multi-year periods often required to obtain the subsidies. The LIHTC program is so complicated and intricate that it is impossible to conceive of ways to make it less complicated and to reduce barriers to entry without an entire overhaul of the program. Such an overhaul would negate 23 years of clarifications and improvements and is politically infeasible at this point.

However, fundamentally the LIHTC program has functioned for years with great success. Replacing LIHTC with a grant will subject it to annual appropriations. This would make it easier for Congress to eliminate a grant program since appropriations must be renewed annually whereas the LIHTC does not require annual appropriations. In addition, although the LIHTC is regulated, there is consensus from all industry sectors that Treasury does not overly regulate the LIHTC. This is in contrast to other subsidies that industry professionals agree are sometimes excessively regulated and have cumbersome requirements. Finally, a grant program will exclude the private sector from participating in affordable housing transactions. As this thesis demonstrated, private sector involvement has been crucial to the LIHTC program's success and is a crucial component for Congress. Therefore, replacing LIHTC is politically impractical at this time and is not worth contemplating.

Conclusion

Despite the changes enacted in HERA 2008 and ARRA, the LIHTC can be significantly improved. The recommended changes discussed in this chapter are those that are most pragmatic. They should positively impact the federal budget and maximize the LIHTC's value. If Congress

enacted these changes, it would be taking necessary steps to reenergize the LIHTC investment market.

Conclusion

The LIHTC program is an invaluable resource for the construction and rehabilitation of affordable housing. While naysayers dispute its efficacy, it has been the most successful and productive affordable housing program in the nation's history. This thesis argues that although the LIHTC program historically functioned well, the economic downturn severely affected its ability to persist. If Congress and the LIHTC advocacy community can implement additional legislation that incorporates the changes discussed in Chapter 3, the program will better serve its intended purpose.

Additional Research

One of the more challenging aspects in writing this thesis was the dearth of available data on LIHTC transactions. HUD publishes the Low-Income Housing Tax Credit database, but its data only reflects information provided to it from the states. This data is inconsistent among states and can be difficult to decipher. Industry advocacy groups also compile their own data and issue compelling studies. However, there is no central repository for uniform LIHTC property and program data. This complicated the task of retrieving data to support a number of claims, and I was forced to rely on industry professionals' experiences without the full support of data.

Although industry advocacy groups conduct extremely thoughtful and thorough research on the LIHTC, further independent and academic research is necessary to compile information on LIHTC projects. Specific topics might include: the need for additional subsidies in LIHTC transactions, the characteristics of LIHTC transaction mortgage terms versus non-LIHTC transactions, the average equity raise and the amount of tax credits allocated per unit in different geographic regions, and the cost of LIHTC units versus market rate units utilizing actual construction cost data. A researcher who collects this LIHTC information and analyzes it could notice trends and could expose problems that may instigate additional changes to the LIHTC program.

The disconnect between academia and practitioners is significant and the two fields should attempt to bridge that gap. After reviewing academic literature concerning the LIHTC program, it became apparent that many academics do not truly understand the program's mechanics. For example, one scholar attempted to predict an investor's yield based on the investor's projected receipt of cash flow and tax credits. As you know from this thesis, investor returns are predicated on tax credits and losses. Cash flow is a negligible component in an investor's yield calculation. LIHTC advocates could benefit from academia's research skills and analysis abilities, while academia could benefit from learning the program's intricacies from practitioners.

Final Thoughts

Although the recent temporary grant legislation served an important purpose, I think that Congress must ensure that it does not continue to extend the grant programs longer than necessary. Providing grants in lieu of tax credits may be a slippery slope, and one that ultimately makes the program more vulnerable to budgetary concerns. Congress should implement a gradually declining system of soft subsidy while strengthening the LIHTC program so that additional private capital is encouraged to invest in LIHTC transactions.

In the near-term, I think that Congress should encourage as much co-investment with the Tax Credit Exchange Program (TCEP) as possible to continue engaging the private sector. Standing alone, TCEP erodes one of the more favorable aspects of the LIHTC program – private sector oversight. By encouraging co-investment with Treasury, investors can increase their yields and make the investments more attractive.

Some of the proposed changes in Chapter 3 are politically risky and difficult for policy makers to consume. However, now is the time to actively engage pragmatic solutions to realign private investment interests with the LIHTC market. LIHTC advocacy groups have successfully lobbied Congress for changes that have fortified the program. Congress and these groups must work together to act on not just politically favorable proposals but all proposals that will assist the LIHTC program. These changes would not only promote the affordable housing industry, but

more importantly, they would benefit the disabled, children, families, elderly and communities that the LIHTC program so vitally serves.

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Appendix 1: Partial List of Interviewees

Aaron W. Stevens, Director, Centerline Capital Group

Carol Galante, Deputy Assistant Secretary for Multifamily Housing Programs, Department of Housing and Urban Development

Catherine Racer, Associate Director, Massachusetts Department of Housing and Community Development

Charles Edson, Senior Counsel, Affordable Housing, Nixon Peabody LLP

David S. Gasson, Vice President, Director of Corporate Communications, Boston Capital Corporation; Executive Director, Housing Advisory Group

David Greenblatt, Senior Vice President for Finance, Beacon Communities LLC

Forrest Milder, Partner, Syndication and Tax, Nixon Peabody LLP

Howard Cohen, Chief Executive Officer, Beacon Communities LLC

Kathleen Sheehan, General Counsel, Beacon Communities LLC

Lauren Bazel, Senior Advisor for Tax Policy, Senator Maria Cantwell (D-WA)

Mark P. Keightley, Ph.D., Government and Finance Division, Congressional Research Service

Paul E. Bouton, Partner, Real Estate & Community Development Department Head, Nixon Peabody LLP

Paul M. Hoffman, Managing Director, CityScape Capital Group, LLC

Richard Goldstein, General Counsel, Affordable Housing Tax Credit Coalition; Partner, Nixon Peabody LLP

Robert Rozen, Partner, National Tax, Ernst & Young