

The Exchange Provision of ARRA: An Incomplete Solution for the LIHTC Industry

By Michael J. Novogradac, CPA

As I write this on February 17, President Barack Obama is in Denver, about to sign into law the \$789 billion American Recovery and Reinvestment Act (ARRA) of 2009. The new law is one of the broadest economic packages in decades, a plan designed to rescue a failing economy, create or retain millions of jobs and stimulate consumer spending. Agreement on the legislation did not come easily and the president's desire for bipartisan support was not to be. All the Republicans and a handful of Democrats in the House voted no, and only three Republicans in the Senate voted yes.

The final bill included mixed results for the low-income housing tax credit (LIHTC) community. Despite considerable support from Senate lawmakers and significant last minute grassroots efforts, the LIHTC accelerator provision that was passed as part of the Senate bill was dropped and was not included in the final recovery package. After the loss of the tax credit carryback provision, the accelerator provision was the last hope for inclusion of a provision in ARRA that had the potential to enhance investor demand for LIHTCs.

On the bright side, ARRA did include two provisions aimed at addressing the troubled LIHTC equity market. The new law includes a \$2.25 billion in gap funding for LIHTC projects as well as the exchange provision that was passed in January in the House bill. The gap funding provision is discussed in more detail in this month's installment of *The Buzz* (on page 12). The Center on Budget and Policy Priorities (CBPP), which in a February 2 release called the exchange proposal a "best fix for low-income housing tax credit," saw the exchange proposal as offering the most cost-effective way to promptly and reliably restore LIHTC-funded affordable housing production — and consequently to stimulate substantial economic activity. This view is not shared by all industry stakeholders.

The exchange provision explained

The low-income housing tax credit exchange provision allows state housing credit allocating agencies to exchange up to 40 percent of their 2009 volume cap credits at the rate of 85 cents per credit. State housing agencies may also exchange up to 100 percent of LIHTCs carried into or returned in 2009 at the same rate of 85 cents. Novogradac & Company estimates that under the exchange program, state housing credit agencies have the potential to convert more than \$3 billion in LIHTCs for more than \$2.7 billion dollars in cash.

Under the program, the Treasury Department grants the exchange proceeds to state housing credit agencies. The state housing agencies, in turn, must use the grant proceeds to make subawards to finance the construction, or acquisition and rehabilitation of affordable housing. It appears that congressional intent was that the grant money would not be taxable income to recipients. The grant money can be awarded to finance buildings without an allocation of LIHTCs; however, the state needs to make a separate determination that the award would increase the total funds available to the state to build and rehabilitate affordable housing. In all cases, any building receiving grant money is required to satisfy the LIHTC rules.

Questions abound

There are many unanswered questions, but David Gasson of the Housing Advisory Group says he doesn't take as dire a view as some others who see the failure of the accelerator as a significant blow to our industry. He notes that a lot can still be done with the legislation that passed, that there are ways to engineer the provision to make the 85 cents work for everyone. "If people are proactive, they will look for ways to make the exchange proposal work," he says.

(continued on page 2)

Exchange Provision

(continued from page 1)

Because of their great need for affordable housing, Gasson says, states will be looking for ways to make the new legislation work. "Assume I am sole investor in a project [because no equity investors can be found] and I am solely responsible for the project, the state is not keen on taking on that role, so ways will be found to exchange allocations as secondary equity or grants. Not primary equity but perhaps equity to fill some gap when investors come in."

William Pavao, executive director of California Tax Credit Allocation Committee (TCAC), says the exchange provisions could be very helpful for projects that either cannot attract an equity partner, or attracted an equity partner but at pricing that leaves a funding gap. In the short term, Pavao says, the state may be able to work with 2008 credit recipients by either exchanging all of their reserved credit for a loan or grant, or exchanging some of their credit for a smaller loan or grant.

The downside of the new bill, Gasson says, is that there's nothing in it aimed at attracting new investment. The Hous-

ing Advisory Group's goal when working for passage of the accelerator was to bring in new investors and equity. "We cannot rely on the investment of recent years and we're going to suffer because of it," Gasson says. "We need to see if there's a way to drive up yield without bringing down price. It's going to be difficult and we'll have to wait to see what happens, but in the meantime we continue to work on expanding the investor base."

CBPP sees private investors continuing to play a central role but does not address the issue of new investors. It contends that the majority of LIHTCs will still be sold to private investors and that the exchange is designed as a short-term response to the sharp drop in investor demand for credits and would apply only in 2009.

David Smith, of Recap Advisors says the exchange provisions should be seen not in isolation but as a part of a package of several linked activities that if done right can help the market revive. The greatest benefits, he says, are flexibility for states with low investor demand, the removal of the temporary oversupply and flexibility for

(continued on page 3)

Journal of Tax Credit Housing Editorial Board

Publisher ♦ Michael J. Novogradac, CPA

Editor ♦ Jane Bowar Zastrow

Managing Editor ♦ Alex Ruiz

Staff Writer ♦ Jennifer Dockery

Technical Editor ♦ Robert S. Thesman, CPA

Contributing Writers ♦ K. David Adamescu, Brandi Day, Rachael McDonald, Buzz Roberts, Jason C. Vargelis, Florence Zeman

Production ♦ Jesse Barredo

Journal of Tax Credit Housing Advisory Board

Frank Baldasare ♦ CW Capital

Bud Clarke, MAI ♦ MMA Financial

Jana Cohen Barbe ♦ Sonnenschein Nath & Rosenthal LLP

Tom Dixon ♦ Boston Capital

Wendy Dolber ♦ Standard & Poor's Corporation

Rick Edson ♦ Housing Capital Advisors Inc.

Anthony Freedman ♦ Holland & Knight

Richard Gerwitz ♦ Citi Community Capital

John Lisella ♦ SunAmerica Affordable Housing Partners Inc.

Philip Melton ♦ Grandbridge Real Estate Capital

Stephen Ryan ♦ Cox, Castle & Nicholson LLP

Sheldon Schreiber ♦ Pepper Hamilton LLP

Arnold Schuster ♦ Sonnenschein Nath & Rosenthal LLP

Rob Wasserman ♦ U.S. Bancorp Community Development Corp.

Journal of Tax Credit Housing Information

Address all correspondence and editorial submissions to:

Jane Bowar Zastrow

Telephone: 415.356.8034

Address inquiries regarding advertising opportunities to:

Carol Hough

Telephone: 415.356.8040

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding the low-income housing tax credit or any other material covered in this publication can only be obtained from your tax advisor.

© Novogradac & Company LLP, 2009 All rights reserved.

ISSN 1940-4980

The Journal is printed using non-toxic soy-based ink. Novogradac & Company LLP encourages readers to recycle

Novogradac & Company LLP
246 First Street, 5th Floor
San Francisco, CA 94105
E-mail: cpas@novoco.com



Exchange Provision

(continued from page 2)

gap financing. The LIHTC market isn't broken, he says, it's just disrupted.

Smith says the House, where the exchange provision was crafted, decided that when confronted with a falling price and a pipeline of deals underwritten at the prefall price, that it would help by taking some commodity out of the market at the prefall price. "The best solution for a price drop is to clear the market of the price and get on with business," Smith says, noting that the present market is an anomaly because the LIHTC has always had rising or level price in its history.

Because tax credit prices are determined by supply and demand, the CBPP contends that the removal of a large number of unsold credits from the market could stabilize or even push up prices for those that remain. It cautions this stand however, noting that it is difficult to predict the extent of the impact. According to CBPP's, higher prices for remaining credits would increase the funds available for development of affordable housing.

Smith has two concerns: how much is to be exchanged and what will be exchanged. He notes that an exchange price of 85 cents is well above market price, which is in the 65- to 70-cent range. "Anyone who can swap, will swap. Eight-five cents is price support, it's artificial," he says, noting he would prefer a 65-cent exchange price. The 85-cent exchange price will create a two-tier market, Smith says, the actual LIHTC equity investment at 65 cents to 70 cents and the LIHTC for cash at 85 cents.

Smith is also uneasy when it comes to swapping allocated credits not sold and turned back by a developer. Non-allocated credits are straightforward, he says, "[The allocating agency] turns back credits, [the federal government] sends money, I fill gaps where I want to and all at above market price, so it's not so bad in this case." On the other hand, if credits have been allocated and the developer has the credits but no home for them, then the state allocating agency cannot make an exchange unless the credits are turned back to it. The problem here, according to Smith, is the price floor that will be attached to deals. "We know a substantial amount from 2007 and 2008 allocations remain unsold, we could have a huge stampede," he says. "An open-ended swap risks creating

a pricing support system that could destroy the LIHTC delivery system."

Smith agrees with Gasson but differs from the CBPP view in that from a technical perspective, the exchange provision provides no economic stimulus (except, Smith says, the potential stimulus of unsticking some deals if it is implemented very quickly, faster than would otherwise). It was attractive to Congress because its budgetary impact is perceived as essentially zero – it exchanges a tax expenditure for an up-front cash expenditure. Many believe that the budgetary estimate that concluded that at 85 cents on the dollar, that the budgetary impact is essentially zero, is not accurate. Critics note that the 85 cents is the fixed up-front cost to the federal government, whether or not the housing being subsidized is provided for the full compliance term. However, the future tax expenditures can be recaptured if the housing being subsidized is not provided for the full compliance term. As such, the actual cost of the provision may ultimately be more, potentially much more. Such critics also note that a portion of the 85 cents will be used directly or indirectly to cover asset management and other expenses being assumed by state allocating agencies. Such expenses are currently being borne by tax credit investors. In any event, CPBB argues that the added resources that the exchange would provide for affordable housing production would generate short-term economic activity that would not otherwise occur.

While the exchange and current credit system would cost the federal government similar amounts through 2019, according to the CBPP, nearly the full amount of the exchange grants will go toward affordable housing construction or rehabilitation in the near term. Without the exchange, CBPP suggests part of the expenditure will go to uses that will not generate as much short-term economic activity, including corporate profits (because more companies will be able to buy tax credits at deep discounts) and construction or rehabilitation in later years (because developments that cannot sell their credits will be forced to return the credits for subsequent reallocation to other projects). Moreover, CBPP reports, the exchange would leave in place the core characteristics of the LIHTC.

(continued on page 4)

Exchange Provision

(continued from page 3)

Smith is concerned that because states would receive more funds in exchange for the credits than developers can now obtain from private investors, private equity investors, whose self-interest provides efficiency, would be removed from the market and their place taken by public agencies whose role has been as allocator and without the same degree of motivation and discipline as a private investor. "A compliance-oriented approach is quite different from an asset-protection strategy," Smith said, noting he does not want to see the LIHTC's "fantastic delivery system" get "busted."

State agencies' into the fray

Implementation of the LIHTC exchange provision of ARRA and its many provisions is left to the states. Agencies elect how much, if any, LIHTC they want to swap for cash. Grants or loans could go to whatever subsets that the states decide; those that turn back all of their credits, those that exchange only some or those with particular needs. All of this will take time as each state works through its solutions. Two of the knotty issues facing states are contained in Section 1602 of the recovery bill. The first, Section 1602(c)(1) requires the state agency to determine whether a developer has made efforts to find an equity investor before asking the state agency to exchange credits for grant money. The problem, Gasson says, is that the provision is so nondescript as written that it leaves it wide open to interpretation.

TCAC's Pavao says this provision applies where a TCAC subaward would go to a project without any tax credit allocation. At a minimum, he says, TCAC would need documentation demonstrating good faith efforts to entice an equity partner, and that no investor could be reasonably identified. TCAC is considering a policy de-

cision on whether to establish a floor for credit pricing below which a cash award would be made in lieu of an allocation altogether. "While not perfectly clear, the Act seems to permit such a sub-award if TCAC determines that such use will increase the total funds available to the state to build and rehabilitate affordable housing." Pavao says this clause has meaning only where an allocation could be made to induce in capital, but that the net investment in affordable housing would be less under that course of action.

Section 1602(b)(4) of ARRA specifies that states are to "impose conditions or restrictions, including a requirement providing for recapture, on any subaward under this section so as to assure that the building with respect to which such subaward is made remains a qualified low-income building during the compliance period."

Pavao says this section seems to be referring to an executed regulatory agreement for the subaward. The terms of the regulatory agreement could be enforceable under contract law, or through a deed of trust securing the award and requiring performance. "TCAC is carefully considering the most practical mechanism for ensuring enforcement," says Pavao.

While the industry had hoped to include the accelerator in ARRA and may have lost this particular battle, we continue to fight for legislation that will attract new investors to the LIHTC. To that end, the industry has solidified a core group of congressional support that will serve it well in the next legislative round and have received overtures from those on Capitol Hill that they want to address our issues in the next housing bill. So, it's on to the next battle. ♦

This article first appeared in the March 2009 issue of the Novogradac Journal of Tax Credit Housing.

© Novogradac & Company LLP 2009 - All Rights Reserved

Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking

(continued on page 5)

Exchange Provision

(continued from page 4)

a transaction should seek advice based on their particular circumstances.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.taxcredithousing.com.