

Novogradac Report on Tax Credits
Transcript: February 9, 2010

Total Word Count: 4144

(Intro music)

Hello! It's Tax Credit Tuesday and I'm Michael Novogradac.

Today is February 9th, 2010.

I am in Washington D.C. today. The nation's capital is digging out from heavy snowfall over the weekend, just as they prepare for another heavy flurry tonight and tomorrow.

Senate action on the jobs bill has been delayed, as Senate Majority Leader Harry Reid cancelled yesterday's scheduled legislative session due to the inclement weather. Action is expected later this week, however.

This week's Tax Credit Tuesday podcast will focus on details of the president's proposed budget.

President Barack Obama released his fiscal year 2011 proposed budget on February 1st and called for the termination or reduction of 126 federal programs. These reductions and cuts are expected to generate \$23 billion in savings next year and \$240 billion in savings over the next 10 years. They are also the subject of considerable concern for many in the affordable housing, community development and renewable energy communities.

But before we dive into the budget, I first want to expand on a topic from last week's podcast.

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As I discussed then, the Government Accountability Office, or GAO, released a report on January 29th that suggests that Congress should consider options to simplify the structure of the new markets tax credit.

The GAO suggests two potential options to simplify the program and make additional funds available to businesses. One of which I strongly agree with and one of which I strongly disagree with.

Let's start where I agree with the GAO.

The report suggests changing the related party test. As our regular listeners know, the related party rules require that the test for relatedness be applied after an NMTC investment is made. The GAO suggests the test be applied before the NMTC investment is made. This is a position endorsed by Novogradac & Company, as well as the Novogradac NMTC Working Group and numerous more members of the NMTC community. Go to NMTCWorkingGroup.com to review letters that the NMTC Working Group has submitted to the CDFI Fund on this issue.

I disagree with the analysis the GAO used regarding its second recommendation. The GAO suggests that it may be more efficient if CDEs receive all or part of their NMTC allocation authority in the form of grants rather than tax credits.

In reflecting on the potential benefits of this option, the GAO report notes that when tax credits sell for 75 to 80 cents, per dollar of tax credit, that the federal government is losing 20 to 25 cents of each

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dollar of tax credit. The reports states, and I quote, “In a grant program, these up-front reductions in the federal subsidy could be largely or entirely avoided.”

The error in the GAO statement is that the NMTC trades at a discount in large measure because of the time value of money. The taxpayer claims the credit over six years and a day. As such, they discount the present value of the tax credit. But similarly, the cost to the federal Treasury is less, as the federal Treasury pays the tax credit or the subsidy over time, as opposed to upfront as they would with a grant. If the GAO wanted to greatly reduce this discount, they could have simply suggested allowing the investor to claim the entire amount of the tax credit in the year of the investment as opposed to over six years and a day. This would put the credit more on par with their theorized CDE cash grant program.

The GAO report also notes that tax credit pricing has been falling in connection with declining demand for tax credits. One alternative to prevent this would be to make changes that make the credit more attractive to investors, such as allow it to offset the alternative minimum tax.

There are many other considerations that are overlooked in the GAO’s leap to a CDE cash grant program, not the least of which is recapture risk. By having full recapture risk, plus interest, the NMTC program has a level of compliance oversight and transaction structuring unrivaled by other tax credit programs. This level of structuring and asset management ensures that the goals of the

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federal program are achieved. A direct cash grant program would have its own asset management costs, but would suffer from what economists term “moral hazard” risk, and you might see more CDE investments fail. If the GAO wanted to reduce some of the administrative and oversight costs, they could recommend less burdensome tax credit recapture risks, that would put the NMTC more on par with the theorized CDE cash grant programs.

Moving beyond these two recommendations, the GAO report also recommended that the Secretary of the Treasury take three specific actions:

First, the CDFI Fund director should collect data that show the sale price of NMTCs from CDEs to investors. They should also collect data that shows fees paid by qualified active low-income community businesses to close new markets tax credit transactions. And they should collect data as to the amount of equity that the CDE projects it will leave in the qualified business at the end of the 7-year period during which investors can claim the tax credits.

Second, the GAO report recommends that the Secretary of the Treasury direct the CDFI Fund Director to continue improving strategies for collecting NMTC project-level data, data that clearly identify the potential outcome of each project and avoids the potential for double-counting the outcomes of some projects or undercounting the outcomes of others.

Third, the GAO report recommends that the Secretary of the Treasury collect data on the failure rate of NMTC projects.

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The CDFI Fund did respond to the GAO's recommendations in a letter dated January 21st and that letter is included in its entirety as an appendix to the report. To summarize, the CDFI Fund agreed with the GAO's observation that the current application of the related party rules may have the unintended consequence of limiting equity investments in businesses and real estate projects. The CDFI Fund solicited comments on this issue last year. CDFI Fund Director Donna Gambrell writes in her letter that the CDFI Fund anticipates implementing revisions to the related party requirements in advance of the 2010 allocation round.

However, Director Gambrell contrasts the CDFI Fund's agreement with the GAO's recommended related party changes with its concern about its recommendation to provide NMTC funding in the form of grants rather than tax credits. She lists four concerns in her letter:

- First, she says it is not clear that such a change will make the federal budget more efficient.
- Second, she notes that switching from a tax credit to a grant would require significant programmatic changes on the part of the Treasury Department.
- Third, she voices a concern that program compliance could suffer without rigorous investor oversight.
- And fourth, the letter says it is quite likely that CDEs will be unable to attract the requisite debt if the NMTC investment incentive is removed.

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Each of these four concerns is discussed in more detail in Director Gambrell's letter and I encourage you to read it. A copy of the GAO report can be downloaded from www.newmarketscredits.com. Go to the heading Resources, and simply click on Reports & Research.

The report also recommends that the CDFI Fund collect additional data from NMTC awardees. Director Gambrell writes that the CDFI Fund generally agrees with this recommendation and says in her letter the CDFI Fund will explore options for expanding its current data collection activities. In fact, Director Gambrell's January 21st letter mentions that the CDFI Fund has contracted with the Urban Institute to perform a longitudinal evaluation of the NMTC program.

And on Thursday, February 4th, the fund announced its intent to request approval from the Office of Management and Budget, or OMB, to implement new information collection activities associated with an independent, multi-year evaluation of the NMTC program.

Next week I will discuss the proposal in more detail, but in short the CDFI Fund is planning a one-time information collection effort that involves the program's participants and stakeholders. According to last week's OMB notice, the data collection effort is intended to describe and assess program activities as well as identify project-specific and community-level outputs and outcomes. The report and the data collection will be quite expansive.

Right now, we believe there are no plans for another GAO report on the NMTC. The mandate from the original authorizing

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legislation required the GAO to report in 2004, 2007 and 2010. This mandate has now been satisfied and we are not aware of any additional requests from Congress.

Nonetheless, the Novogradac NMTC Working Group is developing a letter to the GAO, with comments on numerous points contained in the report. I invite our listeners to send me and my partner, Brad Elphick, any comments you think that the NMTC Working Group should make. Brad's e-mail address is brad.elphick@novoco.com. I can be reached at Michael.novogradac@novoco.com.

O.K. Let's get back to the President's proposed federal budget for 2011. We can start by reviewing the provisions of particular interest to the low-income housing tax credit community.

As I mentioned in last week's podcast, President Obama's proposed budget includes an extension - a recommended extension - of the Section 1602 low-income housing tax credit cash grant exchange program that was created by the Recovery Act. Under the proposal, states would be able to exchange

- 100 percent of their unused housing credit ceiling carried forward from 2009, as well as
- 40 percent of their 2010 per capita authority, and
- 40 percent of the state's share of the 2010 national pool allocation, if any.

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States would have until December 31st, 2012 to use the cash assistance.

This extension of the cash grant exchange program was one of the three consensus proposals that won support from the LIHTC community last year. Unfortunately, the president's proposal does not include either of the other two consensus proposals. Those proposals are the two 5-year carryback provisions as well as changes to passive loss rules. However, the consensus group does plan to continue to pursue these proposals on Capitol Hill.

To learn more about the consensus proposals, you can download the archived Tax Credit Tuesday podcast from September 15th, 2009. You can also learn more about the proposals or join the consensus group online by going to www.rentalhousingaction.org.

Now, let's consider other affordable housing provisions, namely those that fall under the funding for the U.S. Department of Housing and Urban Development, or HUD.

In a statement released on February 1st, HUD Secretary Shaun Donovan said the HUD budget focuses on fiscal discipline and creating jobs. He also says the proposed reforms in HUD's housing and community development programs will make them more streamlined, efficient and accountable.

Now, whether or not there is an actual decrease in HUD's budget depends on which accounting approach you use.

The proposed budget includes a HUD budget authority request of \$41.6 billion, this amount is 5 percent less than HUD's enacted

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fiscal year 2010 amount of \$43.6 billion. Under this approach there is a 5 percent reduction in the HUD budget.

The President's proposed budget, however, provides \$48.5 billion in funding for HUD. The higher funding amount is made possible due to estimated collections of \$6.9 billion from credit premiums charged for HUD mortgage insurance and other credit enhancements, namely FHA mortgage insurance. This higher \$48.5 billion amount is \$1.5 billion more than the prior year. This means that HUD's budget was either reduced by 5 percent or increased by 3 percent, depending on how you measure the HUD budget.

Getting into details. The President's proposal would increase low-income housing vouchers by \$1.4 billion over the 2010 funding level; however, the proposal would also reduce funding for supportive housing for the elderly and the disabled. For example, the budget would suspend funding for Section 202 Capital Advance Grants in fiscal year 2011. HUD says this suspension will allow the department to evaluate and re-design the program in a thoughtful, purposeful way with input from a variety of stakeholders. It is expected that many of the recipients of funds that are being cut would get housing vouchers instead.

The HUD budget also proposes long-term fundamental reforms, including launching a new initiative called Transforming Rental Assistance, or TRA. HUD says the initiative would bring its 20th century rental assistance programs into the 21st century. Supporters say TRA will preserve public housing by enabling its owners to

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address the current and future capital needs of their properties, especially by enabling them to leverage private capital. TRA is also expected streamline HUD's 13 separate rental assistance programs. The proposed budget would provide \$350 million to preserve approximately 300,000 units of public and assisted housing. The purpose of this funding is threefold:

- one, to convert rental assistance to a new funding stream;
- two, generate savings by combining voucher programs; and
- three, provide greater tenant mobility.

The fiscal year 2011 budget also proposes funding a new Catalytic Investment Competition Grants program. Under this proposal, \$150 million would be made in competitive grants under the Community Development Block Grant Program, or CDBG. CDBG, as our regular listeners know, is the federal government's largest community development grant program and the Administration's proposal funds it at \$4.83, nearly \$5 billion.

For rural housing, the Obama Administration's budget is a mixed bag.

On one hand, it zeroes out initiatives that were created in past appropriations legislation but were never actually authorized, including USDA's rural rental preservation demonstration program, known as MPR.

On the other hand, funding for the Section 515 rental housing program would be increased from \$69 million to \$95 million.

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Overall, because of the proposed freeze on significant portions of the nondiscretionary funding in the budget that I discussed last week, most other rural housing programs would remain funded at fiscal year 2010 levels.

Moving on to community development funding, there is good news for the new markets tax credit community.

Also as mentioned in last week's podcast, the proposed budget includes an extension, yes an extension, of the new markets tax credit through 2011, with an allocation amount of \$5 billion for each of 2010 and 2011. The proposal would also permit the NMTC to offset the alternative minimum tax or AMT.

The budget proposal provides \$250 million for the Community Development Financial Institutions or CDFI Fund. In a statement about the budget proposal, Treasury Assistant Secretary for Financial Institutions Michael Barr said that President Obama's strong support for the CDFI Fund and the new markets tax credit in his budget will help to bring jobs and hope to America's distressed communities.

The administration also announced a new Small Business Lending Fund, which would transfer \$30 billion from the Troubled Asset Relief Program or TARP to invest lower-cost capital in Community Development Financial Institutions or CDFIs. This program would require congressional approval.

The Small Business Lending Fund would be targeted at community and smaller banks that lend the most to small businesses,

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and it would offer incentives for banks to increase small business lending.

CDFI Fund Director Gambrell and Advisory Board Chairman Bill Bynum issued statements in support of the fund proposals. Director Gambrell said that resources deployed through this new initiative would certainly be used expeditiously and wisely by CDFIs to spur economic growth and create needed jobs. Chairman Bynum noted that the fund recognizes the impressive track record of CDFIs and their responsible business lending.

In the fiscal year 2011 budget plan the administration also proposed to make the Build America Bonds permanent at a federal subsidy level equal to 28 percent of the coupon interest on the bonds. The proposal would also expand the eligible uses for these bonds.

Build America Bonds are a borrowing tool for state and local governments that was created by the Recovery Act. The Treasury Department provides refundable tax credits to issuers to subsidize a portion of their borrowing costs. The amount is equal to 35 percent of the coupon interest on the bonds. There are no volume limitations on issuance of Build America Bonds for 2009 and 2010, but authority to issue these bonds is set to expire at the end of 2010.

The administration says that the Build America Bond program has been successful and has expanded the market for state and local governmental debt. In the General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, also known as

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the Green Book, the Administration reports that through December 2009, more than \$64 billion in Build America Bonds were issued in more than 779 transactions in 45 states. The Green Book also says that making the Build America Bond program permanent could promote market certainty and greater liquidity.

Now to wrap up my budget remarks, let's take a look at the provisions related to renewable energy finance.

President Obama's budget request includes a number of notable investments in clean energy.

Specifically, the request includes:

Lending authority to support approximately \$40 billion in loan guarantees for innovative clean energy programs;

More than \$108 million for research in the areas of wind, solar and geothermal energies;

More than \$217 million for science research and discovery; and \$300 million for the Advanced Research Project Agency.

The Solar Energy Industries Association says that the budget represents a 22 percent increase from last year's spending for solar. In a statement following the budget's release, the group noted that a number of renewable energy initiatives would see increases at a time when most of the government received substantial budget reductions. In addition to these provisions I just described, the president also requested a \$5 billion expansion the Section 48 cap C manufacturing tax credit, a tax credit created by the Recovery Act.

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Treasury Secretary Tim Geithner spoke about this expansion in his testimony before the Senate Finance Committee and in front of the House Ways and Means Committee last week. He said because it is an expansion of an existing program, there are already worthy businesses ready to receive the benefit and so the additional amount will go to work quickly creating new jobs.

The proposed budget also includes several program reductions as well terminations of certain energy subsidies, including eliminating more than \$2.7 billion in tax subsidies for the oil, coal and gas industries. If it is approved by Congress - and that's a very big if - this change is estimated to generate more than \$38.8 billion in revenue for the federal government over the course of the next 10 years. It's worth noting that in the past this proposal has been met with fervent opposition.

The next steps in the budget process will take place in Congress where the House and Senate budget committees will draft their budget resolutions.

Generally speaking, the draft resolutions are usually drawn up by early April and then they are submitted to their respective floors for consideration.

Last week, the Senate Finance Committee and the House Ways and Means Committee held a series of hearings on the budget. Those hearings featured the testimony of Treasury Secretary Geithner and OMB Director Peter Orzag.

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We are going to follow this process closely and I will update you in future podcasts. We will also provide breaking news email alerts when developments warrant. If you don't already receive these free email alerts, I encourage you to sign up and enter your email address in the form at the bottom of the page.

These e-mail alerts are FREE, yes, FREE So once again, I encourage you to register. Simply go to www.novoco.com

Then just select which news categories are relevant to you; we offer alerts about the low-income housing tax credit, new markets tax credits, renewable energy tax credits and general HUD news. You can sign up for one, or any combination of the four.

As we near the end of this week's podcast, it's time for the Project Profile segment.

A most notable grand opening was held on February 1st of this year. It was held at the International Civil Rights Center and Museum in Greensboro, North Carolina. It is a grand opening that received national attention, including a National Public Radio segment. The museum and center is housed at the historic F.W. Woolworth building, which was built in 1929.

This is the Woolworth where exactly 50 years earlier, Joseph McNeil, on February 1st, 1960, along with three friends, sat at a whites only lunch counter and asked to be served. McNeil and his three friends became known as the Greensboro Four and after they failed to get served, were spat on, and had beverages poured over their heads, they came back the next day and kept coming back,

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asking to be served. Their nonviolent protest sparked additional sit-ins at other Woolworths throughout the South. By July, Woolworth integrated all of its lunch counters. Their actions were a big step on the road toward ending segregation in America.

The building had fallen into disrepair and was actually going to be turned into a parking lot. With the effort and foresight of many, use as a parking lot was averted and, instead, the building was renovated with funding through an investment coordinated by the Community Affordable Housing Equity Corporation, or CAHEC.

Using state and federal historic tax credits, CAHEC provided nearly \$7 million to support the project. Other financing included new markets tax credits as well as contributions from corporations and individuals.

CAHECs' president and CEO Dana Boole recently told the Novogradac Journal of Tax Credits that the company regularly invests in projects that include federal historic or state tax credits. CAHEC was also awarded \$30 million in NMTCs on October 30th of last year. They plan to use the allocation to support the development of commercial and mixed-use real estate through the rehabilitation of historic buildings.

In addition to helping fund the International Civil Rights Center and Museum, CAHEC says it has invested approximately \$13 million in Greensboro area affordable housing projects, projects serving families, special-needs residents and the elderly.

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Boole told the Journal, quote “Where we’re going to be focusing our energies is going to echo where we invest our LIHTCs.” end quote.

To read more about CAHEC’s investment activities and plans, I invite you to pick up a copy of the Journal of Tax Credits. The February issue features an article that examines a recent trend among tax credit syndicators to expand asset management services for state housing finance agencies and venture into new types of tax credit investment.

Wrapping up this week’s podcast is a review of upcoming events of note on the Tax Credit Calendar.

Tomorrow I head from Washington, D.C. to Orlando to speak at Standard & Poor’s 2010 Housing Conference. The event is titled, “Are We There Yet? Defining the New Normal in Housing Finance.” The event is being held February 10th to the 12th.

Last week, Financial Services Committee Chairman Barney Frank announced that his committee will hold a hearing in a couple of week on March 2nd to begin the process of considering the future of housing finance. The hearing will focus on all the private and public entities that support the mortgage market, including the Federal Housing Administration, FHA, Ginnie Mae, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and private lenders and securitizers.

This hearing is going to get added attention as Barney Frank used the word “abolish” in describing the future of Fannie Mae and

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Freddie Mac. Specifically, to quote him in full, a week or so he said, and again I quote:

"I believe this committee will be recommending abolishing Fannie Mae and Freddie Mac in their current form and coming up with a whole new system of housing finance ... That's the approach, rather than the piecemeal one." close quote

The hearing is described as the first step in a legislative process to determine the future of housing finance and the federal government's role in responsible homeownership and the supply of affordable rental housing. Chairman Frank has invited Treasury Secretary Geithner and HUD Secretary Shaun Donovan to present the Administration's perspective, as well as representatives of the advocacy community, academia, and industry to present their ideas on the future of housing finance.

Well, that brings me to the end of this week's Tax Credit Tuesday podcast.

Please join me again next week when I will review the CDFI Fund's proposal for new expansive and detailed information collection activities that I discussed briefly today.

I will also review guidance that the IRS recently released about the six-month cure period for the NMTC.

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There most certainly will be other breaking news in the podcast next week. I also encourage our listeners to send me an email with topics that should be covered in future Tax Credit Tuesday podcasts.

This is Michael Novogradac and I'll be back next Tuesday.
Thanks for listening.

(outro music)

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