PROPOSALS OF THE AFFORDABLE HOUSING TAX CREDIT COALITION TO STIMULATE INVESTMENT IN LOW INCOME HOUSING TAX CREDIT PROPERTIES

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The Low Income Housing Tax Credit (Housing Credit) has for more than twenty years been the principal financial tool in the production and rehabilitation of rental housing affordable to lower income persons. More than two million rental units have been developed under this program since the enactment of the Housing Credit in 1986. The construction of this housing has had a significant positive impact on the economy and in job creation. Indeed, virtually all affordable rental housing developed in the Nation utilizes the equity capital raised from the Housing Credit. While there are other forms of assistance often utilized in this housing, the one constant in affordable rental development has been the Housing Credit. Approximately 70 percent of all rental housing produced involves this very successful program.

One of the results of the subprime mortgage crisis is that the need and demand for rental housing is increasing and is likely to increase further in coming years. With credit tightening, many people will not be able to find or afford home mortgages and others will simply determine that homeownership is not the right housing option for them.

The Housing Credit industry is now experiencing its own crisis, one that threatens its continued success. The major problem is attracting sufficient investor capital to finance the Housing Credit properties that have received Housing Credit awards from state housing agencies. The economic downturn has dramatically reduced investor demand for Housing Credit investments, particularly in the financial services sector, which has provided a substantial majority of the capital for this program for years. The reduction is dramatic—in 2007, approximately $9 Billion of equity was raised in the Housing Credit industry. For 2008, that amount is likely to be somewhere in the range of $4 to $5 Billion, a reduction in one year of 44% to 55%! Even worse, at this time, there is hardly any investor demand, which means that 2009 could be even bleaker than this year.

The result of this lack of equity capital is that thousands of critically needed affordable rental units will not be built or preserved and lower income families and seniors throughout the country will find it more difficult or impossible to find the decent, safe and sanitary housing produced by the Housing Credit program. Many projects which have been awarded Housing Credits will not be built due to lack of equity capital. Although it is impossible to know this number with certainty, our estimate is that hundreds of projects may not be able to move forward.

The implications of this issue affect employment creation and the economy as a whole. According to economists at the National Association of Home Builders (NAHB)[1], the

[1] The Direct Impact of Home Building and Remodeling on the U.S. Economy, National Association of Home Builders, October 7, 2008 (authors Helen Fei Liu and Paul Emrath) @ www.HousingEconomics.com

development of a typical 100 unit multifamily apartment complex generates 116 jobs, $8,670,900 in income from all affected industries and $3,349,400 in tax revenue (including income, sales and property taxes and other assessments) to federal, state and local governments. Jobs are created in the construction trades and in companies that supply goods and services integral to the development of this housing such as lumber, concrete, lighting fixtures, doors and windows, roofing materials, heating and air conditioning equipment as well as financial services firms, property management companies and other professional service companies.

After twenty years of continued success in the capital markets, why is the industry now unable to raise the needed funds? As noted above, the general economic climate and the unavailability of capital are the major culprits. But other factors have played an important role—Fannie Mae and Freddie Mac together had combined for 30% to 40% of the investor capital over the past several years and for obvious reasons, they are no longer making new investments. In fact, there continues to be widespread concern that the GSE's could begin to sell some of their existing portfolios, which would interfere with raising investment capital for new properties. Most of the remaining investment dollars has come from banks and other financial institutions, which are experiencing their own credit and liquidity problems.

The proposed solutions, outlined below, are intended to 1) help provide direct subsidy that will supplement housing credit equity capital and close the financing gap that will likely exist for most housing credit projects; 2) stimulate new investment from corporate investors which have participated in the program, but whose interest in the Housing Credit has waned, and from new companies which have not previously invested by making the investment more financially attractive; 3) help make projects financed by tax-exempt bonds more attractive and 4) provide flexibility for state housing credit agencies. Some of the keys to stimulating new investment are to make the returns to investors more attractive and to provide greater predictability for investors who are uncertain of their tax liability over a long period of time. In the past several years, demand for Housing Credit investments drove yields to investors to historically low levels and many investors simply found the investment financially unattractive and stopped investing. The remaining investors have, as noted above, been severely impacted by the credit crisis and have either reduced substantially or eliminated their investments in this program. However, we are confident that these investors would be highly motivated to begin investing again if the returns were substantially more attractive.

Our goals are to allow the capital markets to find the level at which new capital will be attracted to this program and, at the same time, assure that projects remain financially viable and soundly underwritten. In order to accomplish both goals, it will be necessary, at least for the short-term, to supplement the equity capital produced by the Housing Credit program, which will be at lower levels, with other forms of subsidy that can be used to fill the gap that will likely occur from the reduced capital that will be available.

We very much appreciate that the Congress passed legislation in July of this year (the Housing and Economic Recovery Act of 2008 or "HERA") which contained some important and helpful provisions pertaining to the Housing Credit program. One of these provisions allows the Housing Credit to be used to offset Alternative Minimum Tax (AMT) liability. We believe that over time these provisions, including AMT relief, will prove to be very useful but the improvements contained in HERA, standing alone, are not sufficient to stimulate the investment needed now to produce this housing.

Coalition Proposals

1) Provide a special allocation of additional direct subsidy to be used exclusively by housing credit agencies to provide gap financing necessary for financial feasibility for properties which have received Housing Credit reservations or allocations (including bond financed properties).

As discussed above, in order to attract Housing Credit equity capital, the investment must be more attractive from a yield perspective. Because yield and Housing Credit pricing (on the basis of price per dollar of Housing Credit) work inversely, this will result in less equity being made available for each project, at least until the equity markets can stabilize and begin producing pricing at or close to prior levels. The result will be that many developments will have a gap in the financing necessary for project feasibility. Our suggestion is that housing credit agencies be provided with a direct subsidy to be used as "soft" loan to project owners that would supplement the Housing Credit equity capital whenever the housing credit agency determines that there is a financing gap (we will refer to this as the "Housing Credit Supplement"). As has always been the case, not all Housing Credit developments will attract the same level of pricing and some properties will have other forms of subsidy that will decrease the financing gap so the amount of Housing Credit Supplement financing that would be necessary will vary from transaction to transaction. The housing credit agency would be in the best position to evaluate the amount of Housing Credit Supplement funds needed for any particular project that had been allocated Housing Credits but which has attracted Housing Credit equity capital in amounts which leave a financing gap.

The Coalition had suggested in prior proposals that these funds be made available under the HOME program. After discussions with others in the Housing Credit industry, although we remain open to the idea of using the HOME program for this purpose, we have determined that it may be more efficient to have a new and separate program authorized. However, if a new program is to commenced, it is absolutely critical that in order to provide the stimulus needed for the economy and for the production of this housing, the program must begin operation immediately and not get bogged down in months of unnecessary regulation writing by Federal agencies. We would strongly suggest that the funds be made available for administration by state housing credit agencies under standards established in each state's qualified allocation plans so that the same agency that is determining the Housing Credit amount can make the determination of the amount of Housing Credit Supplement funds necessary for financial feasibility. This is the same role that these agencies have performed—and performed well--since the commencement of the program so there is no need for additional Federal rulemaking as the states will be well equipped to administer these funds.

We would suggest that the funds be used as a subordinate loan for projects that have some amount of Housing Credit equity but which is insufficient for project feasibility. The Housing Credit Supplement loan would have flexible repayment and interest rate terms so that rents would not need to be raised to pay for the debt service associated with the loan and so that the loan would be treated as *bona fide* indebtedness for federal income tax purposes. Alternatively, the Congress may wish to consider allowing the funds to be treated as federal grants but exempt this from the federal grant rule (contained in Section 42(d)(5)(A) of the Code) so that such grants could be included in eligible basis and not be treated as generating income. In addition, the Congress may wish to consider allowing taxpayers the election to treat the funds (whether as a loan or grant that is includible in basis) to be included only in eligible basis, but not depreciable basis. Some taxpayers may find it more attractive, from a GAAP basis, to avoid the additional depreciation that would be associated with these funds.

The following example demonstrates how the funds would operate to close the financing gap, comparing projects developed in 2007 and 2009 and the impact that decreased equity pricing has on the project's finances. Assume that projects have total development costs of $11 Million and each has a qualified basis of $10 Million and they are not federally subsidized. The 2009 project would generate $9 Million in Housing Credits over ten years (using the fixed 9% credit authorized under HERA). The 2007 project, when the Housing Credit rate floated, would generate $8 Million of Housing Credits, assuming an applicable percentage equal to 8%. Also assume that both projects are able to qualify for a first mortgage loan of $3.0 Million at market rates of interest and both have an $800,000 soft payment subordinate loan from the local government. Further assume that in 2007 (when the Housing Credit market was robust) the owner could raise 90 cents for each dollar of Housing Credit, i.e., $7,200,000 ($8 Million x .9) and that in 2009, the owner can raise only 70 cents per dollar, i.e., $6,300,000 ($9 Million x.7). Table 1 demonstrates the financial consequences in 2007 and Table 2 demonstrates the 2009 consequences:

Table 1—2007 Project		Table 2—2009 Project	
Total Development Cost	$11,000,000	Total Development Cost	$11,000,000
Qualified Basis	10,000,000	Qualified Basis	10,000,000
Total Housing Credits	8,000,000	Total Housing Credits	9,000,000
Sources:		Sources:	
Housing Credit Equity	7,200,000	Housing Credit Equity	6,300,000
First Mortgage Loan	3,000,000	First Mortgage Loan	3,000,000
Local Subordinate Loan	800,000	Local Subordinate Loan	800,000
Total Sources	11,000,000	Total Sources	10,100,000
Financing Gap	$0	Financing Gap	$900,000

Under the Coalition's proposal, the Financing Gap shown above in Table 2 would be funded with a loan of Housing Credit Supplement funds and the project would be financially feasible. Assuming that the Housing Credit Supplement loan carried flexible repayment terms from cash flow, rents would not have to be raised and the project's affordability would be maintained.

We estimate that in light of the number of projects that have received Housing Credit awards but are currently unable to attract sufficient capital to be feasible, there would need to be appropriated $5 Billion for the current fiscal year and that these funds would be available for properties that received or will receive allocations of Housing Credits in 2007, 2008 and 2009 but which have not yet received firm commitments or closed on their Housing Credit equity capital transactions. We would also ask for authorization of appropriations of $4 Billion for FY 2010 and $3 Billion for FY 2011. At that point, we would be in a better position to assess with the Congress and Administration whether continued Housing Credit Supplement funding for this purpose would be needed. Having this subsidy for a temporary period would allow time for the market to rebound and begin to produce sufficient equity capital without the requirement for this level of additional Housing Credit Supplement funds.

2) <u>Taxpayers should be permitted to carryback the Housing Credit for up to five years and these Housing Credits should be used to offset AMT liability during that period.</u>

Under Section 39 of the Code, most business credits, including the Housing Credit, may be carried back for one year and carried forward for 20 years. There is an exception for the marginal oil and gas well production credit, which may be carried back for five years. Until 1997, with the passage of the Taxpayer Relief Act of 1997, the Code permitted a three year carryback of business credits.

A lengthened carryback rule would produce two positive results for the Housing Credit industry that we believe would contribute to increased investment activity. First, investors would know that if their tax liability were to decrease and they were unable to use future year credits, they could be used in any of five prior tax years. This would make the program much more attractive, particularly for companies who are currently profitable but are uncertain about their tax liability in coming years.

Second, companies without current tax liability may be tempted to sell their existing portfolios, perhaps at substantially discounted prices. As a result, other investors, sensing the opportunity to purchase these credits at very attractive prices, have declined to make new investments and that situation has further exacerbated the already depressed market. Although the Federal Housing Finance Agency, which oversees Fannie Mae and Freddie Mac, has stated publicly that the GSEs will not make “wholesale” dispositions of their portfolios, even a partial sale of their very substantial holdings would interfere with raising new capital for new properties. A five year carryback for these companies and others without current tax liability would encourage such taxpayers to use their credits in prior years when they had tax liability; presumably, they would choose to use credits where they would receive a dollar-for-dollar return from Treasury rather than sell their credits for something far less.

As noted above, HERA permits Housing Credits to be used against AMT liability, effective for properties placed in service after 2007. We would ask that the revised carryback rule permit these Housing Credits to be used in the prior five year period. In addition, we propose that Housing Credits arising from properties placed in service before 2008 also be allowed against AMT liability during this period. It is our understanding that for some major Housing Credit investors, a lengthened carryback that is not coupled with AMT relief would not be helpful in that these companies were subject to AMT during the prior five years.

3) Congress should allow additional Housing Credits to be claimed in the first year of the Housing Credit period.

Under present law (Code Section 42(f)(2)), a special rule provides that in the first year of the credit period, the amount of Housing Credits that can be claimed is based on the average occupancy of the building measured at the end of each month during that year. Any Housing Credits that cannot be claimed under this rule are deferred until the eleventh year of the compliance period. For example, if a building with 120 units is placed in service on January 1, 2008 and is occupied at the rate of 10 units per month in that year, the building will generate 50% of its allowable credits in 2008 and the remaining 50% will be deferred until 2018.

The result of this rule is that the value of the deferred Housing Credits is greatly diminished on a present value basis and investors are willing to pay much less for such Housing Credits. An additional way, therefore, to attract greater investment in Housing Credit properties would be to modify this rule to permit, under certain circumstances, the full amount of Housing Credits to be claimed in the first year of the credit period.

The Coalition proposes to modify the first year Housing Credit rule so that a taxpayer could elect to claim up to the full amount of the anticipated Housing Credits in the first year that a building is placed in service, provided that the actual occupancy of low-income units in the building has achieved the minimum set-aside (either 20% or 40%, depending on the owner's set-aside election). The anticipated Housing Credit occupancy would be that required by the housing credit agency and reflected in the Housing Credit allocation documents or the extended low-income housing commitment. In the event that the owner did not achieve the anticipated low-income occupancy by the end of the second year of the credit period and after the issuance of IRS Forms 8609, the owner would be required to reduce the Housing Credits claimed in the second year by the amount of excess Housing Credits claimed in the first year, together with interest. So as not to reduce the Housing Credit compliance period, we would also propose that where this election is exercised, the compliance period would be extended by a period of time that is equal to the number of months in the first year that precede the month that a building is placed in service.

The Coalition strongly believes that this relatively simple and straightforward change could have a very significant effect on the amount of investment dollars generated for this program with little impact on Treasury since the overall amount of Housing Credits to be claimed would not increase.

4) Fix the 30% present value Housing Credit at 4%.

In passing HERA, the Congress wisely decided to fix the 70% present value Housing Credit at 9% (this provision expires for buildings placed in service after 2013). Prior to HERA, the rate floated and had averaged approximately 8% for several years before the passage of HERA. By raising fixing the rate at 9%, Congress permitted states to award substantially more Housing Credits where necessary for financial feasibility—the difference between an 8% and 9% Housing Credit could result in up to 12.5% more Housing Credit equity being generated.

The 9% Housing Credit applies to newly constructed and substantially rehabilitated buildings that are not financed by tax-exempt bonds—the only form of financing that is now treated as a federal subsidy under Code Section 42. For buildings financed by tax-exempt bonds, and existing buildings, the Housing Credit has a present value of 30% but the rate continues to float. In December 2008, the rate is 3.36%.

There is little justification for having the rate on bond financed transactions and existing buildings float while non-bond financed and newly constructed projects enjoy a fixed rate. Not only does the floating rate cause substantial uncertainty, it is also contributes to the financial infeasibility of many projects. Were the Congress to fix the 30% present value Housing Credit at 4%, <u>it would provide the ability to raise over 19% more Housing Credit equity</u> (an increase from 3.36% to 4.0% equals 19.05%). That would help stimulate the market for projects financed by tax-exempt bonds, a market that has largely disappeared over the past several months and it would help preserve existing affordable housing, which is a major priority for many in Congress.

5) <u>The Housing Credit should be made a refundable credit.</u>

One of the most serious problems inhibiting investment is that investors are finding it very difficult to predict their tax liability over the term of the Housing Credit period, particularly in these highly uncertain economic times. Obviously, if a company does not have sufficient tax liability to utilize all its Housing Credits, the value of the investment is reduced and the risk of such an occurrence is a major deterrent in the investment decision. Permitting the Housing Credit to be refundable, i.e., Treasury would provide a cash refund to the extent that a taxpayer is unable to use its Housing Credits, would address this situation and help stimulate investment.

However, in making this proposal, the Coalition wishes to emphasize that Congress should limit refundability with respect to the Housing Credit. It should be refundable only to widely-held C corporations which are publicly traded on an established securities market or regulated investors such as insurance companies, but which do not materially participate in the development or operation of the project (except in circumstances where the corporation has stepped in to that role as a result of default by the project sponsor). Such a limitation would be consistent with the application of the “at-risk” rules under Code Section 42(k), from which widely-held C corporations are excluded. When, as is typical, Housing Credit properties are owned by pass-through entities (limited partnerships and limited liability companies), only partners which meet the qualifications set forth above would be permitted to treat the Housing Credit as refundable. The policy justification for this limitation is to assure that widely-held C corporations, which have played an invaluable role in assuring that Housing Credit transactions are properly structured, underwritten and monitored for compliance, continue to serve that valuable role. One of the reasons that the Housing Credit program has been so successful is this involvement by corporate investors in this process. Indeed, the Coalition would strenuously oppose making the Housing Credit refundable unless it is accompanied by such limitations.

We understand that serious consideration is being given to making several investment and production tax credits refundable, such as those benefiting renewal energy. Although we believe that there is ample justification for making the Housing Credit refundable, it is critical that if Congress determines to make other tax credits refundable, the Housing Credit should be included. Otherwise, the Housing Credit industry would be at a severe and unfair disadvantage in raising necessary capital for low income housing.

We would propose making the refundability feature effective for properties placed in service on and after January 1, 2008.

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We appreciate your consideration of these important proposals. If you have any questions or concerns, please contact either Richard Goldstein, Counsel to the Coalition at (202) 585-8730 (rgoldstein@nixonpeabody.com) or James Miller, Legislative Counsel to the Coalition at (202) 282-5724 (jfmiller@winston.com).

The Affordable Housing Tax Credit Coalition (the "Coalition") is a trade association comprised of developers, syndicators, lenders, nonprofit groups, public agencies, and others concerned with the development and financing of affordable rental housing through the use of the Housing Credit. Since its founding in 1988, the Coalition has worked closely with the Congress in making the Housing Credit a permanent part of the Code and in enacting legislation that has improved the program and allowed it to become the most successful federal rental housing production program in history. We are proud of the role we have played and of the reputation we have developed in educating the Congress about how this program can best serve the needs of low income persons.