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TAX CREDIT

Analysis of Low Income Housing Tax Credit Program

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YELLOW SHEET

The Low Income Housing Tax Credit Is Costly and Inefficient, and Improvements Are Needed in Program Administration

This audit evaluated the Missouri Housing Development Commission's (MHDC) administration and the cost-effectiveness of the state's Low Income Housing Tax Credit (LIHTC) program. The credit is a supplement to the federal LIHTC provided by the federal government to every state. The federal credit began in 1986 with Missouri's state credit being established in 1990. MHDC staff use both credits along with other financing sources to provide financing for new housing construction or rehabilitation of existing properties. Developers submit housing proposals to the MHDC which are evaluated in an annual project selection process. Approximately 37,000 low income housing units have been approved for construction using the state LIHTC from 1998 to 2008. State law requires the State Auditor to perform a cost-benefit analysis of all state tax credit programs, and this report is part of ongoing work.

LIHTC is costly

Through fiscal year 2007, a total of $1.6 billion in LIHTCs have been authorized, and $329 million have been redeemed, resulting in $1.27 billion in credits which remain outstanding or pending issuance. For fiscal year 2007, Missouri ranked second in per capita state funding of all states with state LIHTC programs. Missouri was one of three states with a per capita rate exceeding $20. The other states had per capita rates of $4 or less. At the program's current pace, we project a total of $4.2 billion in credits will be authorized and $1.9 billion will be redeemed by 2020, leaving an estimated $2.3 billion in credits outstanding or pending issuance, with annual redemptions exceeding $100 million. (See pages 14 and 16)

Credits issued and redeemed exceed MHDC projections

State LIHTCs issued and redeemed are significantly exceeding the projections MHDC provided the General Assembly in 1997 when state law changed to allow the state credit match limit to increase to up to 100 percent of the federal credit. MHDC estimated the average state tax credit allocation rate would be 50 percent of the federal credit; however, MHDC matched the federal credit level at a rate of 97 percent in 1998, 99 percent in 1999 and essentially 100 percent from 2000 through the current period. For the period 1998 to 2007, MHDC's analysis projected increased issued and redeemable tax credits for this law change at $107 million. Our analysis, using the assumption of a 100 percent match of the federal credit and considering another issue missing from that estimate, projected the increase to be $383 million. Based on actual data through fiscal year 2007, the 1997 statutory change resulted in a $537 million increase in redeemable credits from 1998 through 2007. (See page 15)

The current LIHTC model is inefficient

For every $1 in LIHTC authorized and issued, the current tax credit model provides only about $.35 towards the development of housing. The remaining $.65 goes to investors, syndication firms, and to the federal government in the form of increased taxes resulting from the use of state tax credits. The audit discusses several options to improve the tax credit model, one of which would allow MHDC to issue approximately half as many credits as are currently being issued while providing the same level of equity for housing development. (See page 17)

Project selection process lacks detail

MHDC staff does not create detailed documentation to disclose how projects are selected to receive tax credits. Of the 50 states which use the federal LIHTC, 46 use some form of scoring system in their project evaluation and selection process. This lack of detail has contributed to the perception that political influence impacts project selection. (See page 26)

Allowable project cost limits are high

The allowable project cost limits used during the project evaluation process exceed cost limits recommended by the National Council of State Housing Agencies. The National Council recommends state housing agencies base cost per unit standards on federal Housing and Urban Development (HUD) guidelines and recommends agencies have a defined methodology to support limits exceeding the HUD guidelines. MHDC staff could not provide documentation explaining the criteria used to establish the higher cost limits. High cost limits do not promote cost containment. MHDC also allows project builder's fees which exceed National Council recommendations. (See page 27)

Improvements are needed in program administration

Weaknesses exist in procedures to recapture tax credits on noncompliant projects. State law also limits the recapture period to 10 years when the minimum compliance period for projects is 15 years under federal rules. MHDC has not developed a strategic plan to assess long-term low income housing needs and establish long-term low income housing goals to measure performance. Also the LIHTC program's economic benefit to the state being reported to the General Assembly is overstated. In addition, MHDC has no policy requiring developers notify tenants when low income housing projects are being converted by developers to market based housing or to aid tenants in relocation. (See page 36)

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Abbreviations

DIFP	Department of Insurance, Financial Institutions, and Professional Registration
DOR	Department of Revenue
HUD	Housing and Urban Development
IRS	Internal Revenue Service
LIHTC	Low Income Housing Tax Credit
MHDC	Missouri Housing Development Commission
QAP	Qualified Allocation Plan
RSMo	Missouri Revised Statutes
SAO	State Auditor's Office

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Missouri State Auditor

Honorable Matt Blunt, Governor
and
Joint Committee on Tax Policy
and
Missouri Housing Development Commission
and
Pete Ramsel, Executive Director
Missouri Housing Development Commission
and
Omar Davis, Director
Department of Revenue
and
Gregory A. Steinhoff, Director
Department of Economic Development
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State law mandates the State Auditor's office perform cost-benefit analyses on state tax credit programs. The audit objectives included (1) analyzing the costs and benefits of the Low Income Housing Tax Credit (LIHTC) program to determine if it is an effective and efficient use of state resources, (2) analyzing the structure of other states' LIHTC programs for potential changes to Missouri's program, and (3) evaluating Missouri Housing Development Commission (MHDC) controls and procedure over management of the program.

We determined the state's LIHTC model is costly and inefficient. In 2007, Missouri ranked second in state LIHTC funding, on a per capita basis, of all states with state LIHTC programs. Assuming tax credits are awarded at a pace consistent with prior years, our projections estimate a total of $4.1 billion in credits will be authorized and approximately $1.8 billion in credits will be redeemed, leaving an estimated $2.3 billion in credits outstanding by 2020. In addition, only $.35 of every tax credit dollar issued is actually used to build low income housing. Options exist to improve the efficiency of the tax credit which include changing to a tax credit model that involves refundable or certificated credits.

MHDC does not provide the public with adequate detail of the project selection process, leading to perceptions of political influence over project selections. In addition, project costs are high because the MHDC (1) has established project cost limits higher than federal Housing and Urban Development guidelines, and (2) allows maximum builder fees that exceed National Council of State Housing Agencies recommendations. In addition, improvements are needed in the state's efforts to (1) recapture tax credits, (2) evaluate the state's long-term low income housing needs, (3) estimate the program's economic impact, and (4) assist tenants during project conversions.

We conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States with the exception of the external impairment of access to tax credit redemption and recapture data from income tax returns which limited our ability to conduct our work. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a basis. This report was prepared under the direction of John Blattel. Key contributors to this report included Jon Halwes, Robert Showers, Ben Douglas, Michael Reeves, and Travis Owens.

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State Auditor

Introduction

Missouri's Low Income Housing tax credit (LIHTC) program started in 1990 and is established under Sections 135.350 to 135.363, RSMo. The tax credit has no expiration. The Missouri Housing Development Commission (MHDC)[1] manages this tax credit program which is designed to supplement the federal LIHTC which began in 1986. Tax credits must be used for new construction, rehabilitation, or acquisition and rehabilitation. The LIHTC had $81.6 million in redemptions in fiscal year 2007, making it the state's third most costly tax credit program that year. See Appendix IV for redemption information on all state tax credits.

Tax credits can generally be broken into three categories. Some are established to create a certain economic benefit, some are established to induce certain social benefits and others are created for both an economic and social benefit. The LIHTC program is designed to create both an economic and social benefit with more emphasis on a social impact. The social impact of more and/or better housing can induce economic benefits in a community and the construction phase of projects produces at least some short term economic impact.

The Internal Revenue Service (IRS) allocates federal LIHTCs[2] to each state based on population. The level of funding was $1.75 per capita in 2002 and has been adjusted annually for inflation beginning in 2003. For 2007, the funding level was $1.95 per capita, which for Missouri equals $11.4 million, and increased to $2 per capita in 2008. Guidelines for the federal LIHTC are in Section 42 of the IRS tax code.

Owners of a project to which the federal credit is allocated receive a federal credit equal to 9 percent of the qualified basis[3] of the project each year for 10 years. Projects financed with tax-exempt bonds receive a federal tax credit equal to 4 percent of the qualified basis.[4] Projects seeking 9 percent credits are awarded on a competitive basis. Projects seeking 4 percent

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[1] The MHDC includes the Governor, Lieutenant Governor, Attorney General, State Treasurer and six persons appointed by the governor with the advice and consent of the Senate. An Executive Director manages MHDC operations. MHDC is part of the Department of Economic Development.

[2] The allocation relates to 9 percent projects only.

[3] Qualified basis is the total cost to develop the property, less items not subject to depreciation (land and reserves) and the cost of market rate units. A project's qualified basis may be increased by 130 percent if it is located in a qualified census tract or difficult to develop area, as determined by the Department of Housing and Urban Development (HUD).

[4] Actual tax credit rates are not exactly 9 percent and 4 percent, and vary on a monthly basis. The tax credit rate is determined so that the actual expected present value of the subsidy over the 10-year period equals 70 percent of the project's eligible basis in the case of the 9 percent credit, and 30 percent for the 4 percent credit. The rates are calculated and released monthly by the United States Treasury.

credits have historically been awarded based on the availability of tax exempt bond financing. Starting in 2007, MHDC implemented a process which prioritizes 4 percent project applications to help ensure the best projects receive priority access to available bond funding.

In 1990, Missouri began supplementing the federal program by allocating state income tax credits equal to 20 percent of the federal total. In 1994, the state credit increased to up to 40 percent of the federal credit for areas that lost housing in the 1993 flood. In 1997, the state credit increased to up to 100 percent of the federal credit for all areas and remains at that level.

The credit is limited to a percentage of the qualified basis, based upon depreciable basis, and the percentage of affordable units in the development. The minimum number of qualifying units is (1) 40 percent of the total number of units affordable to persons at 60 percent of the median income or (2) 20 percent affordable to persons at 50 percent of the median income. Missouri's annual Qualified Allocation Plan (QAP) establishes the selection criteria, federal preferences and MHDC priorities for proposal selection. Congress has delegated the administration of the federal LIHTC to state housing agencies (MHDC in Missouri) to assure that good quality housing would be available where it is most needed. MHDC is responsible for the allocation of federal and state credits, but also with assuring compliance with the regulations. The compliance process includes periodic physical inspections of the property as well as reviews of management and occupancy procedures during a minimum 15-year compliance period.

The tax credit is not refundable.[5] Section 135.353.3, RSMo, allows the credits to be carried back 3 years to offset prior tax liability or carried forward for 5 years to offset future tax liability. The tax credits are sold to investors who must become part of the development partnership and may be redeemed against state income tax, corporate franchise tax, financial institution tax, and insurance company premium tax.

Housing tax credits in other states

Missouri is one of 16 states that have established state tax credits for housing. Eight states[6] only utilize a state LIHTC in addition to the federal credit, three states[7] only utilize a contribution credit which is dependent upon contributions to not-for-profit entities, and three states (Arkansas, Missouri, and Vermont) use both the LIHTC and contribution credit. Two states (Oregon and Tennessee) use a state credit tied to bank loans to

[5] The taxpayer must have a tax liability the credit can be offset against.

[6] States which utilize only a state LIHTC are California, Georgia, Hawaii, Massachusetts, New York, North Carolina, Utah, and Virginia.

[7] States which utilize only the contribution credit are Connecticut, Illinois, and New Mexico.

supplement their federal LIHTC program. Of the 11 states[8] which utilize a state LIHTC, 6 use a 10-year credit period like Missouri, while 5 use a shorter timeframe, varying from 1 year to 5 years. See Appendix II for 2007 funding information on each state utilizing a LIHTC.

Developer Application Process for State and Federal Credits

Developers (for-profit and not-for-profit) are eligible to apply for tax credits. Applicants must demonstrate prior, successful housing experience and engage the services of housing professionals, such as architects, appraisers, attorneys, accountants, contractors and property managers with demonstrable tax credit and housing experience. Developers must have the financial capacity to successfully complete and operate the proposed housing development. Proposed housing developments must:

- Meet a demonstrated affordable housing need
- Provide housing for low income persons and families
- Demonstrate local support
- Leverage tax credit funding with other financing and/or rental assistance
- Be economically feasible
- Balance sources and uses of funds

MHDC sets the application and selection schedule annually. Typically, a Notice of Funding Availability is published during the month of August. Once the notice is released, an application packet is available on the MHDC website or by mail, upon request. The deadline for proposal submission is typically in late October, and MHDC staff makes recommendations to the commission in December or January. MHDC project cost limits are set at 140 percent of established HUD guidelines for 8 designated metropolitan areas[9] in the state; with any projects outside these areas being subject to a 100 percent of HUD guideline cost limit. Tax credits are issued to approved project owners over a 10-year period once the housing is ready for occupancy which is typically 2 years after project approval. A project cannot be approved for state LIHTCs without federal credits also being approved for the project. Projects are generally limited to $7 million[10] in state credits and $7 million in federal credits. The state credit has the same guidelines as the federal credit.

[8] Excluding the two states with credits tied to bank loans which had varying credit periods.

[9] The eight designated metropolitan areas established beginning with the 2007 project year are St. Louis, Kansas City, Springfield, Columbia, Jefferson City, St. Joseph, Joplin, and McDonald County. From 2003 through 2006, the 140 percent of HUD guideline was only applicable to Kansas City and St. Louis and in 2001 and 2002, a 125 percent of HUD guideline applied to Kansas City and St. Louis.

[10] $700,000 in annual credits over 10 years.

Project Funding Sources

Approximately 70 percent of funding for 9 percent LIHTC projects approved during 2005, 2006, and 2007 came from the sales proceeds for state and federal LIHTCs. Other sources of funding include MHDC, federal, and private loans; state and federal historic preservation tax credits; and affordable housing tax credits.

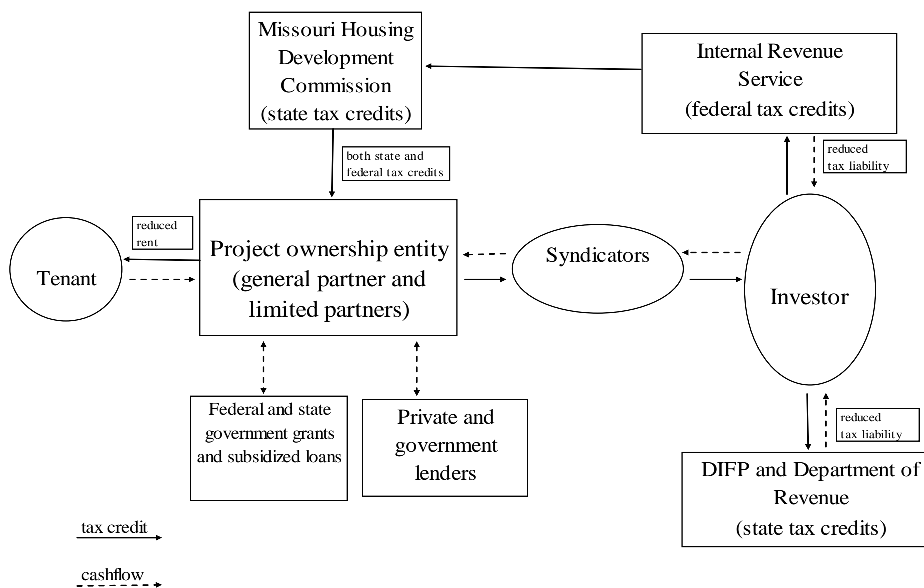
Tax Credit Sale and Investment Process

Developers typically recruit investors as part of a limited partnership arrangement to sell tax credits. The sale is often administered by a syndicator who is responsible for ensuring project compliance with federal tax code rules. Several of the more active syndicators in the state are directly affiliated with developers who are also active in the program. As a general partner, the developer has a small ownership percentage in the project, but has the authority to build and maintain the project on a day to day basis. The investors, as limited partners, have a large ownership percentage in the project with an otherwise passive role. Investors look at the credit, which can be used to offset tax liabilities, as their return on investment. Investors can also receive any tax benefit related to any tax losses generated through a project's operating costs, interest on its debts, and deductions such as depreciation and amortization.

Investors in Missouri typically are corporations. Syndicators told us usually the investors receiving the federal tax credits are different than the investors receiving the state tax credits. In recent years, insurance companies have become big investors in LIHTC projects in Missouri and are redeeming a large portion of the state LIHTCs. The insurance companies use the credits to offset insurance premium taxes.

Figure 1.1 shows the flow of state and federal LIHTCs as part of a typical low income housing project.

Figure 1.1: Flow of Low Income Housing Tax Credits



Source: Pamela Jackson, "The Low Income Housing Tax Credit: A Framework For Evaluation," March 2007 and SAO analysis.

Tax Credit Recapture

MHDC staff monitors each approved project's compliance with federal LIHTC requirements. If non-compliance is identified the owner has up to 45 days to correct the problem, unless an extension is granted. MHDC staff will re-inspect the project, evaluate the status of the compliance problem and file a report with the IRS regardless of whether or not the problem was corrected. Reported uncorrected non-compliance issues may result in recapture of a portion of federal and state tax credits redeemed on the projects. IRS staff determines if federal LIHTCs will be recaptured.

State law[11] bases state LIHTC recapture on the amount of federal credits recaptured. The law requires that if under Section 42 of the IRS code any portion of any federal LIHTCs taken on a low income project is required to be recaptured during the first 10 years after a project is placed in service, the taxpayer claiming credit on the project is required to recapture a portion of any state credits authorized. The state recapture amount shall be equal to the proportion of state credit claimed by the taxpayer that equals the proportion the federal recapture amount bears to the original federal LIHTC amount subject to recapture.

[11] Section 135.355, RSMo.

In order to claim a tax credit, all projects receiving federal LIHTC allocations since 1987 must comply with all eligibility requirements for a period of 15 taxable years, beginning with the first taxable year of a building's credit period. Projects receiving credit allocations after December 31, 1989 are required by the IRS code to comply with all eligibility requirements for an additional 15 years beyond the initial 15-year compliance period for a total of 30 years. This additional 15-year period is referred to in the IRS code as the "extended use period." However, after the initial 15-year compliance period some low income housing projects may be eligible[12] for conversion to market-based rents if the property owner chooses to opt out of the low income housing program.

Tax Credits Authorized, Redeemed, and Outstanding

A total of $1.6 billion in state LIHTCs have been authorized to projects from fiscal year 1994 through 2007,[13] with a total of $571.1 million in credits actually issued.[14] A total of $328.9 million in tax credits have been redeemed from fiscal 1994 through 2007, leaving a total of $1.27 billion in tax credits outstanding or pending issuance, which will be redeemed over the next 10 years.[15] Appendix I, Table I.1 lists detailed information of credits authorized and redeemed by fiscal year, and cumulative credits outstanding or pending issuance.

MHDC has authorized an average of $105.6 million per year in 9 percent state credits for fiscal years 2004 through 2007, with the same amount being authorized in federal credits. The amount of 9 percent credits awarded and authorized has remained relatively consistent in recent years. However, MHDC has significantly increased its use of 4 percent state credits. For fiscal years 2004 through 2007, MHDC authorized an average of $101.6 million in 4 percent tax credits per year. In comparison, MHDC authorized an average of $25.6 million per year in 4 percent credits for fiscal years 2000 through 2003.

[12] Depends on the other types of financing besides tax credits used on the project and other conditions.
[13] MHDC could only provide information back to 1994. The state LIHTC started in 1990, so some limited issuance and redemption activity is excluded from this data.
[14] Tax credits are typically "awarded" in December each year, but are not "authorized" until a later date in the following year, and are not "issued" until the project is complete, which may be several years after the credits have been awarded.
[15] The redemption period may actually be longer than 10 years due to the 5 year carry forward provision. The $1.27 billion in outstanding credits may include some credits which are no longer eligible for redemption due to time expiration or project non-compliance. Current law does not require the DOR to maintain this information.

Low Income Housing Units Built

Approximately 37,000 low income housing units have been approved for construction using the state LIHTC since 1998.

Table 1.1: Low Income Units Approved by Credit Type - 1998 through 2008

Type	1998[1]	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total
9 Percent	1,335	1,084	1,218	1,448	1,255	1,341	1,269	1,315	1,276	980	1,296	13,817
4 Percent	1,286	3,020	631	1,716	2,100	1,735	2,693	4,414[2]	3,990	670	859	23,114
Total	2,621	4,104	1,849	3,164	3,355	3,076	3,962	5,729	5,266	1,650	2,155	36,931

[1] Data prior to 1998 was not obtained due to the time necessary for MHDC staff to compile it.

[2] The large number of 4 percent units in 2005 is due to the usage of a large amount of bond cap that was carried forward from previous years. In addition, a portion of the large number of 4 percent projects approved in 2006 was carried forward into 2007 because there was not sufficient bond cap for the projects to proceed in 2006.

Source: 2001 Legislative Oversight report (1998-2001), MHDC data (2002-2008).

Scope and Methodology

Section 620.1300, RSMo, requires the State Auditor's office to analyze the cost-benefit impact to evaluate the effectiveness of all state tax credit programs.

In order to gain an understanding of the state LIHTC program, we interviewed various individuals involved in all aspects of the program, including MHDC staff, several developers and their representatives, tax attorneys, an architect, and representatives of (1) five syndication firms, (2) a Certified Public Accounting firm involved in the cost certification process, (3) the federal office of HUD, and (4) the IRS. We also discussed tax credit redemptions with representatives of the Department of Economic Development, the Department of Revenue (DOR) and the Department of Insurance, Financial Institutions, and Professional Registration (DIFP). Our review also included visits to eight LIHTC project sites, including projects which were both completed and in-process.

We obtained data from MHDC staff on the number of housing units approved by the commission for the period 2002 through 2008. We also obtained information from MHDC staff on the number of projects converting to market-based housing. This information is presented for informational purposes only; therefore, we have not verified its accuracy.

We obtained information on tax credit authorization from MHDC staff, and tax credit redemptions from MHDC, DOR and DIFP staff. We reviewed the information for accuracy within the limitation discussed on page 12.

In order to understand how Missouri's state LIHTC program compares to the LIHTC programs of other states, we obtained information from various sources, including interviews with an affordable housing research

organization official, and state housing agency representatives with the states of Arkansas, California, Connecticut, Georgia, Hawaii, Illinois, Iowa, Kansas, Kentucky, Massachusetts, Nebraska, New Mexico, New York, North Carolina, Oklahoma, Oregon, Tennessee, Utah, Vermont, and Virginia.

To develop projections of future tax credit activity and liability, we reviewed historical trends in tax credits awarded, authorized, issued and redeemed including data presented in Appendix I. We also reviewed historical information related to the federal LIHTC allocation, including population and allocation rates. We based projections for future years on historical trends, with an emphasis on more recent history. Future 4 percent tax credit activity is dependent upon the Department of Economic Development's allocation of tax-exempt bond cap, and is difficult to project. Our projection for 4 percent tax credits is a conservative estimate compared to the higher level of authorized 4 percent credits awarded from 2004 to 2006.

To evaluate aspects of program management, we evaluated MHDC staff's project selection process, evaluation of project costs, and planning regarding the state's long term housing needs. We also reviewed the LIHTC cost-benefit analysis MHDC reported to the legislature annually as part of the state budget process. In addition, we compared Missouri's program to best practices established by the National Council of State Housing Agencies.

To evaluate the potential of political influence in the project selection process, we reviewed campaign contribution information from the Missouri State Ethics Commission. We attempted to identify contributions made by developers or companies affiliated with developers to the elected members of the MHDC.

To evaluate state LIHTC recapture, we interviewed staff with the MHDC, DOR, and IRS. We obtained information from MHDC on project non-compliance reported to the IRS for the period 2003 to 2007. We reviewed those projects to identify where any recapture of LIHTCs was likely and attempted to evaluate if recapture took place.

To evaluate the impact on residents on project conversion, we discussed the conversion process with MHDC staff and low income housing officials in other states and the federal government.

We obtained aggregate totals of annual tax credit redemptions for all state tax credits for fiscal year 2007 and recaptured LIHTCs for fiscal years 2000 to 2007 from the DOR. We were not provided detailed redemption or recapture information. The Director of the DOR denied us access due to the department's interpretation of the Missouri Supreme Court decision in the

case of *Director of Revenue v. State Auditor 511 S.W.2d 779 (Mo. 1974)*. These external impairments limited our ability to conduct work and therefore, we could not verify the completeness and accuracy of annual redemption totals or the recapture information. IRS confidentiality policies also prevented us from obtaining information on federal LIHTCs recaptured.

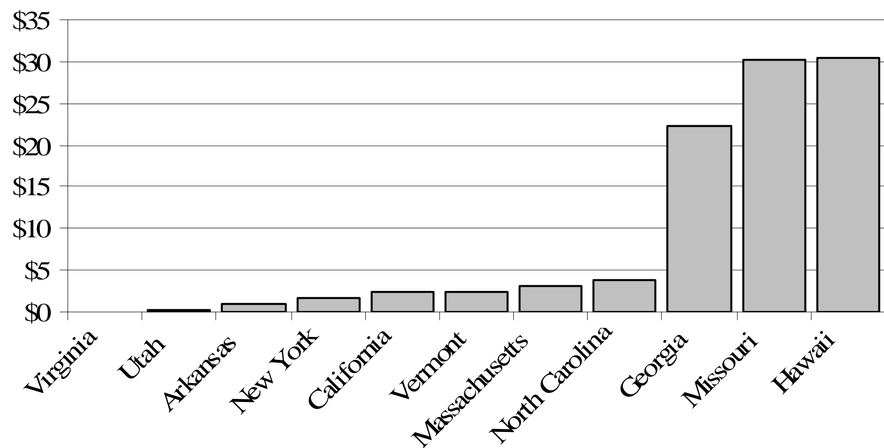
Cost-Effectiveness of the LIHTC Could Be Significantly Improved

The state's LIHTC model (investment model) currently in place is costly and inefficient. In 2007, Missouri ranked second in state LIHTC funding, on a per capita basis, of all states with state LIHTC programs. In addition, only $.35 of every tax credit dollar issued is actually used to build low income housing, with the remainder going to syndication firms and to investors, with much of it being used by investors to pay increased federal tax liability created by the investors' use of the state credits. Options exist to improve the efficiency of the tax credit model. A statutory change to a certificated credit model would expand the market for state credits and increase the price being paid for the state credits, allowing MHDC to issue fewer credits while generating the same level of equity for construction. A reduction in the amount of credits issued would result in a reduction in the amount of credits being redeemed in future years. The state of North Carolina has also implemented a refundable model which more resembles a direct grant program which would also substantially improve the efficiency of the tax credit model.

Current Tax Credit Model Is Costly

In 2007, Missouri ranked second in state LIHTC funding, on a per capita basis, of all states with state LIHTC programs. Missouri was one of three states with a per capita rate exceeding $20. The other states had per capita rates of $4 or less. Figure 2.1 shows per capita funding levels of all states with state LIHTC programs.[16] See Appendix II for detailed information on the per capita computations.

Figure 2.1: 2007 Per Capita Funding for States with State LIHTC Programs



Source: SAO analysis.

[16] We did not include Oregon because of the state's unique law which limits the amount of state credits outstanding to $20 million at any one time. Oregon officials could not provide an estimate of the annual amount of tax credits awarded. We also did not include Tennessee because Tennessee officials could no provide complete information on tax credits issued.

Total tax credits issued are not limited by state law

State law does not limit the amount of state tax credits which may be authorized and issued. Missouri is one of two states, out of 11 with a state LIHTC, which have not implemented statutory limits on the amount of tax credits (both 9 percent and 4 percent) which may be authorized in a given timeframe. States limit the amount of state LIHTCs authorized based on a specific dollar limit, a percentage match of the federal credit set at less than 100 percent, or a combination of both factors. For example, states had the following limits on the annual amount of state tax credits that can be issued:

- Massachusetts - The lesser of $4 million or 50 percent of the federal credit allocation
- New York - $4 million
- Arkansas - $250,000
- Hawaii - State credits are limited to 50 percent of federal credits

Missouri law[17] limits state credits to at most 100 percent of the federal 9 percent tax credit allocation, but essentially has no limit for 4 percent tax credit allocations. MHDC also awards additional state LIHTCs up to 100 percent for any projects eligible for 4 percent federal LIHTCs. These projects require the state designate a portion of its tax-exempt bond cap for low income housing. As a result, MHDC's ability to award 4 percent tax credits is only limited to the amount of tax-exempt bond cap the state's Department of Economic Development allocates for this purpose. Department of Economic Development staff told us significant amounts of bond cap have been available for housing in recent years, which explains the high levels of 4 percent projects approved during 2004 through 2006. In addition, state law does not contain a sunset provision to limit the timeframe in which the current level of LIHTCs may be awarded.

Credits issued and redeemed exceed MHDC projections

State LIHTCs issued and redeemed are significantly exceeding the projections MHDC provided the General Assembly in 1997 when state law changed to allow the state credit match limit to increase to up to 100 percent of the federal credit. In the final fiscal note to the house bill increasing the match limit, MHDC staff reported state credits would continue to be allocated at 20 percent of the federal credit in most parts of the state, but MHDC would increase the allocation to 100 percent in rural areas and areas where it is difficult to develop affordable housing. MHDC estimated in the fiscal note the average allocation rate would be 50 percent of the federal credit. The note further estimated the change would result in lost state

[17] Section 135.352.2, RSMo.

revenue of approximately $1.95 million[18] each year for 10 years. By the 10th year the cost would peak at $19.5 million per year. The cumulative additional issued and redeemable credits for the 10-year period of fiscal years 1998 to 2007 would have been approximately $107 million based on this estimate. That amount was not reported in the fiscal note.

The fiscal note did not consider changes in the amount of federal LIHTCs available annually for 9 percent projects (now at more the $11 million annually compared to $6.6 million in 1998), any estimate of credits issued for 4 percent projects, or expansion of the 100 percent limit beyond rural areas. Despite MHDC's 50 percent credit allocation estimate, MHDC matched the federal credit level at a rate of 97 percent in 1998, 99 percent in 1999 and essentially 100 percent from 2000 through the current period.

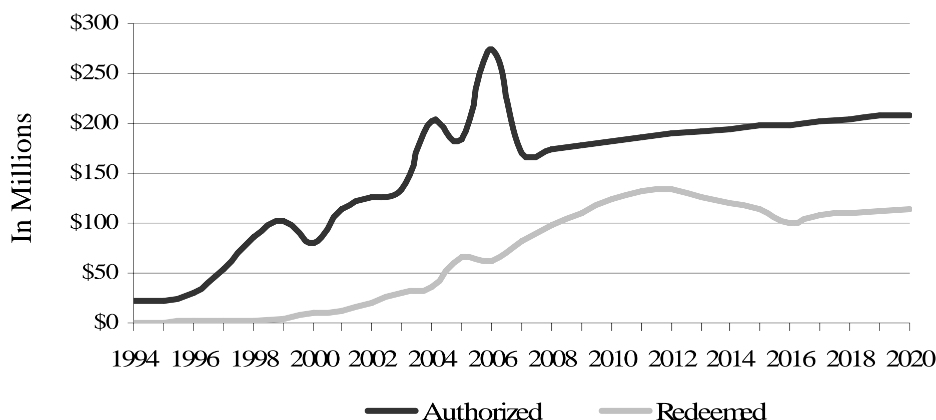
Reworking MHDC's original analysis assuming an average match rate of 100 percent rather than 50 percent, the federal allocation remained at $6.6 million and estimating 4 percent credits at $1.68 million annually (80 percent of the average of 4 percent credits issued from 1998 to 2001) the statute change would result in lost state revenue of approximately $6.96 million each year for 10 years. By the 10th year the cost would peak at $69.6 million per year. The additional issued and redeemable credits for the 10 year period of fiscal years 1998 to 2007 would have been approximately $383 million. That estimate, which is a reasonable projection based on the facts available at that time, shows $276 million in additional costs over the 10-year period covered by the fiscal note. Due to increases in the federal 9 percent credit amount and the increase in the use of 4 percent credits, this result still underestimates the actual increase in program costs as a result of the 1997 statutory change. Based on actual data through fiscal year 2007, the 1997 statutory change resulted in a $537 million increase in redeemable credits from 1998 through 2007.

Projection of future tax credit activity

Based on actual tax credits awarded in recent years, we projected tax credits to be authorized, redeemed, and outstanding through 2020. Assuming tax credits are awarded at a pace consistent with prior years, our projections estimate a total of $4.1 billion in credits will be authorized and approximately $1.8 billion in credits will be redeemed, leaving an estimated $2.3 billion in credits outstanding by 2020. Figure 2.2 shows actual credits authorized and redeemed annually from fiscal year 1994 through 2007, and projected figures from 2008 through 2020. Based on our projections, redemptions will begin to exceed $100 million per year in fiscal year 2008 and will remain above $100 million annually through 2020.

[18] Thirty percent of the estimated fiscal year 1998 federal LIHTC allocation of $6.6 million.

Figure 2.2: Actual and Estimated Tax Credits Authorized and Redeemed - Fiscal Year 1994 to 2020



Source: MHDC and DOR data, and SAO analysis

Current Tax Credit Model Is Inefficient

The current LIHTC model is financing low income housing construction at an effective interest rate of over 20 percent.[19] The MHDC awarded $176.3 million in state LIHTCs during fiscal year 2007, which will be redeemed over the next 10 to 15 years. The 2007 tax credits awarded will be converted into approximately $61.7 million in equity ($.35 per dollar), to be used for the construction and development of low income housing. In years prior to 2007, the LIHTC model was significantly more inefficient with state credits being consistently sold below the current $.35, averaging $.27 and $.32, in 2005 and 2006, respectively. Prior to 2005, credits were typically sold for approximately $.25. The increase in efficiency resulted from MHDC staff requiring a minimum of $.35 for the 2007 applications.

The low sales price is primarily due to the state credit being set up to mirror the federal credit, which reduces the investing taxpayer's state tax liability, thereby reducing the investing taxpayer's federal tax deduction for state taxes paid, according to multiple sources familiar with the tax credit. This results in the automatic devaluation of the state credit of approximately 35 percent.[20] The value of the credit is further reduced by the 10-year discount period and syndicator fees (if the developer uses a syndicator to sell the credits). Researchers cited this inherent and significant inefficiency of the

[19] Rate calculated by assuming $61.7 million was borrowed and $176.3 million was paid over 10 years to repay the debt.
[20] The highest marginal federal income tax rate.

investment credit model when researching potential tax credit models to recommend in the state of Minnesota and rejected this option.[21]

Market for state LIHTCs is relatively small

The market for the state LIHTC is limited to a relatively small pool of investors, including insurance companies, banks, and large corporations, according to our discussions with representatives of a large syndicator. Factors which reduce both the demand for state LIHTCs and the potential number of investors in state LIHTCs include:

- Investors must join the development partnership
- Investor must have a sizable state tax liability and be comfortable predicting that state tax liability over the 10-year time frame
- State credit impacts investor's federal tax liability
- Risk of recapture

The market for federal LIHTCs is generally broader, with more demand than the state credit market, according to the firm representative. Typically investors in federal credits would not be interested in state credits, because each investor has different tax liability structures. In addition, federal tax liability is typically more predictable, and therefore, buying federal credits would carry less risk, according to the representative.

Highest price for credits is not ensured

MHDC does not require developers competitively bid the state and federal credits being sold to help ensure the best sale prices are obtained. MHDC implemented a $.35 pricing floor for state tax credits starting in 2007, which resulted in an increase in the state credit price. Prior to 2006, sale prices for the state LIHTC were generally below $.30. MHDC also implemented a $.85 pricing floor for federal credits in 2007 which also resulted in an increase in the average price paid for federal credits. For 2007, 87 percent of the projects priced state credits at the floor rate and about 50 percent of the projects priced federal credits at the floor rate.

A GAO report on the federal LIHTC[22] reported a significant majority of state housing agencies require housing projects show evidence of multiple competitive bids from syndicators or other investors. For example, a Massachusetts housing agency official told us in that state developers are required to show evidence of 3 competitive bids for sale of the state and federal credit during the application process. The Massachusetts agency also

[21] Janne Flisrand, "Affordable Housing State Tax Credit Models For Minnesota," August 2004.
[22] GAO, "Opportunities to Improve Oversight of the Low-Income Housing Program," March 1997.

has a price floor in place, like Missouri, to ensure a minimum level of equity is provided.

MHDC staff told us while they do not require competitive bidding, they "strongly encourage" the developers to get the best price and believe most developers already use a competitive process to ensure they are getting the best price. MHDC staff stated they believe it is best to not interfere with the syndication process.

Options Exist to Improve Efficiency

Several options exist to improve the efficiency of Missouri's LIHTC. Options include (1) the creation of a direct appropriation to fund low income housing directly from state revenues, without the use of state tax credits, (2) the creation of a refundable credit, currently in use in North Carolina, and (3) the creation of a certificated credit model, currently in use in Massachusetts. The state is not limited to these options; however, based on our review, these options would provide a substantial increase in efficiency.

Appropriated funding is the most efficient option

Appropriations through a state agency to fund low income housing projects, eliminating the use of state tax credits, would be the simplest and most economically and administratively efficient change possible to the state's low income housing program, according to a national affordable housing research official. Tax attorneys told us not-for-profit entities would need to be involved in a direct appropriation model in order to avoid federal tax consequences and for 100 percent of the state's money to go towards the construction of low income housing. If not-for-profit entities were not used, efficiency of the program would still be improved over the current model. Appropriation funding would however subject low income housing funding to the annual budget process. Our research identified one state, Minnesota, that combined funds directly appropriated from a state agency with the federal LIHTC.

Refundable credit model is an efficient option

North Carolina has implemented a "refundable" tax credit model, which allows the state's housing agency to receive tax credit refunds which are then provided directly to developers in the form of an interest free loan. This model allows the state to provide 100 percent of the tax credit directly to the low income project without federal tax implications, according to North Carolina housing agency documents. North Carolina officials said the loans from the state's housing agency are not expected to be repaid by the developers. The IRS has provided North Carolina with a letter of ruling verifying the tax treatment of the distribution of tax credit funds in the form of a loan is legal. North Carolina's housing agency received the Exemplary Legislative Initiative award from the National Council of State Housing Agencies for the creation of the refundable model.

The refundable model has been recognized as a viable option by a national affordable housing research official as well as by researchers in Minnesota evaluating potential tax credit models to implement in that state. According to a tax attorney familiar with the refundable tax credit model, like a direct appropriation, the refundable model allows 100 percent of the state's funds to go toward the housing project, is administratively efficient and encourages higher pricing for federal LIHTCs because it doesn't carry the same tax liabilities as Missouri's current model. The tax attorney also said concerns exist regarding the tax consequences of a loan which does not require repayment. North Carolina began using this model in 2004 and no projects have reached the loan due date, so the potential impact of not repaying the loan is not known.

With the refundable model and the direct appropriation model, projects are funded with current year resources and are not paid for over time. Based on SAO analysis, assuming annual projects authorized and tax credit funding remained at current levels, the transition to a refundable model would result in an increase in redemptions in the short-term because current year credits would be used to fund current projects in addition to projects allocated credits in prior years, However, this change would reduce the long-term liabilities which result from the current tax credit model by a projected 78 percent.[23]

Certificated credit model would provide increased efficiency

Using a certificated credit model,[24] the state of Massachusetts has seen sale prices of $.75 to $.80 per dollar for the state's LIHTC. Under a certificated credit model a state housing agency issues certificates investors could purchase to reduce their state tax liability. Under this model, the end investor does not join the developing partnership, but instead is purchasing a transferable asset. According to officials in Massachusetts this method makes the credit more attractive because it can be resold if the original investor cannot use it.

The majority of the price increase that results from a change to a certificated model is a result of changes in the tax treatment of the state tax credits.[25] As opposed to Missouri's current system where a portion of federal tax deduction is lost, the use of certificates allows investors to apply state tax

[23] In 2020, liabilities of the current system would be approximately $2.3 billion, while liabilities under the refundable model would be approximately $505 million.
[24] Vermont also uses a certificated credit model, but on a much smaller scale. Vermont officials stated they also receive pricing similar, if not higher, than Massachusetts.
[25] In 2004, the Massachusetts Department of Revenue requested and received a letter of ruling from the IRS which allows investors who purchase Massachusetts state credits to deduct the state credit from their federal taxes.

credits used as a deduction on their federal income taxes. A Massachusetts housing agency representative said this change also expanded the market for the state credit, increasing demand and further increasing the price.

Certificated model would require change by MHDC

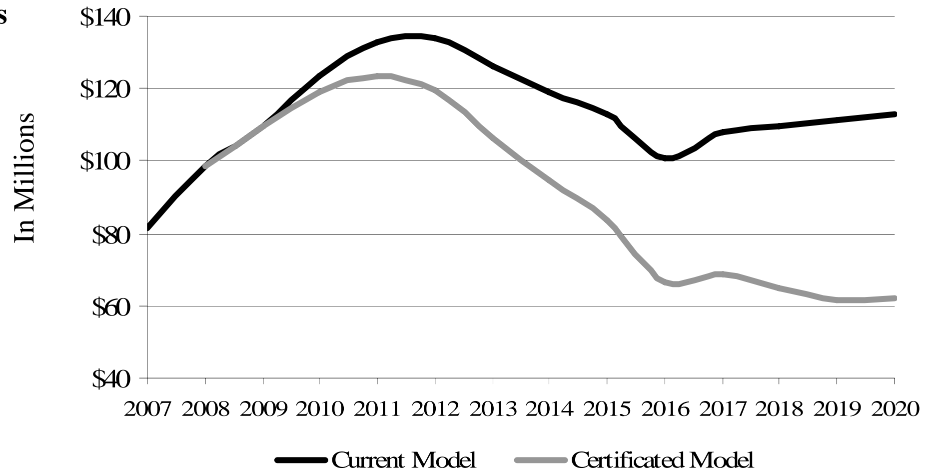
A change to a certificated model would require a change in the manner in which MHDC awards tax credits. According to interviews with a tax attorney, syndicators and other sources familiar with the system in place in Massachusetts, in order to avoid tax consequences to the development partnership, Massachusetts tax credits are issued to not-for-profit housing agencies. These agencies convert the credits into cash, without paying taxes on the transaction, prior to joining the development partnership. This process allows the partnership and its investors to avoid any federal tax consequences associated with the income provided by the state tax credits, according to a tax attorney familiar with the certificated model. According to a syndication firm in Missouri, the state would want to ensure the existing market for federal LIHTCs would not be significantly impacted. A tax attorney familiar with the certificated model told us the use of not-for-profit partners should not impact the federal tax credit partner.

Increased price for credits would result in reductions in credits awarded and redeemed

If the Missouri General Assembly changed the state's LIHTC to a certificated model, a tax attorney familiar with state tax credits told us Missouri state credits would likely sell for prices similar to what Massachusetts is obtaining (currently approximately $.75 per dollar). Such a sale price would allow MHDC to issue half as many credits as are currently being issued, while receiving the same amount of equity for low income housing construction. For example, in 2007 MHDC awarded approximately $176.3 million in credits which will convert into approximately $61.7 million in equity to be used for construction, assuming a sale price of $.35 per dollar. Assuming a sale price of $.75 could be achieved, MHDC would only need to award approximately $82.3 million in credits to provide the same $61.7 million in equity for construction. This change equates to an effective financing rate of approximately 6 percent as opposed to the 20 percent financing rate achieved in the current system.

Based on achieving a price of $.75 starting in 2010, SAO projections estimate state credits authorized through 2020 could be reduced by more than $972 million, and estimated redemptions would be reduced by a total of $320 million (25 percent) from 2010 to 2020. The cumulative outstanding credit estimate would also be reduced by $652 million (28.5 percent). Figure 2.3 depicts actual LIHTC redemptions for 2007 and projected redemptions for 2008 through 2020 for both the current tax credit model and a certificated model. Based on our projections, a change to a certificated credit model would result in an average annual reduction in redemptions of $32 million from 2010 to 2020.

Figure 2.3: Projected Redemptions 2008 - 2020[26]



Source: SAO projections.

Conclusions

The lack of statutory tax credit issuance limits and MHDC's use of the full 100 percent state match of the federal credit have resulted in Missouri's LIHTC program being among the most costly in the nation on a per capita basis. The lack of a sunset provision in state law has also allowed the current funding level to continue without legislative attention. In addition, the current tax credit model is an inefficient use of taxpayer dollars. For every dollar of LIHTCs issued, approximately $.35 goes towards construction of housing, while $.65 goes to investors, syndicators, and to pay for increased federal taxes which result from using the state credit. Because of the inherent federal tax inefficiencies that exist currently, the efficiency of the current model cannot be significantly improved. However, requiring developers to competitively price state and federal LIHTCs would help ensure a fair market rate is being obtained.

To achieve significant improvements to the efficiency of the tax credit model, state law would have to be modified. Modifying state law to allow for a refundable tax credit, such as in use in North Carolina, would eliminate the need for state credits to be bought and sold in an open market and would increase the efficiency of the program. However, questions regarding the tax treatment of the loans from North Carolina's housing agency would need to be addressed. Modifying state law to allow a certificated LIHTC model which utilizes not-for-profit housing entities, such as the model in place in Massachusetts, would eliminate the federal tax consequences of the current

[26] The graph results also assume federal low income housing credits available will follow past growth patterns and low income construction activity remains consistent with 2008 levels.

model, increase demand for Missouri's state credits and would result in significantly higher prices being paid for state credits. Both models would result in more tax credit dollars being used for the construction of housing, giving the state a significantly higher return on its tax credit investment. These changes could be made without significantly disrupting the federal LIHTC market already in place. If Missouri wishes to continue to make significant investments in low income housing, steps need to be taken to ensure state funds are invested as efficiently as possible.

Recommendations

We recommend the General Assembly:

2.1 Evaluate implementing a limit on the amount of LIHTCs that can be awarded annually.

2.2 Establish sunset provisions in state law to ensure the LIHTC receives periodic legislative attention.

2.3 Evaluate changing the Missouri LIHTC to a model that will provide more tax credit equity to projects which may include models similar to the ones used in Massachusetts and North Carolina.

We recommend the MHDC:

2.4 Require developers to provide evidence of competitive pricing for tax credits on all projects.

Agency Comments

MHDC Comments

The following response is provided by the staff members of the Missouri Housing Development Commission and is not the response of the MHDC board of commissioners.

2.1 There are currently de facto limits on the state LIHTC. The 9% credits are statutorily limited (RSMo. §135.352) to 100% of the federal LIHTC program, which in turn is limited in federal law to an annual allocation. The 4% credits are also limited to 100% of the federal credit and are additionally limited to those projects receiving tax-exempt bond financing from the Department of Economic Development. It is important to note that tax-exempt bond financing is also subject to its own annual cap set by the federal government and is split by DED among multiple competing uses resulting in sharply increased competition over the past couple of years.

With the 100% match, the production and preservation of affordable housing is made feasible in more areas of the state; without it, only the

largest and strongest of markets could support affordable housing development. It also provides benefit to the state by facilitating higher quality construction, stronger operating performance, and amenities and social programs which translate into better viability and longer useful life for individual properties, social benefits for children and senior citizens, as well as a source of pride and increased tax base for local communities. By cutting costs up front, Missourians may shoulder additional costs in the future. A reduction in the state LIHTC would likely result in lower quality construction, increasing maintenance needs, restricting cash flow, and necessitating rent increases to cover operating costs. Over time, substantial rehabilitation may well be necessary on a more frequent schedule. Limited access to programs provided through the development and its community partners may force families and seniors to seek assistance through state-funded programs or to face homelessness or long-term nursing home care.

MHDC staff feels implementing lower limits on the amount of state LIHTC annually would reduce the social and economic benefits currently generated by the program by reducing MHDC's ability to maximize the amount of housing provided in all areas of need and to accomplish its mission of providing more than just housing.

SAO Comment

An annual dollar limit cap may require MHDC vary the percentage match by project. MHDC could elect to provide projects in rural counties or projects for the elderly with a 100 percent state credit, while metropolitan projects may need to be structured at less than the 100 percent match. This situation is what MHDC management described in the fiscal note for the legislation which increased the state limit to 100 percent.

2.2 *MHDC staff understands the importance of periodic legislative review and strives to always cooperate fully with the existing legislative reviews performed by the House Budget and Senate Appropriations Committees and the Joint Committee on Tax Policy. However, sunset provisions may be counterproductive by introducing potential for major changes to the program or even its discontinuance thereby producing uncertainty in the market, inhibiting the entrance of more investors in the program and reducing potential competition and aggressive pricing. In fact, when Congress eliminated the sunset provision for the federal LIHTC in 1993, the affordable housing industry experienced a marked increase in the production of affordable units and in competition for LIHTC by both investors and developers. In a May 1, 1997, hearing before the Subcommittee on Oversight of the Ways and Means Committee, both a state housing finance agency official and a private*

builder testified to a 20-cent increase in federal credit pricing when the federal LIHTC was made permanent.

2.3 *MHDC staff acknowledges that the current state LIHTC program does not operate at an optimum level of efficiency, and we are convinced that improvements are possible. Commissioners and staff have been and are continuing to study ways to improve the amount of equity invested directly in each development for the amount of state credits allocated. Staff disagrees with some of the auditor's analysis and assumptions that form the underlying basis for this recommendation. We recognize the significant pricing advantages of the North Carolina and Massachusetts credit programs, but staff is concerned that our study must include careful evaluation of the potential shortcomings of each program which include the forgiveness of loans and use of non-profit entities. These shortcomings may result in adverse tax consequences and possibly contradict IRS guidelines by purposely circumventing federal tax liability.*

2.4 *There are many elements of a development that dictate tax credit pricing, such as developer strength, the location, type and size of the property, the strength or weakness of the proposed development, the timing and amount of investor equity pay-ins, developer guarantees, trust obtained through long-standing business relationships, potential credit adjusters, underwriting standards, local market conditions, reserve requirements, and the payment of developer fee. Staff's concern about interference with the syndication process reflects the multitude of conditions that cannot be governed or influenced by MHDC but that are contingent upon a syndicator's tolerance for risk and competition in the market. MHDC staff is committed to maintaining a minimum floor based upon market conditions and feels it is the most effective way to increase competition and positively influence pricing under the current tax credit model.*

Improvements Are Needed in the Project Evaluation and Selection Process

Improvements are needed in the project evaluation and selection process because the current process does not provide sufficient details to the public. The lack of details has led to the perception that political influence impacts commission decisions. In addition, allowable project cost limits are high as compared to surrounding states and are not consistent with national guidelines. As a result, project costs are not adequately reviewed for reasonableness during the application process. Builder's fee limits also exceed national guidelines, resulting in higher project costs and more tax credits issued.

Selection Process Is Not Based on a Scoring System

MHDC staff does not create detailed documentation to disclose how projects are selected to receive state and federal tax credits. While documentation provided by staff to the commissioners for the 2008 project selection process contained more detail than in prior years, the documentation did not include a scoring system, or any other documentation to allow the commissioners or the public to see how projects compare to one another. Of the 50 states which use the federal LIHTC, 46 use some form of scoring system in their project evaluation and selection process.

While the April 2007 Blue Ribbon Panel[27] report did not recommend a scoring system, it did make recommendations to standardize the evaluation of each project and improve transparency in the project selection process. The report recommended MHDC specify the "guiding factors to be considered in reviewing applications," and that these factors be made available to applicants in advance. The report also recommended the MHDC address each factor in writing when evaluating each application.

MHDC staff said a scoring system is not used because they want to avoid receiving applications designed to score as many points as possible, instead of doing what was best for the project, and to avoid potential lawsuits over how projects were scored. Interviews with housing officials from six surrounding states using scoring systems identified no litigation issues over project selection.

Project cost information not disclosed prior to approval

MHDC does not disclose total project cost information to the public until after the commission votes to approve projects for the year. MHDC discloses on its website general application information for each project such as location, number of low income units and one year of the tax credits applied for, but the information does not show the total cost of the project.

[27] A bi-partisan panel appointed by the Governor made up of several state senators, state representatives, a former MHDC chairman, a former state auditor, and others. The Governor requested the panel review MHDC operations, specifically the transparency and efficiency of the agency, as well as ways to save the taxpayers money.

The state housing agencies of Nebraska, Nevada, Oklahoma, and Oregon include total development costs in information made public prior to project selection. Citizens expressed concern that the current process does not provide the public with adequate information to bring up concerns prior to projects being voted on. State law[28] allows tax credit application details to be withheld from the public until an official decision is made. According to MHDC staff, based on this law, application details made available to the public are kept to a minimum.

Perception of Political Influence Exists

The lack of public details regarding MHDC's selection process has contributed to the perception that political influence and campaign contributions to elected officials on the commission influence the project selection process. In a publicized case, a developer questioned why, during the 2007 selection process, he had fewer projects approved than other developers despite political contributions he had made.

To evaluate the source of contributions to elected officials on the MHDC, we reviewed campaign contribution data submitted to the state's Ethics Commission. The records could not be easily searched and limited information made it difficult to match specific donations to developers or developer's organizations.

Land transaction involving commission member raises concerns

A 2006 land transaction between a member of the commission and a developer who is regularly involved with low income housing developments throughout the state raised concerns of conflicts of interest and political influence. According to newspaper articles, the deal resulted in the Commissioner realizing a profit of $780,000 on a rezoned piece of property which he had held for several months. Approximately a year after this transaction, MHDC established a committee in December 2007 to make changes to MHDC's Standards of Conduct. As of March 2008, proposed changes had not been finalized by the committee.

Allowable Project Cost Limits Are High

MHDC policy allows total replacement costs[29] per unit to be up to 140 percent of published HUD guidelines in the 8 metropolitan areas of the state. The use of replacement costs, which excludes the developer's fee and other syndication fees, is contrary to the National Council of State Housing Agencies (National Council) recommendation to use total development costs. Since developer's fees are typically 15 percent of replacement costs, MHDC effectively allows total development costs to be 161 percent[30] of

[28] Section 610.225, RSMo.
[29] Replacement costs includes construction costs, and soft costs such as loan interest, architect fees and legal fees.
[30] 140 percent * 1.15 = 161 percent.

HUD guidelines, which significantly exceeds cost per unit limits of surrounding states. Cost limits for metropolitan areas in Kansas, Iowa, Illinois, Oklahoma, and Arkansas[31] allow total development costs per unit to be, on average, 97.5 percent of HUD guidelines.

For illustrative purposes, the 2007 St. Louis metropolitan area HUD development cost per unit limit for a two bedroom unit was $157,260. Using the average cost limit of surrounding states, allowable total development costs would be $153,329 per unit.[32] Under MHDC's total development cost limit, the allowable cost would be $253,188 per unit,[33] a difference of $99,859 per unit.

MHDC staff could not provide documentation explaining the criteria used to designate the eight metropolitan high cost regions in the state. In addition, MHDC staff told us they have not developed a methodology to support the use of the 140 percent replacement cost limit in these 8 areas, but said the increased limit is necessary to account for increases in construction costs. However, HUD representatives told us the HUD guidelines are already annually adjusted regionally for construction cost fluctuations. MHDC staff also told us they did not feel it made sense to include developer's fees and syndication fees because the developer's fee is capped and syndication fees are not within the control of the developer. MHDC staff said if they used total development costs to assess cost limits they would have to increase the 140 percent limit to allow for the additional costs.

Based on interviews with housing agency officials in surrounding states and the cost per unit guidelines in use in those states, HUD guidelines appear reasonable. Our review of the 88 projects (9 percent only) approved between 2005 and 2007 showed project costs in Missouri are high, with costs for 48 projects (55 percent) exceeding 100 percent of the HUD guideline, and 13 of those projects exceeding 140 percent of the HUD guideline.[34]

The following is an example of a project approved during 2007 with high costs. The project is located in southeast Missouri in a non-metropolitan area, and includes 15 single family, three bedroom homes with 1,300 square

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[31] The metropolitan areas reviewed included Des Moines, Chicago, Oklahoma City, Little Rock, and Kansas City, Kansas. We attempted to include Memphis and Louisville, but Tennessee and Kentucky use tax credit per unit limits instead of total cost per unit limits.

[32] $157,260 * 97.5 percent = $153,329.

[33] $157,260 * 161 percent = $253,188.

[34] MHDC's exclusion of developer fees from the cost per unit limit calculation allowed all 13 projects to fall below the 140 percent limit.

feet of livable space and a two car garage. According to the developer, the houses will be constructed of primarily brick exteriors and include standard features, such as ceiling fans, washer/dryer and all appliances. Construction costs, including builders' fees, are budgeted at $156,000 per house. Adding other project costs, including developer's fee, the total cost per house is $246,765. This amount represents a cost of $190 per square foot for these homes which is extremely high for residential housing. The HUD maximum allowable cost for this project was $171,101 per unit, a difference of $75,664 per unit or $1.1 million for the project. The project is being financed entirely by state and federal tax credits. The homes will rent for $435 per month.

National Council recommends the use of reasonable cost limits

The National Council recommends state housing agencies set a maximum allowable cost per unit standard, based on actual costs in the state or area. The National Council states the standard will be within HUD guidelines in most areas, but recognizes there may be instances in which the standard may be above or below the HUD limit. In these instances the National Council recommends the housing agency have a defined methodology to support limits exceeding the HUD guidelines. The National Council also recommends the established cost limit be published in the QAP, but not be strictly enforced. Rather, the limit would serve as a mechanism for the housing agency to ensure any developments whose costs fall above the guidelines receive additional scrutiny to ensure the additional costs are justified or reasonable.

According to a GAO report on the federal LIHTC,[35] California's housing agency saw a 12 percent decrease in total project costs the first year the agency adopted the HUD cost limits. The report states the majority of the decrease was in "soft" costs, such as construction financing fees and professional fees.

Construction costs are not adequately reviewed for reasonableness

Construction costs are not adequately reviewed for reasonableness in the application process. MHDC staff stated project costs in the 8 metropolitan areas of Missouri are considered reasonable as long as they fall below 140 percent of the HUD threshold, and do not receive additional scrutiny until the cost per unit exceeds the threshold. Separate developers of two projects with costs of $230,000 and $250,000 per unit told us after their applications had been submitted MHDC did not ask any questions about project costs or ask for any justification of costs. Project costs of both of these projects were

[35] GAO, "Opportunities to Improve Oversight of the Low-Income Housing Program," March 1997.

below the 140 percent MHDC cost limit.[36] Our review of projects approved from 2005 to 2007 showed no projects subject to the 140 percent cost limit exceeded the limit. While construction costs are subject to a verification process once incurred, this process does not assess the reasonableness of the expenditures, according to our interview with accountants involved with cost certification.

MHDC does not have access to contractor records

MHDC does not have access to developer support documentation, such as subcontractor invoices, either while construction is ongoing or after it has been completed. According to MHDC staff, access to documentation has been granted in the past when requested and they did not see the need to include a specific clause in developer documents. However, MHDC did not receive requested documentation on a recent project. According to MHDC staff, the addition of a clause in these documents giving MHDC staff access to project documentation would be beneficial.

Allowable builder's fee exceeds National Council recommendation

Total project costs include a builder's fee, which is made up of builder's profit, overhead and general requirements.[37] MHDC allows maximum builder fees which exceed National Council recommendations. Builder's fees are included in a project's qualified basis, which is used to calculate the amount of tax credits the project is eligible for. If MHDC had limited builder fees to the National Council recommended limits (discussed below) projects approved in 2005 to 2007 would have been authorized approximately $10.5 million fewer tax credits.

The National Council recommends the use of a 6 percent profit maximum, 2 percent overhead maximum, and 6 percent general requirements maximum, for a total maximum of 14 percent of construction costs. Prior to the 2008 QAP, MHDC's maximum builder's fee has been set at 18 percent, with no specific maximums for profit, overhead or general requirements. Projects approved for tax credits from 2005 to 2007 had $114.7 million in builder's fees, an average of 16.2 percent of construction costs and $678,709 per project. For 2008 applications, MHDC reduced the maximum builder's fee to a total of 16 percent, which includes an 8 percent limit on profit. Both limits still exceed National Council recommendations. MHDC staff told us they reduced the builder's fee limit to 16 percent to be in line with the maximum builder's fee rate on HUD projects.

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[36] One of these projects was located in a non-metropolitan area and was not subject to the 140 percent cost limit, however, the project costs exceeded 100 percent of the HUD guideline.

[37] General requirements include construction supervision, field engineering, field office expenses, building permits, temporary facilities expenses, temporary utilities, site cleanup, watchman wages, builder's risk insurance, testing, and contractor's cost certification. General requirement expenses are certified as part of the project's cost certification process.

Conclusions

MHDC does not have a standardized evaluation process. The recommendations of the Blue Ribbon panel suggest the need for additional consistency and cross-comparability in project evaluation. The development of a scoring system would allow for cross-comparability and would help MHDC to defend the projects selected to the public. Adding at least high-level cost per unit information for proposed projects to the information made public prior to project selection would help citizens understand the comparability of projects. Increased public information would help reduce concerns of political favoritism playing a role in the selection process and would improve taxpayer confidence in the tax credit allocation process.

MHDC has not implemented adequate controls over project costs. Contrary to National Council guidance, MHDC uses replacement costs to assess cost limits and has set allowable cost per unit limits higher than national standards recommend and higher than surrounding states. As a result, project costs are not adequately analyzed for reasonableness during the application process. MHDC could not provide documentation supporting the use of the increased cost limits in the eight metropolitan areas. In addition, builder's fees and developer's fees are based on a percentage of project costs. Based on these factors, MHDC has eliminated a significant motivation for developers to control proposed project costs. MHDC officials also have not ensured access to project supporting documentation once construction has started, limiting their ability to review documentation when they feel it is necessary. In addition, MHDC allows builder's fee limits in excess of National Council recommendations which increases project costs resulting in more tax credits being issued.

Recommendations

We recommend the MHDC:

3.1 Implement a scoring system or some other means of documenting cross-comparison of projects.

3.2 Improve public awareness of the project selection process by including at least high level project cost data in the information made public.

3.3 Base cost limit calculations on total development costs.

3.4 Reduce allowable project cost limits to be in-line with HUD limits. Any designation of metropolitan areas resulting in a deviation from HUD limits should be supported by a formal evaluation of construction costs.

3.5 Establish procedures to evaluate the reasonableness and justification of project costs which exceed project cost limits prior to project approval.

3.6 Ensure access to all developer supporting documentation by adding necessary clauses to future developer agreements.

3.7 Reduce the maximum builder's fee and the component part of the fee to be consistent with National Council of State Housing Agencies recommendations.

Agency Comments

MHDC Comments

The following response is provided by the staff members of the Missouri Housing Development Commission and is not the response of the MHDC board of commissioners.

3.1 MHDC staff performs a cross-comparison of projects by applying evaluation criteria presented in the FY2008 Qualified Allocation Plan and the Developer's Guide. In the 2008 NOFA process, staff provided commissioners with detailed comments concerning each application's performance against the criteria, cost comparison data, and the narratives and development and operating budget information as submitted. In 2001, MHDC staff proposed a point system, and the commissioners chose not to adopt it. In 2007, the Blue Ribbon Panel considered a point system, and decided not to recommend it. Scoring systems present limitations in the assessment of complex layers of factors such as need, economic feasibility, local support, market conditions, developer strength, alternate sources of financing, project amenities, family vs. elderly needs, and regional distribution. These systems give a false sense of objectivity to a process that inherently includes some level of subjectivity in the evaluation of complex factors. Scoring encourages developers to focus on proposals that score well as opposed to what is best for the community.

3.2 MHDC staff agrees with the importance of transparency in public programs, but is concerned that providing the total development cost of each application for public review will not assist citizens or officials in creating reasonable assumptions about the competitiveness of each proposal. In fact, this information would likely be counterproductive without the contextual information necessary to adequately understand a specific transaction. Total development cost is influenced by the type of construction, the local market, proposed amenities, local competition, site issues, proposed social service components, Union/non-Union labor, and program requirements such as prevailing wage. Without the benefit of detailed application information or familiarity with the ramifications of these factors, the usefulness of total development cost information is limited. MHDC staff appreciates the suggestion to improve public awareness and shall develop a report providing

important cost and development data grouped appropriately to provide public awareness without creating misleading assumptions or confusion about an application's true competitiveness. Any consideration of the disclosure of information in pending applications must be balanced against the requirements of the Sunshine Law.

3.3 *In utilizing total replacement costs, MHDC is operating within IRS or HUD regulations. Basing limits on the total development cost is problematic because it includes factors that may vary considerably from project-to-project. MHDC staff has chosen to use total replacement cost which eliminates developer fees, syndication costs, tax credit fees, and reserves from the calculation. Syndication costs and reserves do not lend themselves to objective comparison from development-to-development as it is subject to the standards of particular syndicators as well as the location, size, and other aspects of individual developments which may require greater lease-up reserves, operating reserves, or emergency reserves in order to attract equity investment. A developer might also wish to fund tenant initiatives or social service reserves which are of great benefit to residents and should not be seen as a detriment to the competitiveness of the proposal.*

Developer fees are already subject to a limit, and MHDC staff is planning changes to the maximum allowed fee for consideration by the commissioners for the FY2009 Qualified Allocation Plan.

The additional room provided by basing the limit on the total replacement cost allows MHDC and the owner to invest in higher quality, more durable materials, stronger operating performance, and beneficial amenities which results in less cost for maintenance and rehab in the long-term, higher quality of life for residents, community pride and acceptance, the ability for children to have access to social programs expanding their future, and the opportunity for seniors to age-in-place in a supportive environment. Increased cost at the front end will lessen future rehab costs, depressed properties, or need for resident access to state-funded programs related to homelessness or nursing home care.

3.4 *MHDC staff disagrees with the auditor's premise that MHDC's current limits are outside of currently allowed practice. HUD appropriations legislation for 2008 included an increase in the high cost factor to 170%, which appears to recognize that the base limits are not keeping pace with costs of construction in major metropolitan areas. Further, the federal legislation allows for an increase up to 215% of base limits for properties on a case-by-case basis.*

IRS code is silent on the topic of project cost limits and affords state housing finance agencies the authority to limit project costs to those that are feasible to bring a project to completion. MHDC staff has chosen to allow the higher limit in metropolitan areas as allowed by accepted practice in order to participate meaningfully in the revitalization and redevelopment of urban areas which has resulted in demonstrated economic growth and subsequent private investment in areas such as St. Louis, Kansas City, St. Joseph, Springfield, and Joplin. The effect of raising the ceiling on costs in St. Louis, Kansas City, and the other HUD-recognized metropolitan statistical areas does not result in enriched developers or extravagant properties. Instead, it fosters quality and longevity of bricks and mortar, better living conditions for families and seniors, beneficial amenities, and investments in communities that are sources of pride and generators of further development the benefit of which cannot be fully measured. Further, by doing so MHDC is operating within the IRS and HUD guidelines. Both the IRS and NCSHA recognize the right and necessity for each state to determine cost standards that are appropriate to its market and mission.

SAO Comment

The audit report does not suggest MHDC's cost limits are more than what is allowable. As MHDC's response acknowledges above, HUD regularly updates its allowable cost limits by updating its "cost factors." This means HUD multiplies the base cost limit (which never changes) by a cost factor (i.e., 170 percent), which is updated regularly to reflect changes in construction costs, to determine the HUD cost limit for each region. As stated in the text of the report, MHDC then multiplies the HUD cost limit by 161 percent to determine the MHDC cost limit. Effectively, MHDC's cost limit is 161 percent on top of HUD's cost factor, which can be as much as 170 percent. While it is within MHDC's power to establish a cost limit considered necessary, we do not believe the current limit is reasonable.

3.5 MHDC staff already tests development proposals against cost limits and reports applications that exceed the limits to commissioners during the evaluation process. Staff shall document specific reasons that support approval or denial of an application based upon the factors contributing to the additional cost. Staff shall also develop additional methods for project evaluation such as the utilization of RS Means construction cost data and cost estimation software.

3.6 MHDC staff will revise its developer agreements to document its authority to request and receive supporting documentation during the final allocation review process.

3.7 MHDC staff does not feel its current builder's fee limits to be excessive, especially considering additional contractor requirements related to workforce eligibility compliance which are not contemplated in the NCSHA recommendation. While many states have adopted a 14% maximum, others allow up to 16%, 18%, and even 20%. Staff is currently considering other ways to limit costs in its FY2009 Qualified Allocation Plan.

Opportunities Exist to Improve Program Administration

Weaknesses exist in the state's procedures and laws regarding recapture of LIHTCs. These weaknesses may have resulted in tax credits subject to recapture not being recaptured and unnecessarily limit the recapture period. In addition, MHDC has not developed long-term low income housing needs or goals to help plan future program activity, and the economic activity resulting from the state LIHTC has been overstated. Also, MHDC has not developed a process to notify and assist tenants when projects begin conversion to market-based rates.

Weaknesses in Tax Credit Recapture

Procedures evaluating compliance with LIHTC recapture requirements need improvement and Missouri's recapture law needs evaluation. These situations have occurred because (1) MHDC had not reported taxpayers receiving LIHTCs with project compliance violations to the DOR for follow-up, and (2) state law limits the recapture period to only the first 10 years of a minimum 15-year compliance period.

MHDC and DOR lacked sufficient communication

Lack of communication between MHDC and DOR has resulted in LIHTCs potentially not being recaptured. State law[38] provides for state tax credit recapture during the first 10 years after projects are placed in service. The recapture amount is to be based on the amount of federal credits recaptured on the project. However, prior to our audit, MHDC did not provide information to the DOR on projects with compliance violations for DOR officials to evaluate whether taxpayers recaptured state LIHTCs when their federal credits had been recaptured. A MHDC official said MHDC staff had not communicated project non-compliance information to DOR in prior years because IRS and DOR privacy rules blocked or restricted access to taxpayer information and MHDC staff did not know what IRS information DOR staff had access to.

MHDC staff perform regular compliance review on all LIHTC projects and report violations to the IRS. The IRS determines whether federal credits will be recaptured based on the non-compliance reported. MHDC cannot obtain specific taxpayers information (i. e., amount of recaptured credits) from the IRS due to confidentiality restrictions. However, the DOR has an agreement with the IRS for access to federal tax information.

In August 2007, MHDC and DOR initiated the development of a memorandum of understanding that would provide for communication between MHDC and DOR regarding when MHDC submits information to the IRS for non-compliant projects. DOR officials said MHDC staff is now providing the department with information on non-compliant projects and

[38] Section 135.355, RSMo.

DOR will be using that information to monitor when state tax credits should be pursued for recapture.

LIHTC recapture has been limited

Taxpayers are to report recaptured LIHTCs on their state tax returns. For the period fiscal year 2000 to 2007, DOR reported to us that only about $38,000[39] in credits had been recaptured.[40] A DOR official said the department performed no procedures to identify if all LIHTCs subject to recapture had been reported by taxpayers during this period.

To identify LIHTC projects with tax credits subject to recapture, we obtained information on violations reported by MHDC to the IRS from 2003 to 2007. We also obtained information from the IRS of the types of violations which generally cannot be corrected and likely are subject to tax credit recapture. Our review of 23 projects with difficult to correct violations identified at least 2 with the non-compliance occurring within the first 10 years of the project with recapture of federal and state tax credits being likely.

IRS confidentiality restrictions also prevent the IRS from providing taxpayer information to the SAO. We attempted to contact the project developers and investors to identify if credits had been recaptured on these projects. For one of the projects, we identified $27,692 in federal credits subject to recapture with $12,943 in state credits[41] also subject to recapture. The aggregate recapture data reported to us by DOR by fiscal year did not report a recapture amount near this amount after fiscal year 2002. The project became non-compliant in 2004 and recapture would have taken place after that time. As of January 2008, the investor told us his company's staff was researching if these credits had been recaptured. As of early 2008, MHDC officials said DOR staff was reviewing tax credit recapture on both projects.

Missouri recapture period limited

Missouri's LIHTC recapture period is less than the recapture period for the federal LIHTC. State law[42] provides for state tax credit recapture the first 10 years after projects are placed in service, although Section 42 of the Internal Revenue Code requires project compliance over 15 years and federal credit recapture for the entire 15-year compliance period. As a result, if property

[39] DOR officials said the amount could be up to $6,296 higher; however, their records did not distinguish whether recapture of the other monies related to the LIHTC program or other programs.
[40] DOR provided the SAO aggregate information for this period. As discussed on page 12, the SAO is restricted from access to specific state taxpayer records.
[41] State tax credits only matched 40 percent of federal credits on this project.
[42] Section 135.355, RSMo.

owners fail to comply with tax credit requirements, after 10 years, the state has no recourse with regard to recapture of state credits for the remainder of the 15-year compliance period.

In contrast to Missouri law, some other states require tax credit recapture over the entire 15-year compliance period. For example, Massachusetts LIHTC policy states LIHTCs allocated with respect to a project are subject to recapture (and disallowance to the extent not yet claimed) at any time during the 15-year compliance period if the project is subject to recapture of federal LIHTCs. The policy further describes the amount of tax credit to be recaptured, the timing of recapture, and provides examples of recapture. In addition to Massachusetts, at least two other states, Georgia and Hawaii, require state tax credit recapture over the entire 15-year compliance period.

Long-term Plans and Goals Have Not Been Developed

MHDC has not developed a strategic plan to assess long-term low income housing needs and establish long-term low income housing goals to measure performance. According to Office of Administration strategic planning literature, performance measurement is the process of assessing progress toward achieving predetermined goals and provides a framework to help allocate and prioritize resources. For these reasons, in 2005 the Governor ordered state agencies to develop long-term strategic plans and goals and measure progress. Currently MHDC only uses annual plans which focus primarily on internal operational goals and does not consider long-term needs and goals.

MHDC provided audit staff with a document which attempted to show which areas of the state had an increased housing need; however, the document was several years old and had limited usefulness, according to MHDC staff. MHDC staff said they did not feel such planning is necessary because MHDC has a significant amount of experience in the Missouri low income housing market and the housing needs of the state.

Economic Impact Reported for the LIHTC Is Overstated

The economic impact being reported to the legislature regarding the LIHTC is overstated. The economic impact of tax credit programs is reported annually to the legislature as part of the state budget process. The fiscal year 2009 analysis for the LIHTC shows for fiscal year 2007 the credit returned $.56 in state revenue for every dollar spent, created $213.2 million in new economic output, and created approximately 7,700 new jobs. Department of Economic Development staff prepare the cost-benefit analysis for MHDC based on information and assumptions provided by MHDC staff. A June 2007 cost/benefit study[43] completed at the request of MHDC also concluded

[43] John Cook, CPA et. al., "Cost/Benefit Analysis of the Missouri Low-Income Housing Tax Credit Program," BKD, LLP in cooperation with Missouri State University, June 2007.

the state LIHTC produced significant economic activity, including $6.5 billion in economic activity from 2000 to 2005.

Based on our interview with the individual who performed the economic impact portion of the 2007 cost/benefit study, the economic impact reported is at the very high end of what can be attributed to the LIHTC. The economic impact currently reported to the legislature and reported in the June 2007 cost/benefit study; assume no low income housing construction would take place if not for the state credit. However, the federal LIHTC is available to the state even if a state LIHTC did not exist. According to the individual who performed the study, the number of projects which would be built if the state credit did not exist is likely lower than what is currently being built, but it is undetermined how much lower. The report also stated "some level of housing production would occur without the state or federal credits and this must be taken into consideration." The individual also said construction employees may be double counted in the analysis from year to year and would likely work elsewhere in the absence of low income housing production, but he could not estimate the impact. Many states are able to produce low income housing without a state credit. For example, a report issued during 2007 by the Kansas Legislative Auditor said the state of Kansas produced an average of 804 units of low income housing per year from 2004 to 2007, despite not having a state LIHTC.

The budget document provided to the legislature reports the state credit allows rents to be $155 per month cheaper than they otherwise would be without the credit. The amount is determined by analyzing the amount of additional debt financing projects would have needed if not for the state credit. However, this result would require the same developments to be built under the current system as would be built if the state LIHTC did not exist. Based on comments from MHDC staff, this assumption is not reasonable because the additional costs related to construction quality and project location would make the developments financially unfeasible without the state credit.

Project Conversion Impacts Tenants

MHDC has no policy requiring developers notify tenants when low income housing projects are being converted by developers to market-based housing or to aid tenants in relocation. After 15 years low income housing projects may be eligible[44] for conversion to market-based rents if the property owner chooses to opt out of the low income housing program. Federal law provides for a 3-year transition period for tenants as the property converts to market-based rates. However, property owners are not required to immediately

[44] Depends on the other types of financing besides tax credits used on the project and other conditions.

notify tenants, when conversion is initiated, that they will be subject to higher rents after the transition period or be forced to move. Also tenants choosing to move are not provided any relocation assistance. A MHDC official said MHDC management had not thought about the potential effect of no notification and relocation assistance requirements because conversions are just starting to take place and have not been an ongoing process.

The federal LIHTC began in the mid to late 1980's. As a result early projects have just recently become eligible for conversion. At the end of 2007, Missouri had 190 projects eligible for conversion with 7 projects currently in the conversion process. The number of projects eligible for conversion will continue to increase each year as more projects reach conversion eligible time limits.

Conclusions

Missed recaptured tax credits result in lost revenue for the state. Until 2007, MHDC and DOR did not communicate regarding potential recaptured state LIHTCs resulting in tax credits potentially not being recaptured. The planned communication now taking place should help ensure credits are appropriately recaptured. In addition, Missouri's tax credit recapture period of 10 years unnecessarily limits recovery of state LIHTCs since minimum project compliance periods are 15 years for LIHTC projects.

Without strategic goals it is difficult to prioritize resources and to assess the state's potential long-range housing needs and the costs. A strategic plan would help clarify how much low income housing is in place, and how much is still needed. A strategic plan would also help to ensure legislators are aware of how much future liability the state can expect to incur to fund housing goals.

Inaccurate or misleading cost-benefit program analyses provided to MHDC and the General Assembly have limited the ability to evaluate the cost-effectiveness of the program. The economic impact of the state LIHTC is overstated because both budget documents and a cost-benefit study contracted for by MHDC assume no projects would be completed if not for the state tax credit. This assumption is not reasonable because if a state credit did not exist low income housing would be built in Missouri with at least the federal LIHTC as occurs in other states that do not have state LIHTCs. To measure the benefit of the state credit the additional housing produced with the assistance of the state credit would need to be identified and analyzed. Also estimates of the reduced rents resulting from the state tax credit are misleading because the estimates assume the same project would have been built if the credit did not exist which may or may not be true.

Tenants may be financially harmed when LIHTC projects convert to market-based rates. Currently tenants do not receive specific notification or relocation assistance when the conversion takes place. These issues will become more of a concern as additional projects become eligible for conversion.

Recommendations

We recommend MHDC and DOR:

4.1 Work together to ensure state LIHTCs subject to recapture are being recaptured.

We recommend the General Assembly:

4.2 Change state law to extend the recapture period for LIHTCs to 15 years from the current 10 years.

We recommend MHDC:

4.3 Develop a strategic plan to assess long-term low income housing needs of the state, establish long-term low income housing goals and measure the agency's progress towards those goals.

4.4 Provide a more accurate cost-benefit analysis to the General Assembly annually as part of the state budget process.

4.5 Develop policies that require owners of LIHTC projects to timely notify low income tenants when their properties are being converted to market-based rents. In addition, establish a program to provide relocation assistance to low income tenants who lose their housing because of the conversion.

Agency Comments

MHDC Comments

The following response is provided by the staff members of the Missouri Housing Development Commission and is not the response of the MHDC board of commissioners.

4.1 MHDC staff is pleased to have developed a process with the Department of Revenue to report instances of non-compliance that may result in federal recapture of low-income housing tax credits, thus triggering recapture of state low-income housing tax credits. Since regulations concerning taxpayer privacy prevent MHDC from direct access to recapture information from either the IRS or DOR, our ability to participate in the process is limited. The partnership between MHDC and DOR has resulted in MHDC utilizing the authority of RSMo.

§610.032 to present an executive agency request to DOR for disclosure of certain confidential information to executive agencies necessary to allow the agency to perform its constitutional or statutory duties. We intend to utilize the information for internal evaluation of owner and management performance and participation in the low-income housing tax credit program.

4.2 *MHDC staff does not support this recommendation, as the additional five years of exposure beyond the ten years the credit is available will have the effect of chilling the interest of potential investors, thus decreasing competition for investment opportunities and negatively affecting the equity investment in the credit. The increased recapture period would not produce a positive impact on the efficiency of the credit.*

4.3 *Long-term plans and goals including our five-year strategic financial plan have been a part of our annual planning sessions for at least the last ten years. Staff has been compiling and monitoring component data that can be consolidated into a formal housing plan. We currently track or have access to data on approximately 100,000 affordable units in the state. MHDC staff is intimately involved in the state homeless study, the biannual homeless count, and the housing portion of the state's annual action plan and five-year consolidated plan. We recently sponsored and facilitated the senior housing study.*

Every year, we plan carefully our priorities for addressing the most pressing affordable housing needs in the state which are well-established and outlined in the Qualified Allocation Plan. Presently, these priorities are: the preservation of housing with project-based rental assistance, the preservation of other existing affordable rental housing stock, the revitalization of neighborhoods and communities through historic preservation, the construction of workforce housing in areas with significant population and economic growth, and the production of single-family homes with homeownership opportunities made available to existing residents at the end of the 15-year compliance period.

MHDC staff recognizes that a formal plan with the above-referenced priorities and goals accompanied by measurable outcomes may be a more effective tool to communicate our long-term strategy and demonstrated progress to our commissioners, the legislature, communities, developers, service agencies, and the general public. Staff is committed to proceed with the development of a formal long-term plan which we project to have in place during FY2009.

4.4 *MHDC staff has followed standard procedures in the development of the cost-benefit analysis reported on the Form 14s. All DED tax credit programs are analyzed by MERIC using the REMI model. Staff feels the biggest challenge is the fact that the REMI model is meant to measure economic benefits, while the state LIHTC is largely a social program unable to be accurately captured by this method. This is why the Form 14s have historically provided additional qualitative data on other benefits. Staff will use its best efforts to isolate benefits that can be specifically attributed to the state low-income housing tax credit. The challenges in doing so are great, considering there is no accurate way to project what could have occurred if the state credit was not available. We can generalize that the state credit allows us to create more units, with more development available in rural areas, and makes 4% credit financing structures possible outside metropolitan areas.*

4.5 *MHDC staff appreciates the recommendation for resident notification of conversion. We are in the process of implementing a process for requiring owners preparing for conversion to provide proof of resident notification of their intentions and tenant protections during the three-year period following conversion. Such proof will be required to be included in the qualified contract application package that must be submitted to MHDC in Year 14 for review and approval. Staff shall further require owners to transmit a second notice prior to conversion that informs residents that conversion is imminent and establishes the date three years in the future at which tenant protections against market-based rents shall expire. Staff is also implementing a requirement that a standard provision addressing this matter be incorporated into every tenant lease for LIHTC properties.*

MHDC staff does not see the need to implement relocation assistance requirements for displaced residents at the end of the three-year period following conversion. Current occupancy data in rural and metropolitan areas demonstrates an average annual turnover of 30% in properties of all types. Because the resident population is relatively mobile, the impact of the expiration of affordable rents for residents who were occupants at conversion three years prior will not be as great as the auditor may have assumed. In an informal poll of state housing finance agencies, only two of 34 respondents require relocation assistance to be provided to low-income residents at the expiration of affordability.

DOR Comments

4.1 The department concurs. MHDC began providing the department information on projects with compliance violations in September 2007. The department reviews 2007 returns as filed to identify state tax credits that have not been appropriately captured.

Missouri Low Income Housing Tax Credit Activity

Table I.1 shows the authorized, redeemed and outstanding or pending issuance LIHTCs for the period July 1, 1993 to June 30, 2007. Data for previous periods could not be provided.

Table I.1: Low Income Housing Tax Credits Authorized, Redeemed, and Outstanding or Pending Issuance by Fiscal Year

	Tax Credits		
Fiscal Year	Authorized	Redeemed by Fiscal Year	Cumulative Outstanding or Pending Issuance[2]
1994	$22,027,870	55,706	21,972,164
1995	22,862,860	646,237	44,188,787
1996	30,106,140	1,072,649	73,222,278
1997	54,177,540	2,027,362	125,372,456
1998	85,806,200	2,907,544	208,271,112
1999	101,367,660	4,323,281	305,315,491
2000	80,455,840	10,105,111	375,666,220
2001	113,735,120	12,368,170	477,033,170
2002	125,558,880	19,474,343	583,117,707
2003	134,388,920	29,978,473	687,528,154
2004	202,644,630	36,916,831	853,255,953
2005	183,106,160	65,392,601	970,969,512
2006	273,640,430[1]	61,963,798	1,182,646,144
2007	169,445,790[1]	81,646,784	1,270,445,150
Total	$1,599,324,040	328,878,890	

[1] Credits are issued upon completion and occupancy for an approved project which can take up to 2 years for most projects. Few if any credits have been issued for 2006 and 2007 approved projects as of January 2008. Issued credits for a project may be slightly more or less than the amount authorized for the project.

[2] The $1.27 billion in outstanding credits may include some credits which are no longer eligible for redemption due to time expiration or project non-compliance. Current law does not require the DOR to maintain this information.

Source: MHDC and DOR data, and SAO analysis.

Per Capita Low Income Housing Funding by State

Based on interviews with other state housing agencies we determined the amount of state LIHTCs awarded in 2007. Using 2007 Census Bureau population figures, we calculated per capita state housing funding as shown in Table II.1.

Table II.1: Per Capita State LIHTC Awards by State - 2007

State	Credits Awarded	2007 Population	Per Capita
Virginia	$500,000	7,642,884	.07
Utah	870,000	2,550,063	.34
Arkansas	2,416,520	2,810,872	.86
New York	31,000,000	19,306,183	1.61
California	87,246,906	36,457,549	2.39
Vermont	1,500,000	623,908	2.40
Massachusetts	20,000,000	6,437,193	3.11
North Carolina	35,000,000	8,856,505	3.95
Georgia	207,891,900	9,363,941	22.20
Missouri	176,325,850	5,842,713	30.18
Hawaii	39,276,290	1,285,498	30.55

Source: Interviews with other state housing agency officials and MHDC records.

The credit amount represents the annual tax credit awarded multiplied by the duration of the tax credit. State LIHTCs are typically 10 year credits (10 percent redeemable each year for a period of 10 years), with the exceptions being North Carolina (1 year), Virginia (1 year), California (4 years), Vermont (5 years), and Massachusetts (5 years). Oregon officials could not provide information on 2007 state housing credits awarded, resulting in the state being excluded from this analysis. Oregon's per capita cost would be minimal because Oregon state law limits the cumulative total amount of state credits outstanding to $20 million. We also could not obtain information from Tennessee officials to calculate per capita information.

Tax Credit Review Status

Table III.1 shows the statewide tax credit programs and the SAO review status of each program.

Table III.1: Tax Credit Programs and Review Status

Program	Administering Department	Report Number for Review
Missouri Low Income Housing	Economic Development	2008-23
Wood Energy	Natural Resources	2007-58
New Generation Cooperative Incentive	Agriculture	2007-06
Agricultural Product Utilization Contributor	Agriculture	2007-05
Community Development Corporation/Bank	Economic Development	2005-55
(Capital) Small Business Investment	Economic Development	2005-54
Certified Capital Companies (CapCo)	Economic Development	2004-56
New Enterprise Creation	Economic Development	2004-56
Adoption (Special Needs)	Revenue	2004-13
Community College New Jobs Training Bonds	Economic Development	2003-32
Brownfield Jobs/Investment	Economic Development	2002-33
Brownfield Remediation	Economic Development	2002-33
Historic Preservation	Economic Development	2002-33
Qualified Research Expense	Economic Development	2002-33
Seed Capital	Economic Development	2002-33
Youth Opportunities and Violence Prevention	Economic Development	2002-33
Film Production	Economic Development	2001-13
Rebuilding Communities	Economic Development	2001-13
Small Business Incubator	Economic Development	2001-13
Winery and Grape Growers	Economic Development	2001-13
Affordable Housing Assistance	Economic Development	To Be Reviewed
Bank Franchise	Revenue	To Be Reviewed
Bank Tax Credit for S Corporation Shareholders	Revenue	To Be Reviewed
Brownfield Demolition	Economic Development	To Be Reviewed
BUILD Missouri Bonds	Economic Development	To Be Reviewed
Business Facility	Economic Development	To Be Reviewed
Cellulose Casings	Revenue	To Be Reviewed
Charcoal Producers	Natural Resources	To Be Reviewed
Children in Crisis	Revenue	To Be Reviewed
Development	Economic Development	To Be Reviewed
Disabled Access	Revenue	To Be Reviewed
Domestic Violence	Social Services	To Be Reviewed
Enhanced Enterprise Zone	Economic Development	To Be Reviewed
Enterprise Zone	Economic Development	To Be Reviewed
Examination Fees and Other Fees	DIFP	To Be Reviewed
Family Development Account	Economic Development	To Be Reviewed
Family Farm[1]	Agriculture	To Be Reviewed

Appendix III
Tax Credit Review Status

Program	Administering Department	Report Number for Review
Food Pantry Donation[2]	Revenue	To Be Reviewed
Guarantee Fee	Economic Development	To Be Reviewed
Homestead Preservation	Revenue	To Be Reviewed
Life and Health Guarantee Association	DIFP	To Be Reviewed
Maternity Home	Social Services	To Be Reviewed
MDFB Development and Reserve	Economic Development	To Be Reviewed
MDFB Export Finance	Economic Development	To Be Reviewed
MDFB Bond Guarantee Credit	Economic Development	To Be Reviewed
MDFB Infrastructure Development	Economic Development	To Be Reviewed
Missouri Health Care Access Fund[2]	Revenue	To Be Reviewed
Missouri Health Insurance Pool	DIFP	To Be Reviewed
Missouri Property and Casualty Guarantee Association	DIFP	To Be Reviewed
Missouri Quality Jobs	Economic Development	To Be Reviewed
Neighborhood Assistance	Economic Development	To Be Reviewed
Neighborhood Preservation	Economic Development	To Be Reviewed
New Enhanced Enterprise Zone	Economic Development	To Be Reviewed
Pharmaceutical	Revenue	To Be Reviewed
Pregnancy Resource Center[1]	Social Services	To Be Reviewed
Property Tax	Revenue	To Be Reviewed
Qualified Equity Investment[2]	Economic Development	To Be Reviewed
Residential Treatment Agency[1]	Social Services	To Be Reviewed
Retain Jobs	Revenue	To Be Reviewed
Self-employed Heath Insurance[2]	Revenue	To Be Reviewed
Shared Care	Health and Senior Services	To Be Reviewed
Sponsorship and Mentoring Program	Elementary and Secondary Education	To Be Reviewed
Transportation Development	Economic Development	To Be Reviewed

[1] New tax credit in fiscal year 2007. No activity reported on Appendix IV.
[2] New tax credit in fiscal year 2008.

Source: SAO.

Tax Credit Redemptions

Table IV.1 shows the redeemed tax credits for fiscal years 2004 through 2007 for all state tax credit programs. We did not audit the information.

Table IV.1: Tax Credit Redemptions by Program

	Fiscal Year			
Program	**2004**	**2005**	**2006**	**2007**
Adoption (Special Needs)	$1,995,882	2,582,546	2,460,245	2,931,967
Affordable Housing Assistance	7,554,503	7,702,860	4,080,564	10,497,793
Agricultural Product Utilization Contributor	1,964,872	1,639,541	1,857,235	2,248,989
Bank Franchise	1,596,458	2,543,523	2,413,631	1,771,165
Bank Tax Credit for S Corporation Shareholders	1,233,830	941,460	1,451,903	1,248,932
Brownfield Jobs/Investment	2,134,891	1,726,687	1,476,143	1,701,409
Brownfield Remediation/Demolition	16,101,975	10,627,870	10,611,324	16,733,274
BUILD Missouri Bonds	9,667,000	3,770,557	5,402,416	6,958,318
Business Facility	7,826,417	4,546,330	5,892,727	6,066,136
Cellulose Casings	429,480	382,540	341,315	574,180
Certified Capital Companies	13,564,932	13,371,610	13,164,904	13,121,442
Charcoal Producers	0	384,609	70,151	180,987
Children in Crisis	n/a	n/a	n/a	168,128
Community Development Corporation/Bank	1,632,669	2,021,628	34,870	2,958
Community College New Jobs Training Bonds	8,061,584	6,847,304	5,771,777	4,920,374
Development	562,622	2,487,152	4,518,483	2,100,685
Disabled Access	87,401	56,761	36,549	11,813
Domestic Violence	475,283	515,035	525,348	696,670
Dry Fire Hydrant	13,169	17,228	805	3,737
Enhanced Enterprise Zone	n/a	9,809,254	5,922,720	6,646,873
Enterprise Zone	19,766,366	15,485,501	14,759,891	13,202,069
Examination Fees and Other Fees[1]	5,844,206[2]	4,962,341[2]	5,413,885	4,881,750
Family Development Account	27,488	12,875	9,237	11,761
Film Production	423,857	322,079	788,596	1,240,972
Guarantee Fee	0	11,224	73,009	68,607
Historic Preservation	66,089,980	74,532,355	103,134,226	132,841,728
Homestead Preservation	n/a	n/a	n/a	2,932,514
Life and Health Guarantee Association[1]	177,712	302,516	4,910	0
Maternity Home	982,747	743,636	760,674	983,509
MDFB Bond Guarantee Credit	0	594,034	0	276,241
MDFB Development and Reserve	0	1,500	0	500
MDFB Export Finance	0	0	0	0
MDFB Infrastructure Development	10,020,578	25,953,799	21,858,725	24,706,809
Missouri Business Modernization and Technology (Seed Capital)	288,174	164,894	60,313	82,977

Appendix IV
Tax Credit Redemptions

Program	Fiscal Year 2004	2005	2006	2007
Missouri Health Insurance Pool[1]	3,687,665	3,688,639	5,497,999	3,672,701
Missouri Low Income Housing	36,916,831	65,392,601	61,963,799	81,646,784
Missouri Property and Casualty Guarantee Association[1]	16,823,462	16,959,512	6,019,763	5,754,394
Missouri Quality Jobs	n/a	n/a	0	1,715,530
Neighborhood Assistance	10,217,628	9,286,880	10,009,497	13,924,340
Neighborhood Preservation	4,001,293	8,461,503	4,627,368	5,549,062
New Enterprise Creation	3,259,307	2,504,561	1,534,647	1,048,997
New Enhanced Enterprise Zone	n/a	n/a	n/a	5,188
New Generation Cooperative Incentive	3,466,068	3,334,935	4,990,666	4,136,380
Pharmaceutical	524,527	142,373	1,672	n/a[3]
Property Tax	95,237,314	99,455,570	96,090,703	93,118,747
Qualified Research Expense	2,038,230	1,626,864	1,006,688	487,320
Rebuilding Communities	1,415,889	1,694,006	1,764,167	1,390,803
Retain Jobs	n/a	0	2,882,995	4,285,366
Shared Care	39,109	33,574	39,247	105,757
Small Business Incubator	167,360	246,807	322,278	179,368
Small Business Investment (Capital)	49,478	109,050	58,189	66,720
Sponsorship and Mentoring Program	0	0	0	0
Transportation Development	3,678,532	3,545,219	980,806	910,421
Winery and Grape Growers	260,397	179,323	69,564	174,736
Wood Energy	1,205,443	3,700,285	3,728,100	2,709,211
Youth Opportunities and Violence Prevention	3,272,225	3,211,185	3,256,950	4,893,591
Total	$364,784,834	418,634,136	417,741,674	485,590,683

[1] Redemptions are on a calendar year rather than fiscal year and based on tax year credit was applied against.
[2] Until the fiscal year 2007 budget process the amount reported by the DIFP for this credit was only the examination fee portion and not the other taxes and fees for which credits were also redeemed.
[3] The Pharmaceutical tax credit expired in 2001 and tax credits are no longer being redeemed.

Source: Office of Administration, DOR, and tax credit administering agencies.