

A PROPOSAL TO ALLOW STATES TO EXCHANGE EXCESS TAX EXEMPT BOND AUTHORITY
AND 4% LOW INCOME HOUSING TAX CREDITS FOR CASH GRANTS

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Background

The Low-Income Housing Tax Credit (LIHTC) is the nation's largest and most successful affordable rental housing production program, having financed more than two million homes since 1987 and about 120,000 annually in recent years. According to the National Council of State Housing Agencies, approximately 90 percent of all affordable rental housing is financed through the LIHTC. According to the National Association of Homebuilders, the program supported 180,000 jobs annually until recently.

The Problem

The combination of the \$2.25 billion Tax Credit Assistance Program (TCAP) and the Section 1602 9% Tax Credit Exchange Program (TCEP) authorized by the American Recovery and Reinvestment Act of 2009 (ARRA) will enable states to address a significant portion of the estimated \$10 billion shortfall in investor equity resulting from the 2008 collapse of the financial markets and the resulting loss of interest in purchasing tax credits. But preliminary information from some states suggests that these resources will not be adequate to provide alternative funding for all LIHTC transactions waiting to proceed in 2009 and 2010. In particular, developments planning to use the 4% LIHTC are frequently not able to find investors and in most cases will have insufficient access to the TCAP and TCEP programs to make up for the absence of this equity. This shortfall, if unaddressed, threatens to derail hundreds of construction projects nationally consisting of thousands of much needed affordable rental homes for lower income Americans. In addition, it is now clear that the LIHTC investor market has not bounced back to normal as some had hoped and that other measures need to be taken, both *short-term* to enable developers and localities to continue to produce badly needed affordable rental homes, and *longer term* measures to reinvigorate the incentives for investors to re-enter the market.

The Need for A Single Set of Proposals to Restore Liquidity to the LIHTC Program

LIHTC industry leaders and nonprofit housing advocates were unable to agree on a common set of measures early on during the negotiations leading to the passage of ARRA earlier this year and it proved costly as Congress was unwilling to do more than include the relatively low cost and short-term TCAP and TCEP. Secretary Donovan and Congressional staff have been clear that any further action to help the LIHTC will require broad support from the LIHTC community for a single set of measures. It is now clear that this package must, at a minimum, include not only an extension of the expiring TCEP but also incentives to attract investor capital back into the LIHTC market, such as the LIHTC carryback proposal being circulated by the Affordable Housing Tax Credit Coalition and Affordable Housing Investor Council, **and** something to help states who wish to assist stalled 4% LIHTC developments.

The Need for A Revenue Neutral, Short Term 4% LIHTC Solution:

Three principles of any 4% LIHTC measure are that it should be (1) short term, (2) voluntary for states wishing to participate, and (3) as close to revenue neutral to the federal government as possible. The first two principles were important reasons that the 9% TCEP was successfully incorporated into ARRA. One critical difference in developing a 4% LIHTC solution, however, is that unlike the 9% LIHTC, these credits are not capped on a set per capita formula to each state and but are made available to the developers of affordable rental housing using qualified private activity bonds under Section 142 of the Internal Revenue Code ("Bonds"), which are capped. This means the cost to the federal government of assisting 4% LIHTC developments through a program exchanging 4% Credits for cash similar to TCEP, if not carefully structured, could be substantial.

One way to limit, if not eliminate, any cost of a 4% LIHTC exchange program is to require that states give up an amount of Section 146 bond volume cap sufficient to roughly equal the cost to the Treasury of providing the \$0.85 per dollar of 4% Credits exchanged. Based on preliminary data obtained from several states, it appears that the cost to the Treasury of each \$1 of 4% Credit is roughly equivalent to the cost of \$3 of Section 146 volume cap. [In fact, if the value of the forgone 4% credits were included, the Treasury would have a net gain.] The proposal, then, is that any state may trade in \$3 of Bond cap for \$1 of cash for use by developments meeting the eligibility requirements of the 4% LIHTC program. *To further reassure Congress that there will be no cost to the Treasury by indirectly increasing the use of Bonds, the proposal includes a provision capping the amount of Bonds each state may exchange for 4% LIHTC cash at the higher of that state's average use of multifamily bonds during the period 2003-2007 or 10% of its annual Bond volume cap.*

Why would states choose to make this exchange? Since the relative value of the interest rate tax deduction provided tax-exempt bonds is currently small due to the small differential between the price of taxable and tax-exempt financing, the value of the Bonds by themselves is limited and not adequate to create true affordability for housing. States placing a priority on creating rental housing with deeper affordability where investors are not available would likely be very interested in making this exchange.

Why is the Section 142 Bonds for 4% Exchange a better solution than setting a floor rate for the 4% LIHTC, which is currently at 3.30%? Two reasons: (1) First, setting a floor to the 4% LIHTC will not help most stalled 4% LIHTC transactions in the short term since the main problem right now for developers of 4% LIHTC properties is the inability to obtain investor equity at any price. What little equity is available in the market is generally investing in 9% LIHTC transactions due to the perception that these transactions have significantly less real estate risk with higher ratios of equity to debt and rents typically set even further below market, providing a bigger cushion in the event of a swing in market rents. (2) Second, setting a floor to the 4% credit rate will cost the Treasury hundreds of millions of dollars without any ability to offset these costs. While this is a step that we support taking, it will be difficult to find a way to pay for it without either another economic stimulus bill or an offsetting increase in revenues that we cannot currently identify.

Detailed Explanation of Exchange Mechanism and Cost/Savings to Treasury

The amount of bond volume cap required to be used to generate \$1 of cash from Treasury was determined based on historical usage of bond volume cap and corresponding 4% credits generated. The goal in designing an exchange of bond volume cap for cash in lieu of credits was to be revenue neutral to Treasury. However, the estimates of costs and savings is complex and partially determined by the amount of bond volume cap that is anticipated to be utilized and what portion will be used for rental housing in conjunction with 4% credits under Section 42.

The main issues that we see going into the determination of revenue neutrality based on our proposal are as follows:

1. There is a reduction in bond volume cap of \$3 for each \$0.85 in cash provided to the state allocating agency;
2. There is a limit in the amount of bond volume cap that can be exchanged. The limit is the greater of 10% of each states' volume cap or 125% of the average multifamily bond volume used during the period 2003 to 2007;
3. For each \$0.85 provided to the state allocating agency, there will be a reduction in the amount of 4% credits awarded. The reduction in available credits would be \$1 for each \$0.85 awarded. To the extent the cash replaces a credit that would have been created and sold to an investor, there is a savings to the Treasury of \$1 for each \$0.85 of cash exchanged;
4. The exchange of bond volume cap for a cash award to the state credit agencies will reduce the overall volume of Section 42 credit in the marketplace. This will have the impact of increasing pricing for the remaining credits which will have a positive impact on the national market for credits resulting in more jobs and more affordable housing produced;
5. Providing for a reduction in the amount of tax exempt bond volume utilized will increase revenues to Treasury through a reduction in the amount of tax exempt bonds in existence at any one time;
6. The affordable housing development infrastructure will benefit by allowing projects to go forward which are otherwise stuck due to lack of private investor interest. In CA, for example, more units have been put in place under the 4% credit provisions of Section 42 each year than have been produced under the 9% credit ceiling program;
7. Increasing the volume of transactions will create more construction jobs; and
8. Developers of a portion of these projects are nonprofit corporations that have no use for the tax losses. If the owner is a nonprofit organization, no losses will be utilized. For profit developers who take advantage of the exchange may be able to use some of the losses but there is a high probability that many of the losses will go unused as most developers already are able to shelter much of their income. The result will be a significant savings to Treasury when compared to the use of credits and private investors that do utilize the tax losses to shelter other taxable income.

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