

FINAL REPORT OF THE
LOW INCOME HOUSING TAX CREDIT SUBCOMMITTEE OF THE
MISSOURI TAX CREDIT REVIEW COMMISSION

November 1, 2010

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Missouri Tax Credit Review Commission

Report of the Low Income Housing Tax Credit Subcommittee

Overview

During his remarks to the Missouri Tax Credit Review Commission (the “Commission”) on September 8, 2010, Governor Nixon observed that “we’re looking at a budget gap in Fiscal Year 2012 that could exceed \$400,000,000 at the state level.”¹ The Governor also observed that tax credit spending has increased as a percentage of state revenues while spending for other programs has been reduced.² He continued by expressing concern over the growth of 61 tax credit programs and the effect such growth has had on other state priorities.

The Governor’s comments provided clear guidance as to the primary responsibility of the Commission and its subcommittees. The Governor asked us to (1) determine which tax programs were generating a good return on investment for the taxpayers of Missouri; (2) which programs were not generating a good return; and (3) to provide fact-based recommendations for change.³ Elaborating further, the Governor stated that we should strive to take the economic development tools we have and make them more efficient.⁴ He noted: “Tax credits work best when they deliver on what they were intended for. Putting people to work, boosting development, building strong communities.”⁵

With this in mind, the Low Income Housing Tax Credit Subcommittee has attempted to determine (1) whether the low income housing tax credit program generates a good return on the investment made by the state, (2) whether it puts people to work, boosts development, and builds stronger communities, and (3) possible ways to make the program more efficient.

The Subcommittee is fully aware that absent increased efficiencies the low income housing tax credit program faces the very real possibility of a reduction in size. The Subcommittee has worked hard to find alternatives to a reduction of the current equity that is generated for low income housing and believes that if at all possible, the current level of equity generated for the program should be maintained. It is hopeful that efficiencies have been identified that would create the same equity while reducing the number of tax credits required to generate that equity.

Because the low income housing tax credit is a ten year credit and because credits issued this year will not be redeemed for at least two to three years from now, this subcommittee has very

¹ Tr. Page 4, Tax Credit Review Commission Meeting of September 8, 2010.

² Tr. Page 5, Tax Credit Review Commission Meeting of September 8, 2010.

³ Tr. Page 3, Tax Credit Review Commission Meeting of September 8, 2010.

⁴ Tr. Page 9, Tax Credit Review Commission Meeting of September 8, 2010.

⁵ Tr. Page 18, Tax Credit Review Commission Meeting of September 8, 2010.

little power to produce an impact on the state budget in the near term.⁶ As a result our subcommittee has focused on the efficiency of the credit and the ability to have a long term impact on budgets in the future.

Establishment of Low Income Housing Tax Credit Subcommittee

The Low Income Housing Tax Credit subcommittee was authorized by the Missouri Tax Credit Review Commission during its meeting on September 8, 2010. Members were subsequently appointed and consist of the following individuals: Mark Gardner, Chair, Gardner Capital, Inc.; Shannon Weber, Carpenter's District Council of Greater St. Louis & Vicinity; Craig Van Matre, attorney with Van Matre, Harrison, Hollis, Pitzer & Taylor; Penny Rector, Member, MASA Legal Counsel; Todd Weaver, Legacy Building Group; Representative Tim Flook, Dee Joyner, Commerce Bank; Senator Robin Wright-Jones, Stephen Acree, Regional Housing and Community Development Alliance (RHCDCA).

The above named members include a diverse group representing a broad range of interests. The subcommittee also had the benefit of the input from non-members who also represented a broad range of interests. Finally, the subcommittee had the benefit of the testimony of numerous individuals at the statewide hearings conducted by the Commission. Those individuals also represented a diverse group with a broad range of interests.

The result is that the report of the Low Income Housing Tax Credit Subcommittee does not represent just the interests of those who participate in, or benefit from the program, but rather it is intended to represent and reflect the beliefs and opinions held by a broad cross-section of the people of the State of Missouri.

Meetings of the Low Income Housing Tax Credit Subcommittee

In addition to the state wide hearings conducted by the Commission to obtain input from the public at large, the subcommittee held three public meetings. Those meetings were held on October 7, 2010; October 25, 2010 and November 1, 2010. Many thoughtful ideas and suggestions were made by those who participated and the discussions.

Other Information and Materials Considered

In addition to the input from members, non-members and the public at large, the subcommittee was fortunate to have a number of comprehensive studies listed in Exhibit "A". It would have been impossible, with the time constraints involved, to have commissioned additional studies which could have approached the comprehensive nature of the studies identified in Exhibit "A" and thus, the subcommittee relied on the body of material already available to it.

⁶ Tax credits are not earned until a project is built and leased up. Typically credits awarded in a given year will not produce a full year of credits for two to three years. Even then the first year of credits is typically a fraction of the full credits than could be earned that year if all units had been leased for a full year.

Additionally, the subcommittee consulted with the Tax Law Subcommittee and is grateful for the thoughts and efforts of that subcommittee. Its continued efforts will be essential in order to accomplish many of the recommendations contained within this report.

Addressing the Questions Presented by the Commission

The subcommittee has attempted in this report to respond to the 15 questions presented to the subcommittee by the Commission. It has also attempted to establish priorities as part of that response and to provide the Commission with possible ways of improving the efficiency of the program, thereby reducing the total number of tax credits necessary to fund the program.

In addition to the Low Income Housing Tax Credit Program the subcommittee was charged with making recommendations with respect the AHAP Credit Program and will include, in a later section of this report, recommendations with respect to that program.

Priorities

The three principal priorities identified by the Subcommittee were: (1) attempt to preserve the level of *equity* currently provided to support affordable housing, (2) to find a more efficient means of delivering that equity with a corresponding substantial reduction in the number of tax credits necessary to generate that equity,⁷ and (3) consideration of a means of adjusting the size of the program so that it grows or contracts as state revenues grow or contract.

Overview of the Low Income Housing Tax Credit Program

The purpose of the Low Income Housing Tax Credit Program is to provide an incentive for the construction of new housing or the rehabilitation of existing rental housing so that it is affordable to low and moderate income families in Missouri. The program is authorized by Sections 135.350 to 135.363, RSMo. Projects that receive credits must create rental units for households having incomes below 60% of the area median family income and maintain affordability for up to 30 years. The federal low income housing program was established in 1986 and has universally been recognized as the most successful federal housing program ever implemented.

This program works by leveraging equity investments from the private sector to provide housing with lower rents. The program provides a matching state credit to the companion federal low-income housing tax credit. The credit is a 10 year credit with a 10 year recapture period. The state credits are equal to approximately 9% of the eligible development costs. Developments financed with tax exempt bonds are eligible to apply for state tax credit for approximately 4% of the eligible development costs. The credit can be carried back 3 years or forward 5 and can be transferred or sold.

The state credit can be allocated up to a 100% match of the federal tax credit allocated to a project. The federal credit is capped at an annual amount set by the IRS and is based on the population of the state and is adjusted annually. The Missouri allocation is currently approximately \$132M per year. Because the state credit is a matching credit it is set at the same

⁷ Alternative means of providing equity have also been considered and will be discussed.

amount. The state also has a 4% credit that is issued in conjunction with tax exempt bonds. There is an annual cap of \$6 million on the 4% credit or \$60 million over a period of 10 years. Total state low income tax credits that could be allocated are approximately \$192.0M.

While some states bordering Missouri have less generous state tax credit provisions they frequently subsidize their projects by other means such as loans and grants. It is therefore difficult to compare levels of subsidization by looking at the level of tax credit funding employed by a given state. Additionally, some states simply don't do as well in providing low income housing for their residents and some states only provide significant housing in large metropolitan areas where funding needs are less due to higher income levels. The result is that individuals living in rural areas who cannot pay the higher rents are left to live in substandard housing. *It is important to note that the lower the funding level by a state the more likely the metropolitan areas are to be served at the expense of the rural areas.* The subcommittee will provide a supplemental report explaining the different funding mechanisms used by other states to fund affordable housing and analyze the effects of that funding.

There is no geographic restriction on the eligibility of the credit although credits are allocated by population to three geographic regions of the state (St. Louis, Kansas City, and Outstate).

The state credit can be applied to (1) income taxes, (2) corporation franchise taxes, (3) certain bank taxes, (4) insurance premium taxes, (5) other financial institutions taxes, and (6) the express company tax.

Any person can submit an application for housing tax credits. The Agency recommends what it feels are the best projects and the Missouri Housing Development Commission actually votes to make the awards.

Purpose of Low Income Housing Tax Credit Accomplished

Clearly the state low income housing tax credit program was designed to accomplish the discernable goal of supplementing the federal low income housing tax credit program and there is clearly a cause and effect relationship between the its intended purposed and what is actually accomplishes.

The program was designed to provide additional equity to affordable housing projects in order to permit rents to be at a level where they are truly affordable for those whose income is less than 60% of the area median income and to provide relief for families who are spending more than 30% of their income on housing. Numerous studies have documented the social and economic problems faced by seniors and families whose incomes are lower than 60% of the area median income and who must pay more than 30% of their income on housing. Such individuals are typically forced to live in substandard housing and are unable to provide the basic necessities for themselves or their families unless affordable housing is available. These two issues will be addressed in more detail in the social aspects section of this report. The program has been recognized nationally as one of the best low income housing programs and has done an

exceptionally good job at providing needed affordable housing at rents that seniors and families can afford.⁸

The issues dealing with the economics of the program are dealt with in a specific section of this report and address those issues posed by the Commission that deal with the economic development aspects of the program.

Principal Inefficiencies of the State Tax Credit Program

There are two primary inefficiencies with the housing program. Those inefficiencies are the fact that the housing credit is earned over a period of ten years and the fact that when the credit is used to reduce an investor's state tax liability it results in a loss of the taxpayer's state deduction from its federal tax return.

Investors make capital contributions to a project partnership well in advance of receiving tax credits. In many cases the investment will be made 2 to 3 years before earning a full year of tax credits because the project must be constructed before credits are earned and the units are leased. Thus, an investor may only earn partial credits for the first year. The result may be that an investor actually recovers its full investment over a period of 13 years as opposed to the 10 year period credit period.⁹

To highlight the problem with a 10 year credit, one only needs to compare it with the more efficient historic tax credit. Because the low income housing tax credit is a 10 year credit, and as discussed above, more apt to be a 13 year investment, it generates \$.40 per credit dollar. The historic credit on a pre-tax basis generates in excess of \$.80 on the dollar. The obvious advantage to the historic credit is that it is a one year credit with no recapture provision. While the equity generated for low income housing is substantially less than the equity provided for historic preservation overall, it is necessary to issue substantially more low income tax credits to provide the same amount of equity. This inefficiency will be dealt with in more detail later in this report because it is one of the inefficiencies that can be mitigated by state action.

The second major inefficiency, as noted above, results from the fact that the investor who uses the tax credit *reduces* his state income tax liability. As noted, the *payment* of a state tax typically results in a reduction of the taxpayer's federal tax liability. Because the state tax credit *reduces* the state tax *paid* (it is not treated as the payment of a tax), the federal deduction is lost. The result is that the use of a dollar of tax credit will increase the taxpayer's federal tax liability by \$.035 thereby decreasing the value of the credit to the state taxpayer by 35%.¹⁰ This inefficiency is being addressed by the Tax Law Subcommittee and it is possible a solution will be found to remove this inefficiency.

⁸ We believe this was clearly established in the public hearings but is also documented in the Analysis of Jessica Estates III, L.P., Missouri Housing Development Commission Report, dated February 6, 2009. See also, Cost/Benefit Analysis of the Missouri Low Income Housing Tax Credit Program, Missouri Housing Development Commission, June 6, 2007. All cited materials will be attached to this report in an Appendix.

⁹ In reality syndicators usually make the initial investment and then later sell their interest to investors. The result is the same. The syndicator must incur interest expense to carry the investment until it is sold which increases the syndicator's cost and thereby reduces the price it can pay for the credits.

¹⁰ This assumes a federal tax rate of 35%.

Eliminating the two above referenced inefficiencies would substantially increase the value of the state credit and would permit a reduction in the amount of state tax credits necessary to produce the same amount of equity to fund affordable housing.

Whether the Low Income Housing Tax Credit Program Is a Good Investment

This section will address the economic issues raised by the Commission in its list of 15 questions to the subcommittees.

One of the first questions addressed by the subcommittee was the issue of whether the low income housing tax credit program is a good investment for the state.

It is the belief of the subcommittee that the Program is in fact a good investment for the state but that it needs to be made more efficient. However, at the outset it must be understood that the program cannot be evaluated strictly as an economic development tool although it clearly provides economic development and a measureable return on its investment for the state. Notwithstanding, it is also a social program that indirectly saves the state money by providing economic benefits that might not be readily apparent. These benefits will be discussed in more detail later in this report.

The Economic Benefits of the Low Income Housing Tax Credit Program

The Missouri Department of Economic Development (DED) provides an analysis each year on the effectiveness of the various tax credit programs. DED uses the REMI Missouri Economic Model of Economic Impact. While the REMI model is fine as far as it goes it does not fully measure output and in fact is limited to the direct economic impact of a program. The IMPLAN model on the other hand uses Input-Output (I-O) analysis which measures both direct and indirect economic impact.

A detailed economic impact analysis of the Low Income Housing Tax Credit Program can be found in two separate MHDC studies. The first study, commissioned by MHDC and dated June 6, 2007 was performed jointly by the accounting firm of BKD, LLP and Missouri State University and is titled "Cost/Benefit Analysis of the Missouri Low-Income Housing Tax Credit Program." The second study commissioned by MHDC, dated February 6, 2009, was performed by BKD, LLP and studied one individual project. It is titled "Analysis of Jessica Estates III, LLP, Participant in the Missouri Low-Income Housing Tax Credit Program." Both studies are included within an Appendix to this Report.

It is impractical to review these two studies in detail in the body of this report but the interested reader may review the full text of the studies. The 2007 Study analyzed a sample of 30 projects from a population 327 projects which received credits in years 2000 through 2005. The study's findings included the following:

- Each dollar of state tax credit awarded generates \$9.60 in economic activity.

- Each dollar of state tax credit awarded results in an increase in gross state product of \$5.45.
- Credits awarded during the project period generated almost \$6.5 billion of total economic impact to the state of Missouri and increased gross state product by over \$3.73 billion.
- Credits awarded during the project period generated over 41,800 full-time job equivalents as a result of increased construction activity and annual operations.
- The 327 projects awarded credits produced 21,250 units of affordable housing of which 5,675 (26.7%) were designated for seniors and the remaining 15,575 (73.3%) were for working families.
- The 327 projects are located throughout the state with 15,703 units being developed in the state's major metropolitan areas of Kansas City and St. Louis, 2,447 units developed in minor metropolitan areas (other metro) areas and 3,100 units developed in rural areas.
- On average, rents would increase between 18.7% and 24.3% to absorb the additional debt service needed to replace the equity generated by the LIHTC. Limited sources of alternative funding would make many projects economically unfeasible.¹¹

The 2009 Jessica Estates Study which occurred demonstrated the specific impact of one project. Because it was near a metropolitan area it actually generated a greater return to the state. Included within its findings:

- Each dollar of state tax credit awarded to the project is estimated to generate \$12.33 in economic activity.
- Each dollar of state tax credit awarded to the project is estimated to result in an increase in gross state product of \$6.52.
- Construction and operation of the project is estimated to generate of \$7.8 million of total economic impact to the state of Missouri and estimated to increased gross state product by over \$4.3 million.
- Construction and operation of the project is estimated to have generated 53 full-time equivalent jobs.
- Sales tax paid on construction materials is estimated at \$101,000. Property taxes increased by over \$16,000 per year as a result of the project.¹²

¹¹ Cost/Benefit Analysis of the Missouri Low-Income Housing Tax Credit Program, dated June 6, 2007, page 1.

¹² "Analysis of Jessica Estates III, LLP, Participant in the Missouri Low-Income Housing Tax Credit Program", page 1.

The economic benefits derived from the program are due to the combination of the equity produced by federal tax credits and the state tax credits and other sources of federal funding. For every dollar generated by state tax credits, the state has historically received approximately two dollars or more of benefit from federal investors who have invested in the projects to obtain the federal tax credit and the passive losses generated from those projects. The federal investors are frequently large banks such as J.P. Morgan Chase, Wells Fargo, Bank of America and Citibank. Additionally large national corporations such as Verizon, American Express and national insurance companies frequently invest in Missouri projects so that Missouri has the benefit of receiving a substantial investment in its state from companies who might not normally invest in Missouri. Thus, the program is able to leverage substantial investment from outside the State of Missouri to build its housing.

It is also difficult to measure the impact on a community when an older apartment building is rehabilitated as an acquisition rehab or when a historic building in a downtown is restored and preserved. Not only does the restoration of a historic downtown building bring pride to a community but it can serve as the catalyst and cornerstone for the revitalization of the entire downtown area. Frequently such preservation will serve to encourage downtown communities to invest further in programs to revitalize their downtowns and draw additional investment and businesses to what was a decaying downtown area. This has happened many times over the course of the program and many communities have enthusiastically embraced the preservation that jumpstarted a community wide effort to preserve their downtowns and the resulting economic activity it has created.¹³

Social Aspects of the Program

The social aspects of the program cannot be overlooked. The 2007 MHDC study noted the following social costs of not providing affordable housing.

- Greater risk of health problems related to poor housing conditions and inadequate health care. Higher risk of exposure to environmental contaminants.
- Seniors are forced to enter nursing homes or assisted living facilities earlier in life at an increased cost to state programs.
- Increased rates of emotional stress.
- Higher cost burden of housing causes less money to be available for food, clothing, and other necessities. This leads to poor nutrition and a myriad of health problems.
- Poorer health outcomes and increased use of public health services.
- Increased housing instability and great risk of homelessness.
- Poor school performance for children and higher drop out rates.

¹³ Evidence of this can be found in the testimony from the Public Hearings.

- Increased likelihood of state intervention to remove children from squalid conditions and increase in justice processing.
- Greater exposure to violence.¹⁴

In addition to the social considerations that directly affect tenants there are other social impacts on communities in general when infill housing is built that removes vacant lots or vacant buildings from an area that was previously affected by crime. The infill housing or rehabilitation of a vacant building can turn a blighted area into a desirable area for the community thereby reducing crime and the cost of patrolling such areas and responding to crime in the area. In addition these developments create additional economic development once the area is restored and is no longer blighted.¹⁵

Continued Need for Affordable Housing

The 2007 MHDC study found that there were over 98,000 families in Missouri paying more than 50% of their income for rent and that any amount over 30% places a significant burden on those families. Furthermore, over 71,000 Missouri families are living in substandard housing.¹⁶ National studies all indicate that these numbers are growing not declining.

It is also important to note that when employers evaluate communities for relocation or the creation of a new location three of the most frequent points of inquiry concern schools, infrastructure in general and whether there is affordable housing or “work force housing” for their employees. Thus, affordable or work force housing can lead indirectly to economic growth for a community and its absence can represent a substantial barrier to such growth.

The testimony from the public hearings also contains numerous examples of how affordable housing has benefited communities and stimulated economic growth. It also demonstrates strong public support for affordable housing.

The 2007 MHDC study found that “on average, rents would increase between 18.7% and 24.3 % to absorb the additional debt service needed to replace the equity generated by the LIHTC” and that without the low-income housing tax credit many developments would be economically unfeasible. The Missouri LIHTC brings equity to projects allowing construction of units that are affordable to the Missouri’s working families and seniors.

The Missouri Department of Economic Development’s Tax Credit Analysis dated November 2009 REVISED¹⁷ states:

The additional project equity raised by the state LIHTC allows more projects to be built and makes project rents more affordable. In 41 out of 78 projects authorized in FY09, the

¹⁴ Id. at page 37.

¹⁵ Testimony from Public Hearings.

¹⁶ Cost/Benefit Analysis of the Missouri Low-Income Housing Tax Credit Program, dated June 6, 2007, page 33.

¹⁷ This study is included in the Appendix.

projects would not be feasible as Low Income Housing Tax Credit units without the state tax credit equity, resulting in a loss of 1,931 affordable rental units in the state. In the 35 remaining projects, the rents would increase an average of \$288/month without the state tax credit equity.

The Need for Affordable Housing is Greater Than Ever

Our state finds itself in the same situation as the country as a whole. When the economy goes into recession, state revenues decline. At the same time the need for affordable housing peaks. It is difficult to reconcile these two competing interests. One argument is that we, as a state can't continue to fund affordable housing at existing levels. The converse is we can't afford not to because this is the time when the need is the greatest and as long as the recession continues the need will grow. An additional argument in support of providing such housing is the high economic development scoring of the housing program.

As noted above, the housing program is an economic development tool. One could easily make the argument that it should enjoy some priority simply from an economic development perspective. However as also noted above, it is also a social program and while this subcommittee is aware of the budgetary issues, and while it recognizes that absent improved efficiencies, the program may have to be reduced in size, such reduction comes at the worst possible time for the state's seniors and working families who are struggling to find affordable housing during the current recession. The combined economic benefit of the program with a corresponding need for housing should elevate it to the status of one of the most beneficial and valuable tax credit programs in the state.

The current recession has been devastating to many Americans. The unemployment rate has increased dramatically, hovering around 9.5% with Missouri's rate slightly higher at 9.8%. It is generally recognized that the true unemployment rate is actually higher as the reported rate does not include the longer term unemployed who have given up on finding a job or the under-employed.

Industry is slow to hire new employees preferring to hire part time employees. Many of the unemployed or under-employed still have a spouse working but their overall family income has been reduced dramatically through the loss of one income. Other families have seen their income drop because a member who once held a full time job now holds a part-time job. Many of these same people have suffered the foreclosure of a home and have no decent affordable place to go. There is insufficient affordable housing for these people. They would now qualify for affordable housing if it were available. Many seniors have also suffered setbacks in retirement investments and are now struggling to find more affordable housing.

In every area of the country there is a lack sufficient housing for seniors and families. We must continue to create additional housing stock in response to this growing need, realizing that the current shortage of housing stock will suffer greater stress as the recession continues. It is also suggested that MHDC could be of assistance in prioritizing those parts of the state in greatest need of affordable housing so that affordable housing is not concentrated in areas where need may not be the greatest.

As the National Low Income Housing Coalition found, the recession has hit the lowest income people in our country the hardest.¹⁸ That industry group in a later report, dated April 21, 2010, found that as anticipated, “rents continue to rise,¹⁹ while wages continue to fall across the country.”²⁰ The report continues in noting “the recession has only worsened an already severe housing crisis.”²¹ According to Dean Baker, Co-Director of the Center for Economic Policy and Research, “The persistence of high rates of unemployment and under-employment is making it ever more difficult for families to secure decent housing. Unfortunately, the situation is not likely to improve anytime soon.”²² Jo Ann Jenkins, president of AARP’s affiliated charity, AARP Foundation noted: “While the recession has been devastating for many older Americans, this recent data indicates that lower-income folks are being hit particularly hard. Each day, millions are choosing between essentials like buying groceries, or paying for prescriptions. It’s a devastating choice that no one should have to make.”²³ Additionally, lower income adults are twice as likely to have looked for affordable housing in the last six months than those with higher incomes.²⁴

The lack of affordable housing during the recession has led to a greater incidence of families sharing housing, frequently due to foreclosure and the absence of affordable housing. This “doubled up” housing continues to increase and adds instability to the lives of those involved, affecting children who are forced to live in cramped conditions.²⁵ In a report by the National Low Income Housing Coalition, the Coalition described affordable housing being in a crisis state noting that the unemployment and foreclosure crises had exacerbated the difficulties that low income families have historically faced in trying to find decent, affordable housing.²⁶ It also found that the recession is hitting those at the lower end of the economic spectrum where the unemployment rate is 12.6% and that many have had to accept part-time work to avoid being unemployed.²⁷

As noted above, this is a difficult time for the state and a difficult time for those who have been hit hardest by the current recession. It is important to address the budget but not forget about those who need help the most through a program that scores well from an economic development standpoint.

¹⁸ As Predicted, Recession Increases Deep Poverty, National Low Income Housing Coalition. September 10, 2009.

¹⁹ While one might assume the increase in foreclosures would lead to the conversion of foreclosed houses into affordable rental properties there is no evidence to support such a theory. Presumably banks are holding the houses for resale and most of those homes become owner occupied and do not add to the affordable rental housing stock.

²⁰ Recession Continues to Push Rental Housing Further “Out of Reach” for Low Income Americans.

²¹ Id.

²² Id.

²³ Recession Impact on Lower-Income Adults, Disabled-World.com., page 1.

²⁴ Id.

²⁵ Center for American Progress, The New Housing Normal for Low-Income Families, June 2010.

²⁶ Out of Reach 2009, Persistent Problems, New Challenges for Renters, National Low Income Housing Coalition, April, 2009, page 1.

²⁷ Id. at page 2.

Protecting the Quality of Affordable Housing

While it is important to contain costs and ensure that tax dollars are spent wisely, it is also important to recognize that at one time affordable housing had a stigma and was not welcome in many communities across this State. The Missouri Housing Development Commission (MHDC) worked with developers to ensure that the housing that was built was quality housing and was well maintained. Communities now welcome affordable housing for their seniors and families and in fact compete to obtain these projects because they bring economic development, provide needed housing and because *the quality of the projects and the manner in which they are maintained make them desirable additions to the community*. In fact, the quality of affordable housing developments typically *increases* the value of surrounding neighborhoods.²⁸ We must be careful not to diminish the quality of housing in our efforts to control costs.

Ways to Improve the Efficiency of the Missouri State Low Income Housing Tax Credit

The subcommittee believes shortening the credit delivery period is one of the most effective means of improving the efficiency of the state tax credit. Certain assumptions will be made in this section with respect to outstanding tax issues which would enable the credit to reach the efficiencies discussed in this section. The subcommittee recommends that the Commission support shortening the time frame for the credit to 1, 3, or 5 years. Because of the previously discussed budgetary issues and the obvious cost of transitioning, the subcommittee did not feel it was its place to recommend the specific term.

1 Year Credit (9% credit)

A one year credit would obviously be the most efficient credit. There are a number of different possible tax structures that could be employed in implementing a one year credit. These would require changes in federal tax law, private letter rulings from the IRS and changes in state law. The details of how this would be accomplished will be left to the Tax Law Subcommittee. Until it can be determined which tax structure can be implemented it is difficult to project a precise market value for a 1 year credit. Different structures would yield substantially different pricing.

Perhaps the best case scenario would be that the project partnership does not have to recognize income from the transfer of the credit and the syndicator and ultimate user will have basis equal to their cost. Under those circumstances, a credit without recapture, should sell for in excess of \$.80 cents, perhaps as high as \$.85. This would further assume the syndicator, as with the historic credit, would not have to pay for the credit until it was available to sell. If the syndicator is required to put money into the project during construction period then it would affect pricing. The current allocation for the 9% credit is approximately \$132M which at \$.40 cents would generate approximately \$53M in equity for projects. Assuming the one year credit would generate between \$.80 and \$.85, a one year credit of \$62.5M would have the potential to generate the same amount of equity.²⁹

²⁸ An Upward Lift, Tax Credit Advisor, August 2010, page 9.

²⁹ It should be noted that pricing assumptions are based upon projections. The actual market price could be more or less.

3 Year Credit (9% credit)

Making the same assumptions with respect to changes in the law as discussed above, a 3 year credit could generate in the range of \$.65 cents per credit dollar permitting a reduction in credits to \$82.0M over a 3 year period to generate approximately \$53M of equity.³⁰

5 Year Credit (9% credit)

Making the same assumptions with respect to changes in the law as discussed above, a 5 year credit could generate in the range of \$.60 cents per credit dollar permitting a reduction in credits to \$89M over a 5 year period to generate approximately \$53.0M in equity.³¹

1 Year Credit (4% credit)

The 4% credit currently has a cap of \$60M. In 2008 approximately 48M of 4% credits were authorized but many projects never closed bringing the total 4% credits for 2008 down to approximately \$23M.³² In 2009 approximately \$49.0M of credits were authorized but again many did not close bringing the total 2009 credits down to \$25M.³³ In 2010 \$49.0M were authorized but we have no hard numbers as to what will actually be closed. Even assuming the full 2010 credits which were authorized are ultimately closed the three year average would be approximately \$33.0M per year.³⁴ If one were to assume that for the near future that amount were to remain stable, then the actual cost to the state would be substantially less than one would project with a fully funded 4% credit. Assuming a three year average of \$33.0M for 4% credits at a price of \$.40 per credit dollar, the resulting equity would be \$13.2M. Assuming the one year credit would generate between \$.80 and \$.85, a one year credit of approximately \$16.0M would have the potential to generate the same amount of equity (\$13.2M).

3 Year Credit (4% credit)

Making the same assumptions with respect to changes in the law as discussed above, a 3 year credit could generate in the range of \$.65 cents per credit dollar permitting a reduction in credits to just over \$20.0M over a 3 year period to generate the same amount of equity.

5 Year Credit (4% credit)

Making the same assumptions with respect to changes in the law as discussed above, a 5 year credit could generate in the range of \$.60 cents per credit dollar permitting a reduction in credits to \$22M to generate the same equity.

³⁰ If basis cannot be obtained in the credits then the efficiencies claimed here will be materially affected.

³¹ If basis cannot be obtained in the credits then the efficiencies claimed here will be materially affected.

³² Source: MHDC.

³³ Id.

³⁴ Id.

Buyback

It is clear that the low income housing tax credit can be made more efficient by shortening the term of the credits to less than 10 years. The difficulty in shortening the term of the credit lies in the fact that there is, and will be, an existing 10 year inventory of credits that must be redeemed. Any reduction in the term of the state credit would obviously necessitate an increase in the number of credits per year in order to generate the same equity, but in the long term it would save the state a significant amount of money.

However, if the credit period were shortened to 1 year and if the annual amount of the 1 year credit was \$90M then it creates an obvious short term problem. It is the “cost of transitioning” from a long term credit to a short term credit.

The state must now redeem \$90M in state credits each year while simultaneously redeeming an outstanding inventory of credits at the rate of approximately \$150M a year. Instead of costing the state \$150M, the cost of the “new credit” combined with the redemption of the “outstanding inventory” would cost the state \$240M. The redemptions obviously decrease each year as the “outstanding inventory” burns off. The cost would decrease by approximately \$15M a year. Eventually the state crosses the critical timeline where it is actually saving money even with the outstanding inventory being redeemed.

In order to ease the transitioning to a shorter term credit the subcommittee supports the concept of buying back a portion of the outstanding inventory of credits in general, including the low income housing tax credit. The credits that mature in the next 3 to 5 years are obviously the most critical because that is the time period when the transition would have the greatest impact on the budget.

The size of the outstanding credits exceeds \$1.0B from Fiscal Year 2012 through 2022. While this is an imposing number it also presents the opportunity for the state to remove a considerable portion of that by way of a “Dutch auction.” Based on conversations with developers and syndicators, there is interest in such a procedure and it is believed that credits can successfully be repurchased by the state. It is also quite possible that due to the recession, there may be investors who have purchased a 10 year stream of credits that they cannot fully use.

Make the Housing Tax Credit Earned When the Building is Placed in Service and the First Unit is Leased.

Currently state housing credits are earned on a unit by unit basis as a building is leased. A unit leased in January earns a full year of credits. A unit leased in February earns 11/12ths of a year of credits. A unit leased in December earns 1/12th of a year of credits. Credits that are not earned in year 1 are carried forward to year 11 making the investment an 11 year investment instead of the anticipated 10 year investment.³⁵

³⁵ As noted earlier credits are typically earned two to three years after an award and thus the 11 year investment may actually be a 13-14 year investment.

Projects typically generate only a portion of the full credits allocated for a particular year and as a result this creates uncertainty that results in a discounting of the value of the credit. If investors knew that a building would generate a full year of credits for the year in which the first unit was placed in service, it would remove the uncertainty and let the investor claim his credits uniformly over a 10 year period. That in turn would result in more certainty and higher credit pricing.

Recapture

The recapture provision of the low income housing tax credit provides the state with the ability to recapture authorized credits upon the occurrence of certain conditions such as non-compliance with the law governing tax credits. It also provides an incentive for investors and syndicators to police projects to ensure the developers comply with the law and properly maintain the projects.

Finally, the recapture provision provides an economic incentive for investors and syndicators to be active participants in helping struggling projects. The fact that investors and syndicators have participated in efforts to avoid project failure and recapture is reflected in the fact that MHDC estimates that only approximately \$47,000 of low income housing tax credits have been recaptured through 2007. Numbers are not available subsequent to that date. It is one of the success stories of the low income housing program.

However, in return for these benefits, the recapture provision also has some impact on pricing. The recapture provisions in the federal credit already provides an enforcement mechanism and that may be sufficient. The market place always factors risk in pricing and although recapture is exceedingly rare in Missouri, it has occurred and it does have some impact on pricing. The subcommittee was not able to reach a consensus on whether the recapture provision should be removed or retained but felt that the Commission as a whole or the legislature should make that decision. However, if the removal of the recapture provision would improve the overall efficiency of the program as part of a restructuring of how the credit works then it should be given consideration in that context.

If the recapture provision were to be removed, it should be removed with respect to the outstanding inventory of credits otherwise those credits would be placed and a competitive disadvantage in the marketplace.

Establish Maximum Costs per Unit for Stacking of Credits

The issue has been raised as to whether certain cost limits should be set for when low income housing tax credits are combined with historic credits. It has been suggested that if both low income housing tax credits and historic tax credits are used then the historic credit should be reduced from 25% of QRE to 20%.

Alternatives to the Current Tax Credit Structure

The subcommittee considered a number of alternatives to the current tax credit structure.

Vouchers

The subcommittee considered vouchers as an alternative funding mechanism to tax credits. It was concluded that vouchers carry a stigma, are not a superior method of financing and that it would necessitate a substantial expansion of the state program to administer such a system.

Direct Grants

The subcommittee considered direct grants from the state as an alternative means of financing housing. The problem with grants is that they are taxable to the recipient and therefore did not appear to offer an improvement over the current program.

Loans

The subcommittee considered a direct loan program as an alternative to tax credits but a loan program raises its own set of issues. The most significant concern was that the project could not service the debt or have the means to repay the loan at the end of the compliance period. If the loan were forgiven at that point it would create income for the project partnership or the developer. This uncertainty could discourage federal investors from investing in Missouri and would also create a significant uncertainty for developers. Ultimately it was concluded that the direct loan approach, at least with the information available at this time, was not a viable option.

Deferred Developer's Fees

Concerns have been raised regarding deferred developer's fees that are never paid and should therefore lead to a partial recapture of credits. Deferred developers fees have typically not been a problem with new construction 9% projects or 9% historic projects because federal syndicators generally will not permit significant deferred developer's fees on those projects. It has occurred more often in 4% bond deals and acquisition rehabilitation projects where deferred fees are to be paid out of operating cash flow. A specific action or recommendation as to the extent to which fees may be deferred on either 9% or 4% projects or whether qualified basis should be reduced by the amount of any deferred fee which has no source of repayment other than positive cash flow; it is a matter that should be given consideration by MHDC.

Additional Possible Recommendations that may Supplement the Current List of Recommendations

On October 22, 2010, Margaret Lineberry, the Executive Director of the Missouri Housing Development Commission provided the subcommittee with a comprehensive memo detailing potential changes that could improve the efficiency of the program. Her input is valued in that she is the Executive Director of the program being evaluated. The first section of the report deals with possible cost savings that could be implemented by the Agency. Those ideas are deserving of attention, discussion and consideration. While these ideas and suggestions may technically be beyond the scope of what the Chairman believes to be the scope of this subcommittee's charge, it is suggested that a forum be created where these ideas can be discussed with the participation of the staff, members of the syndication and development community and members of the Missouri

Housing Development Commission. The Executive Director's input on these matters is appreciated. The subcommittee is including a copy of the memorandum in its Appendix so the full Commission may have access to it.

The memorandum also presented several other ideas that have been incorporated into our report and recommendations. For example our report addresses the possibility of a 5 year credit, an idea which is in fact one favored by the Chairman. The concept of sellable transferable credit was also suggested and is one of the ideas that we believe would be incorporated into a shorter term credit, depending of the work of the Tax Law Committee. The Executive Director has also suggested permitting investors to receive credits sooner. That idea has been incorporated into our recommendations as was her idea of a buy-back of outstanding credits.

The third section of the Executive Director's memo deals with new programs to replace the existing LIHTC program. The subcommittee would ask that the Tax Law Committee review the suggestion of a loan program or the issuance of bonds as these matters are certainly beyond the expertise of the Chairman and time does not permit a detailed legal analysis by this subcommittee. But, input from the Tax Law Committee would be welcome and it is possible these ideas can be taken up in the Commission's general meetings. Again, the subcommittee is grateful for the Executive Director's input on these matters.

Subcommittee Recommendations:

1. Reduce the number of credits issued by the state by reducing the term of the tax credit to either 1, 3 or 5 years. By adopting this recommendation the tax credit will become more efficient and will require less tax credits to produce the same equity for projects. If the credit is restructured, syndicators holding outstanding inventories of credits should be given the option of redeeming their credits and receiving new credits with the same characteristics of the new credits. The intent is to place the existing inventories of credits on the same economic footing so that they are equal in value to the new credits. The subcommittee understands that reducing credit amounts due to increased efficiencies may not avoid having to reduce the size of the program.
2. Consider eliminating the recapture provision from the state credit. The committee was not comfortable making a specific recommendation on eliminating the recapture provision because it felt that it was a policy issue that should be decided by the State Legislature. However, if elimination of the recapture provision is a component of a proposed restructuring of the credit to make it more efficient then the subcommittee would support that action.
3. We would urge the Tax Law Subcommittee to join with those in the industry to attempt to obtain changes in the federal tax law or make suggestions for restructuring the state credit so that the loss of the state deduction from the taxpayer's federal return can be avoided.
4. Maintain equity levels at or near current levels. It is hoped this goal can be accomplished through increased efficiencies in the program such as a shorter credit period and the other

actions suggested in these recommendations. As noted above, the subcommittee is aware of the fact that depending on the extent efficiencies can or cannot be obtained it may be necessary to reduce the size of the program.

5. State law should be changed to provide that when the first unit of a low income housing tax credit project is leased, the full project earns credits from that point. This will serve to increase credit pricing. To the extent credit pricing can be increased, the number of credits issued by the state can be correspondingly reduced.
6. The number of tax credits authorized issued each year should be tied to state revenues. This adjustment can be made on an annual basis. A base year would be established (e.g. Fiscal Year 2012) if state revenues for FY 2012 decreased by 5% over revenues from FY 2011, the number of credits authorized for the 2012 FY would be reduced by 5%. If state revenues increased the next year by 5%, the number of credits would rise by 5% to its previous level. By adopting this recommendation there is no longer the threat that the program will exceed the growth in state revenues.
7. It is recommended that for projects receiving both state low income housing tax credits and historic tax credits that the historic credits be limited to 20% of the QRE for the historic credit.
8. Carryback/Carry Forward. The Low Income Housing Tax Credit currently permits a 3 year "carryback" and 5 year "carryforward." Neither seems excessive and reducing either might adversely affect pricing. If the Commission feels a need to shorten either period the Committee would recommend shortening the carryback to 2 years but only on credits issued on a going forward basis. Changing the rules on investors who have already purchased credits would create significant disruption in the investor community. The subcommittee understands the desire to shorten carryback provisions to increase budget certainty but to the extent it is shortened it will have some negative impact on pricing. A negative impact on pricing means the credit becomes less efficient not more efficient and the same number of credits produces less equity and therefore less housing. If possible the 3 year carryback should remain in place.

Affordable Housing Assistance Program

Purpose

The purpose of the AHAP credit is to provide an incentive for businesses and individuals to make donations to non-profit organizations that assist in the production of affordable rental housing or homeownership for low-income families in Missouri. The AHAP credit is authorized by Sections 32.105 to 32.125, RSMo.

How the Program Works

The AHAP tax credit is a one-time credit that may be allocated to an eligible donor for up to 55 percent of the total value of an eligible donation. There are two types of AHAP tax credits: (1)

Production credits for donations related to construction, rehabilitation, and rental assistance activities; and (2) Operating Assistance credits for donations that help fund the operating costs of the non-profit organization. The program offers \$10 million in Production credits and \$1 million in Operating Assistance credits annually.

Non-profit organizations submit applications for specific Production and/or Operating Assistance projects. Once an application is approved, MHDC authorizes the non-profit for a reservation of credits. The non-profit then uses the reservation of credits to solicit donations for the approved project.

In order to receive a tax credit, a business firm or eligible individual must donate cash, professional services, real or personal property to a non-profit housing organization. After a qualified donor makes an application and submits the necessary paperwork, MHDC issues the credits directly to the donor. The amount of tax credit allocated is equal to 55% of the value of the contribution.

Eligible Areas

The credit is eligible on a statewide basis.

Eligible Applicants

Non-profit housing organizations are eligible to apply for the tax credit.

Eligible Use of Tax Credits

This tax credit can be applied to income taxes; the corporation franchise tax; the bank tax; insurance premium taxes; other financial institutions taxes; and the express company tax.

Special Attributes

The AHAP credit can be carried forward 10 years and is sellable and transferable.

Application Procedure

The credit is governed by applications and guidelines established by MHDC. Applications for Production credits are accepted throughout the year until the statutory cap is reached. Applications for Operating Assistance credits are accepted only during posted application periods. MHDC typically holds two application rounds for Operating Assistance credits per fiscal year.

Special Program Requirements

In order to qualify for the credit a proposal must meet the following requirements:

1. It must demonstrate a housing need;

2. It must provide affordable housing for low-income families by restricting rents and purchase prices;
3. It must meet one of the following affordability thresholds:
 - a. Provide rental housing for persons at or below 50% of area median income;
 - b. Provide homeownership opportunities for households at or below 100% of the area median income; or
 - c. Provide market rate housing in “rebuilding communities” as defined by state statute;
4. Provide assistance for the administrative costs of a non-profit housing organization.

Approved proposals for rental or for-sale housing must follow income and rent/resale restrictions for a period of ten years.

Recommendations

1. Because there are fewer funding sources available to help non-profits with operating activities, applications typically exceed the \$1.0M cap. Because there is a substantial need from non-profit housing organizations for operating assistance, it would make sense to increase the AHAP limit for Operating Assistance credits with a corresponding decrease in the Production credits. The Operating Assistance cap could be increased to \$2-3M and the Production cap decreased to \$8-9M. Alternatively, the remaining portion of the Production cap that remains unauthorized for the last two quarters of the fiscal year, could be made available to be used as either Production or Operating Assistance credits. This would not change the overall cap but would merely allow a reallocation of the credits between Production and Operating Assistance credits.
2. Expand the allowable users of the credit to include individuals without business income. Currently Missouri law limits the users of AHAP credits to business firms, which include persons with business income, partners in a firm, shareholders in a subchapter S corporation, charitable organizations with taxable unrelated business income, corporations subject to franchise tax, insurance companies and financial institutions. Individuals and households who donate to the same approved affordable housing project but who do not have business income are not allowed to utilize the AHAP credit. It is recommended that to improve the credit, the eligible users be expanded to include any donor to an approved project. This proposal would not have a significant budget impact.
3. Consider reducing the AHAP credit to 45% of the contribution which is a reduction from the current 55%. The AHAP credit is already transferrable so it will not obtain the boost expected for the other donation credits which are not currently transferrable. The subcommittee would propose as an alternative, reducing the total AHAP credit by approximately 10% or \$1.0M. Because the subcommittee is concerned with the impact of the reduction of the contribution from 55% to 45% it would prefer that the cap be reduced in lieu of decreasing the contribution percentage.

Appendix
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1. See www.tcrc.mo.gov for the full text of the Tax Credit Review Commission Meeting on September 8, 2010
2. Id.
3. Id.
4. Id.
5. Id.
8. Analysis of Jessica Estates III, L.P., Missouri Housing Development Commission Report, dated February 6, 2009 and Cost/Benefit Analysis of the Missouri Low Income Housing Tax Credit Program, Missouri Housing Development Commission, June 6, 2007
11. Cost/Benefit Analysis of the Missouri Low Income Housing Tax Credit Program, Missouri Housing Development Commission, June 6, 2007, page 1
12. Analysis of Jessica Estates III, L.P., Missouri Housing Development Commission Report, dated February 6, 2009, page 1
13. See www.tcrc.mo.gov for the full Additional Commentary Public Hearing Testimony
14. Analysis of Jessica Estates III, L.P., Missouri Housing Development Commission Report, dated February 6, 2009 page 37
15. See www.tcrc.mo.gov for the full Additional Commentary Public Hearing Testimony
16. Cost/Benefit Analysis of the Missouri Low Income Housing Tax Credit Program, Missouri Housing Development Commission, June 6, 2007, page 33
17. Missouri Department of Economic Development's Tax Credit Analysis dated November 2009 REVISED
18. As Predicted, Recession Increases Deep Poverty, National Low Income Housing Coalition, September 10, 2009
20. Recession Continues to Push Rental Housing Further "Out of Reach" for Low Income Americans
21. Id.
22. Id.
23. Recession Impact on Lower-Income Adults, Disabled-World.com, page 1.
24. Id.
25. The New Housing Normal for Low-Income Families, Center for American Progress, June 2010
26. See www.nlihc.org for full text of Out of Reach 2009, Persistent Problems, New Challenges for Renters, National Low Income Housing Coalition April, 2009. Due to the size of the document, only the coverage page and pages 1 and 2 are attached.
27. Id.
28. An Upward Lift, Tax Credit Advisor, August 2010, page 9