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Community Development Corporation
1307 Washington Avenue, Suite 300
St. Louis, MO 63103

February 10, 2012

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
Docket No. OCC-2011-0014
RIN 1557-AD44

Jennifer J. Johnson
Secretary

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Docket No. R-1432
RIN 7100 AD 82

Robert E. Feldman

Executive Secretary

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Attention: Comments
RIN 3064-AD85

Elizabeth M. Murphy
Secretary

Securities and Exchange Commission
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

RIN 3235-AL07

File No. S7-41-11

David A. Stawick, Secretary of the
Commission

Commodities Futures Trading Commission

Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

RIN: 3038-AD05

Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Dear Ladies and Gentlemen:

U.S. Bank (or the "Bank") appreciates the opportunity to submit comments to the proposed rule implementing (the "proposed rules") Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker Rule"). U.S. Bank is the fifth-largest commercial bank in the United States. The company operates 3,086 banking offices in 25 states and 5,086 ATMs. U.S. Bank offers regional consumer and business banking and wealth management services, national wholesale and trust services, and international payments services to more than 17 million customers. Headquartered in Minneapolis, U.S. Bank was founded in 1863 and currently employs more than 61,000 people.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

We have a number of concerns with the scope of the proposed rules. While U.S. Bank has not engaged in the type of proprietary trading or made substantial investments in hedge funds or private equity funds that are prohibited under the Volcker Rule, we are nevertheless concerned that the rules will harm our ability to provide liquidity to our customers, hinder our ability to engage in critical asset liability management activities and require an extensive compliance and record-keeping/reporting system to prove that we are not engaged in the prohibited activities. Due to the number and complexity of issues involved with the proposed rules, U.S. Bank is not submitting separate comment letters on most areas of concern, but has participated in and strongly supports the separate comment letters of The Clearing House, SIFMA, and a joint letter submitted by a number of regional banks, including U.S. Bank.

This letter will specifically address one area of concern for U.S. Bank and its community development subsidiary, U.S. Bancorp Community Development Corporation ("USBCDC"): the impact of the proposed rules on banking entities' ability to participate in low-income housing (LIHTC), new markets (NMTC) and historic tax credit (HTC) programs and answers the specific questions regarding the impact on these public welfare investments posed in the notice of proposed rulemaking (Questions 276 – 279 and 316). Our comments are intended to clarify how investments in these tax credit programs (collectively, "Tax Credit Investments") and the sponsoring of private equity funds comprised of such investments (collectively, "Tax Credit Funds")

We commend the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Securities and Exchange Commission (the "Agencies") for clearly stating in the proposed rules that banking entities are permitted under the Volcker Rule to make Tax Credit Investments and sponsor Tax Credit Funds. Notwithstanding the importance of this clarification, we believe that the structure of the proposed rules will unduly restrict the sponsorship of Tax Credit Funds in contravention of the clear intent of the Act.

U.S. Bank and USBCDC and other creditworthy banks have played a key role in serving as investors in and sponsors of Tax Credit Funds and providing guaranties for the funds. In the past four years, U.S. Bank has guaranteed approximately \$2 billion of Tax Credits that has resulted in \$1.9 billion in investor equity. This was achieved via the sponsorship of 29 funds with 18 unique investors. The strong majority of these investors would not have invested in public welfare investments but for the guarantee. Without the guarantees, a large portion of the \$1.9 billion of investor equity would not have been injected into our nation's communities. The investors range from Silicon Valley technology companies to Midwestern industrial companies to smaller insurance companies all of whom do would be unable to make these investments without the guarantee.

Following is a brief overview of the traditional roles played by banking entities in the Tax Credit Programs and our comments regarding the proposed rules. We have also included sample regulatory language for your consideration.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

1. Traditional Roles Played by Banking Entities

Since each Tax Credit Program's inception, banking entities have played significant roles as investors, sponsors and guarantors. Transactions within the Tax Credit Programs are generally designed through a tiered structure. The typical structure¹ starts with an equity fund (the "Tax Credit Fund"), in the form of a partnership or limited liability company, which acquires an ownership interest in limited liability companies or partnerships that acquire, develop and manage tax credit producing assets (the "Operating Partnerships").² Many banking entities have historically served and continue to serve as sponsors, managing members and general partners of Tax Credit Funds. Tax Credit Funds sell substantially all of their ownership interests to investors, many of which are banking entities. Through the various partnership or limited liability agreements, transaction participants make certain representations, warranties, and guarantees. Developers, general partners and managing members of the Operating Partnerships make the most significant guarantees in a typical structure and are typically in the first loss position. The guarantees that developers, general partners and managing members are traditionally required to provide include construction completion, permanent loan funding, operating deficit, tax credit and recapture guarantees

Tax Credit Funds have experienced very high tax credit compliance rates³ and are collectively associated with low risks. According to information published by the Internal Revenue Service, we estimated that corporations had recapture rates of less than 0.05% and 0.12% for the LIHTC and HTC programs during 2008, respectively.⁴ This information indicated that no NMTC recapture had occurred.⁴

In addition to developer, general partner and managing member guarantees, investors often require some additional level of assurance through a guarantee that at a minimum ensures the receipt of a minimum amount of tax credits. Other times, investors require what is, in essence, an enhancement or a wrap of the developer guarantee. Specifically, many investors require that the

¹ See Attachment 1 for an example diagram.

² Operating Partnerships includes Limited Liability Companies.

³ For the LIHTC program, see Attachment 3 for Novogradac & Company LLP's Low-Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies. Internal Revenue Code ("IRC") Sections 42, 45D and 47 govern the LIHTC, NMTC and HTC programs, respectively. Tax Credit Investments must comply with the provisions of the respective IRC sections. Failure to comply with the applicable provisions results in the recapture of tax credits. Investors are required to pay tax in the amount of the tax credits recaptured plus interest charges when a recapture event occurs. Tax credits are generally the investors' primary return on their Tax Credit Investments. High compliance rates are considered one indicator of low risk. For a detailed discussion on the success of the LIHTC program, see Attachment 3, Novogradac & Company LLP's Low-Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies.

⁴ 2008 Estimated Data Line Counts Corporation Tax Returns, Department of the Treasury - Internal Revenue Service, Thomas E. Burger.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

investment be guaranteed by the sponsor of the Tax Credit Fund or other creditworthy entity. This guarantee generally assures a minimum return, and, often more importantly, enables the investor to benefit from more favorable accounting presentation permitted by current accounting standards as proscribed by the FASB (Financial Accounting Standards Board). The more favorable accounting presentation, the "effective yield method" of accounting, is only available for Tax Credit Investments where the availability of the tax credits is guaranteed by a "creditworthy" entity.⁵ While no specific guidance is provided in the accounting literature regarding what types of entities would be considered creditworthy guarantors, the guidance makes reference to such guarantees being similar to a letter of credit or tax indemnity agreement, which suggests (and has been interpreted as) a high threshold of creditworthiness.

2. Comments in response to notice of proposed rule

For your convenience, we have provided specific comments below to questions listed in the notice of proposed rulemaking.

***Question 278:** Should the proposed rule permit a banking entity to sponsor an SBIC and other identified public welfare investments? Why or why not? Does the Agencies' determination under section 13(d)(1)(J) of the BHC Act regarding sponsoring of an SBIC, public welfare or qualified rehabilitation investment effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?*

We strongly support the proposed exemption allowing banking entities to sponsor SBIC, public welfare and qualified rehabilitation investment funds pursuant to the authority granted to the Agencies under section 13(d)(1)(J) of the BHC Act. Since banking entities are clearly permitted to make this type of investment under the Volcker Rule⁶ and assume the entire market risk, we agree they should also be permitted to sell the investments and similarly participate as a sponsor or syndicator of a fund that owns and operates such investments. The permitted risk of investing

⁵ Emerging Issues Task Force 94-1, Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects, Financial Accounting Standards Board.

⁶ Bank Holding Company Act, Section 13(d) — PERMITTED ACTIVITIES-(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted: . . . (E) Investments in one or more small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662), investments designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

is greater than the risk of sponsoring a SBIC or Tax Credit Fund and in no way contradicts the objective to promote and protect the safety and soundness of banking entities. Furthermore, as discussed in detail below, Tax Credit Funds have collectively been associated with low risks. We note further that as a national bank, our public welfare investments are already subject to capital and surplus limits, OCC notice and prior approval requirements and OCC examination. Allowing banking entities to continue their vital role in underwriting and sponsoring SBIC and public welfare investments, subject to existing regulatory requirements, will promote the financial stability of our nation's communities served by these important affordable housing, small business and other public welfare programs.

***Question 276:** Is the proposed rule's approach to implementing the SBIC, public welfare and qualified rehabilitation investment exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?*

***Question 277:** Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?
(Comments on these questions addressed together below)*

The Volcker Rule clearly allows banking entities to make SBIC, public welfare and qualified rehabilitation investments and we agree with your conclusion that that it also allows banking entities to sponsor SBICs and Tax Credit Funds. We believe that the proposed approach to implement this exemption, however, may restrict banking entities' ability to guarantee, or otherwise engage in covered transactions with, the Tax Credit Funds that they sponsor. We respectfully request that the Agencies either narrow the definition of "covered fund" to exclude permitted investments such as SBICs and Tax Credit Funds or, in the alternative, clarify the current language in Section __.16.

Section __.13(a)(1) of the proposed rule permits a banking entity to acquire or retain an ownership interest in, or act as sponsor to a covered fund "that is designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. § 24), including the welfare of low- and moderate-income communities or families..." or "that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program."⁷ The implication of the proposed rule clearly is that funds comprised of public welfare or other designated permitted investments remain "covered funds" even though investments in such funds are permitted. Section __.13 of the proposed rule does not specify whether or not this permitted activity overrides the prohibitions included in Section __.16 of the proposed rules, the so-called "Super 23A provisions." As currently drafted, the Super 23A provisions may apply to public

⁷ Proposed rule, Section __.13(a)(1)(ii) & (iii).

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

welfare or SBIC investment funds sponsored by a banking entity and would prevent the sponsoring bank from guaranteeing obligations of the fund.

The Volcker Rule generally prohibits a banking entity from engaging in any transaction with a hedge fund or private equity fund if the transaction "would be a covered transaction as defined in Section 23A of the Federal Reserve Act (12 U.S.C. 371c), . . . as if such banking entity and the affiliate thereof were a member bank and the hedge fund or private equity fund were an affiliate thereof."⁸ This prohibition was not intended by Congress to apply to the permitted investments allowed by subsection (E) of Section 13(d) of the Volcker Rule. In the subsequent subsection (G), which is the exemption permitting banking entities to sponsor private equity and hedge funds under certain circumstances, the Volcker Rule specifically provides that the permitted activity in subsection (G) is subject to the Super 23A provisions of Section 13(f). There is no such specific limitation set forth to the exemption in subsection (E). If the Agencies were to read Section 13(f) as applying to all investments permitted in Section 13(d), it would render the specific language in subsection (G) unnecessary and is not a proper reading of the statute. We believe Congress did not intend to sweep SBIC, public welfare investments and funds comprised of public welfare investments into the definitions of "private equity fund" or "hedge fund" and subject them to the Super 23A provisions.

The Agencies recognized the need for banking entities as sponsors of SBICs and Tax Credit Funds by permitting banking entities to continue sponsoring funds comprised of these permitted investments in Section 13(a)(1) of the proposed rule.⁹ We believe that a banking entity should be permitted to engage in covered transactions¹⁰ with investments that are permitted under Section __.13(a) of the proposed rule for many of the same reasons as those used to support why banking entities may sponsor Tax Credit Investments. Guaranteeing a portion of the obligations of a fund, as described in more detail below, is an integral part of sponsorship of the fund and inextricably linked with the sponsoring bank's managing member or general partner interest.

Under Section 23A as implemented by Regulation W, the LLCs or partnerships created by USBCDC for syndication of Tax Credit Investments are not "affiliates" of USBCDC or U.S. Bank, but rather they are subsidiaries of the bank. U.S. Bank's guaranty of these subsidiary Tax Credit Funds are therefore not covered transactions. Preserving the ability of national banks to provide guaranties to its sponsored Tax Credit Funds does not expose banks to the risks the Volcker Rule was intended to prevent. National banks' public welfare investments are already subject to strict capital limits under the OCC's Part 24 rules and each investment is subject to notice or prior approval requirements and OCC examination. Allowing national banks to

⁸ BHCA, Section 13(f).

⁹ Footnote 292 of the preamble to the proposed rule.

¹⁰ According to the Federal Reserve Act, Section 23A(b)(7), "covered transactions" include the following: extension of credit (loans); purchase or investment in securities; purchase of assets; acceptance of securities as collateral security; issuance of a guarantee, acceptance, or letter of credit.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

continue sponsoring and guaranteeing these types of highly regulated investments will in no way pose a threat to the financial stability of the United States.

Section __.16(a)(2) as currently drafted contains an exception that allows a banking entity to acquire or retain any interest in a covered fund in accordance with the proposed rule. The Agencies provided the exceptions in this section for activities which Congress concluded should not, as a matter of policy, be included with the Volcker Rule's prohibitions assuming certain risk and safety and soundness requirements were met. In the discussion in the preamble to the proposed rule, the Agencies state that: "There is no evidence that Congress intended section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section." We propose that the language be clarified to permit a banking entity to enter into transactions with covered funds permitted under Section __.13(a). Please see the sample regulatory language included for your consideration on page 10 below.

Question 279: *What would the effect of the proposed rule be on a banking entity's ability to sponsor and syndicate funds supported by public welfare investments or low income housing tax credits which are utilized to assist banks and other insured depository institutions with meeting their Community Reinvestment Act ("CRA") obligations?*

The proposed rule currently permits banking entities to continue sponsoring and investing in public welfare investments. We commend the Agencies for recognizing the benefits of bank-sponsored Tax Credit Funds and addressing this in the proposed rule. As the proposed rule stands, banking entities may continue to satisfy the investment test for the purpose of their community reinvestment goals through Tax Credit Funds sponsored by other banking entities. Permitting this activity enables smaller banks to take advantage of a larger bank's ability to efficiently underwrite, select and package the investments into a fund. Larger banks generally have larger community reinvestment goals and have therefore become more efficient because of economies of scale. Over time, many of the larger banking entities have sold these investments to other banks that do not have the same resources available for the underwriting and selection process. This has permitted a number of smaller banks to efficiently satisfy their community reinvestment goals and to provide meaningful benefits to the communities they serve.

Question 316: *What types of transactions or relationships that currently exist between banking entities and a covered fund (or another covered fund in which such covered fund makes a controlling investment) would be prohibited under the proposed rule? What would be the effect of the proposed rule on banking entities' ability to continue to meet the needs and demands of their clients? Are there other transactions between a banking entity and such covered funds that are not already covered but that should be prohibited or limited under the proposed rule?*

Common transactions that occur between Tax Credit Funds and their sponsors include loans, letters of credit and guarantees which are "covered transactions." Under the proposed rule, arguably, banking entities will no longer be able to engage in these transactions with the Tax

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

Credit Funds they sponsor. We believe that it is important to preserve a banking entity's ability to enter into these types of transactions with Tax Credit Funds.

Banking entities have historically provided and continue to provide guarantees to Tax Credit Funds. Sponsors of Tax Credit Investments often provide secondary or wrap guarantees that minimize risk of loss to investors in the event that developers, general partners and managing members of the Operating Partnerships fail to perform and then default on their guarantee obligations. Sponsor guarantees provide a level of additional assurance that guaranteed Tax Credit Funds will achieve a minimum yield over the scheduled investment horizon. These contractual obligations generally cover a period of five to fifteen years and are analogous to a letter of credit. A banking entity guarantor underwrites the activity and essentially issues a "letter of credit" that guarantees the Tax Credit Fund access to funds in the event that a developer fails to meet its underlying obligations. Some investors require a guarantee on the Tax Credit Fund in order to receive more favorable accounting treatment. Under generally accepted accounting principles, the guarantee must be provided by a creditworthy entity.

Smaller banks often benefit as they seek guarantees in conjunction with their Tax Credit Investments. These banks generally lack sufficient understanding of the Tax Credit Programs and rely on companies such as U.S. Bank to efficiently underwrite, select and package the investments into a fund. They also may purchase a guarantee to reduce the likelihood that they would not receive all of the expected benefits. These community banks often obtain the guarantees from banks that have a familiarity with CRA requirements. Recently, the Federal Home Loan Bank has promoted public welfare investments to small- and medium-sized banks as a means of satisfying CRA requirements.¹¹

We believe it is equally important to permit banking entities to continue guaranteeing Tax Credit Investments as it is to permit them to sponsor Tax Credit Investments. Guarantees of Tax Credit Investments often times pose less risk to a banking entity, as a guarantor, than making direct investments, as an investor, because guaranteed transactions have a built-in protection between the anticipated and guaranteed performance of the assets. The anticipated performance or "expected yield" is equal to management's expectations when the investment is originally made. The guaranteed performance is typically lower than what management expects and represents a "minimum yield". As such, the guarantor only absorbs a loss when the asset performs under the minimum yield. If the asset performs worse than expected but better than what is guaranteed, the guarantor incurs no loss. However, when directly investing, a banking entity absorbs a loss when the asset does not perform as anticipated. Given that investing in Tax Credit Investments was acceptable to Congress when they passed the Act, one can reasonably conclude that the associated guarantees of Tax Credit Investments are also acceptable.

¹¹ In 2009, both Atlanta and Boston Federal Home Loan Banks provided workshops in surrounding states that focused on both LIHTC and NMTIC investments as a means of increasing CRA investments.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

Tax Credit Fund guarantees are inextricably intertwined with the sponsors' general partner or managing member interest. This relationship fosters the safety and soundness that the Volcker Rule was designed to promote. Sponsors of Tax Credit Funds, as general partners or managing members, are able to control and manage the Tax Credit Fund which minimizes the risks associated with the guarantee. Guarantors have the ability to use risk minimizing measures when they are an affiliate of the sponsor. If the proposed rule stands, banking entities will sell their general partner or managing member interest and lose the ability to manage or control the funds which they have guaranteed.

Guarantees also help banks raise capital by providing a more diverse product line that appeals to a wider pool of investors. It is important to understand that the ability for banking entities to guarantee their tax credit funds provides more capital for the communities and families of low- to moderate-income that the Tax Credit Programs benefit. The guaranteed Tax Credit Investment market is significant. During the last four years, U.S. Bank has sponsored \$1.9 billion of new guaranteed Tax Credit Investments. We believe that this additional infusion of private equity into communities of low- to moderate-income promotes the financial stability of the United States and does not represent a risk to the safety and soundness of banking entities.

The Act was passed, in part, to enhance the safety and soundness of banking entities by limiting activities that could cause undue risks or losses. The need for a guarantee is often perceived by some as an indicator of higher risk. However, the Tax Credit Programs have a tremendous track record of success. For instance, an Ernst & Young study estimated that more than \$75 billion had been invested in LIHTC transactions between 1987 and 2008. Since the inception of the LIHTC program, more than 99% of the investments have been successful in terms of compliance with Section 42 of the Internal Revenue Code and with debt service payment requirements. Both Novogradac & Company LLP and Reznick Group have recently completed studies which analyzed the performance of housing tax credit properties. Both studies indicate that the rate of foreclosure in housing tax credit properties is much lower than the rate of foreclosure in other real estate investments.¹² The NMTC and HTC programs have performed similarly since the programs' inceptions. The Department of Treasury's 2008 estimated data line counts for corporate tax returns reflected a HTC recapture rate of less than 0.05%. According to the same data, no instance of recapture had occurred in the NMTC program. Based on historical information and analysis, banking entities are not exposing themselves to high risk transactions when guaranteeing a Tax Credit Fund. A more thorough discussion of Tax Credit Investments is included in Attachment 2.

Tax Credit Investments do not result in a material conflict of interest, expose banking entities to high-risk assets or pose a threat to the safety and soundness of the banking entity or the financial

¹² Low-Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies, Novogradac & Company LLP, May 2011.
The Low-Income Housing Tax Credit Program at Year 25: A Current Look at Its Performance, Reznick Group, August 2011.

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

stability of the United States. We believe that, given the stability and success of the Tax Credit Programs, the agencies should consider providing an exemption for covered funds comprised of Tax Credit Investments such that banking entities can continue to guarantee the performance of Tax Credit Funds. The FSOC Study states that "...it will be important for Agencies to carefully weigh all characteristics of permitted and prohibited activities as they design the Volcker Rule implementation framework."¹³ Given the exceptions provided for Tax Credit Investments by Congress, it is logical that no other restrictions were intended for these investments; therefore, we request that the Agencies consider an exception that permits banking entities to guarantee Tax Credit Funds.

3. Sample Regulatory Language

We urge the Agencies to follow the recommendations of SIFMA and other trade associations with whom we have joined on comment letters to exclude from the definition of "covered fund" issuers that do not have characteristics of a hedge fund or private equity fund and that were clearly not intended to be swept into the prohibitions of the Volcker Rule, including the Tax Credit Funds as discussed above. This would resolve the specific issue we have noted above regarding guaranteed Tax Credit Funds, but would also eliminate other potential confusion and burdens created by the overly broad definition.¹⁴

If the Agencies choose not to modify the definition of "covered fund," we propose adding the following clarifying language:

Insert a new subparagraph (iii) under §__.16(a)(2):

"(iii) Enter into any transaction with or for the benefit of a covered fund permitted under §__.13(a), subject to the limitations set forth in sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and c-1)."

* * * * *

We believe that the suggested regulatory language included in this letter is consistent with the intent of the Volcker Rule based in part on the discussion included in the FSOC Study. FSOC clearly identified the purpose of prohibiting banking entities from sponsoring private equity funds and realized that Congress may not have intended to capture certain private equity funds that are technically within the scope of the Volcker Rule. FSOC states:

¹³ Study & Recommendation on Prohibiting Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, Financial Stability Oversight Council, pages 1-2.

¹⁴ For example, U.S. Bank's investment in Tax Credit Funds exceeds \$1 billion: if these investments remain within the definition of "covered fund", the bank would be subject to the additional compliance standards as required by §__.20(c)(2)(ii). We respectfully request that the Agencies clarify these requirements in the event it does not modify the definition of "covered fund."

OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

"the purpose of [the prohibition of sponsoring private equity funds] is to:

- (1) ensure that banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule's restrictions on proprietary trading;
- (2) confine the private fund activities of banking entities to customer-related services; and
- (3) eliminate incentives and opportunities for banking entities to "bail out" funds that they sponsor, advise, or where they have a significant investment."¹⁵

First, the activity conducted by the Tax Credit Funds in no way represents proprietary trading. Proprietary trading is essentially the buying of certain investments with the intent to hold them for a short term and then sell them for a profit. Tax Credit Funds make investments with the intent to hold them for a period ranging from over five to over fifteen years. The investors typically purchase the tax credits for their own use and hold the investments over the period that the tax credits are generated and received. As discussed in Attachment 2, investors have historically suffered an extremely low loss rate on these investments.

Next, banking entities sponsor Tax Credit Funds to serve the needs of their investing customers and developer clients. Tax Credit Funds are created and generally designed to sell substantially all of the ownership interest to investors. Many investors do not have the knowledge, experience or resources to underwrite investments in Tax Credit Funds. Similarly, the vast majority of developers do not have the knowledge, experience or resources to sell Tax Credit Investments directly to investors. Investors without these skills invest in private equity funds and exercise their rights to delegate the underwriting responsibilities to third parties, such as banking entities that are more proficient in such evaluations. Developers without these skills look to sponsors to access the Tax Credit Investment market on their behalf.

Last, banking entities, as sponsors of the Tax Credit Funds, are not exposed to significant risks or obligations to "bail out" Tax Credit Funds that they have sponsored. The guarantees provided by sponsors of Tax Credit Funds should not be interpreted as opportunities for banking entities to "bail out" funds that they sponsor. Rather, the guarantees should be interpreted as a permitted activity because Congress has permitted investments designed to primarily promote the public welfare and the risks associated with these guarantees are less than the risks incurred when making the permitted direct investments. Furthermore, sponsor guarantees are back-stop guarantees, where developers, general partners and managing members of Operating Partnerships are in the first loss position if the investments they develop and manage fail to deliver the anticipated minimum level of investor benefits.

¹⁵ Study & Recommendation on Prohibiting Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, Financial Stability Oversight Council, pages 3-4.



OCC, Federal Reserve, FDIC, SEC and CFTC
February 10, 2012

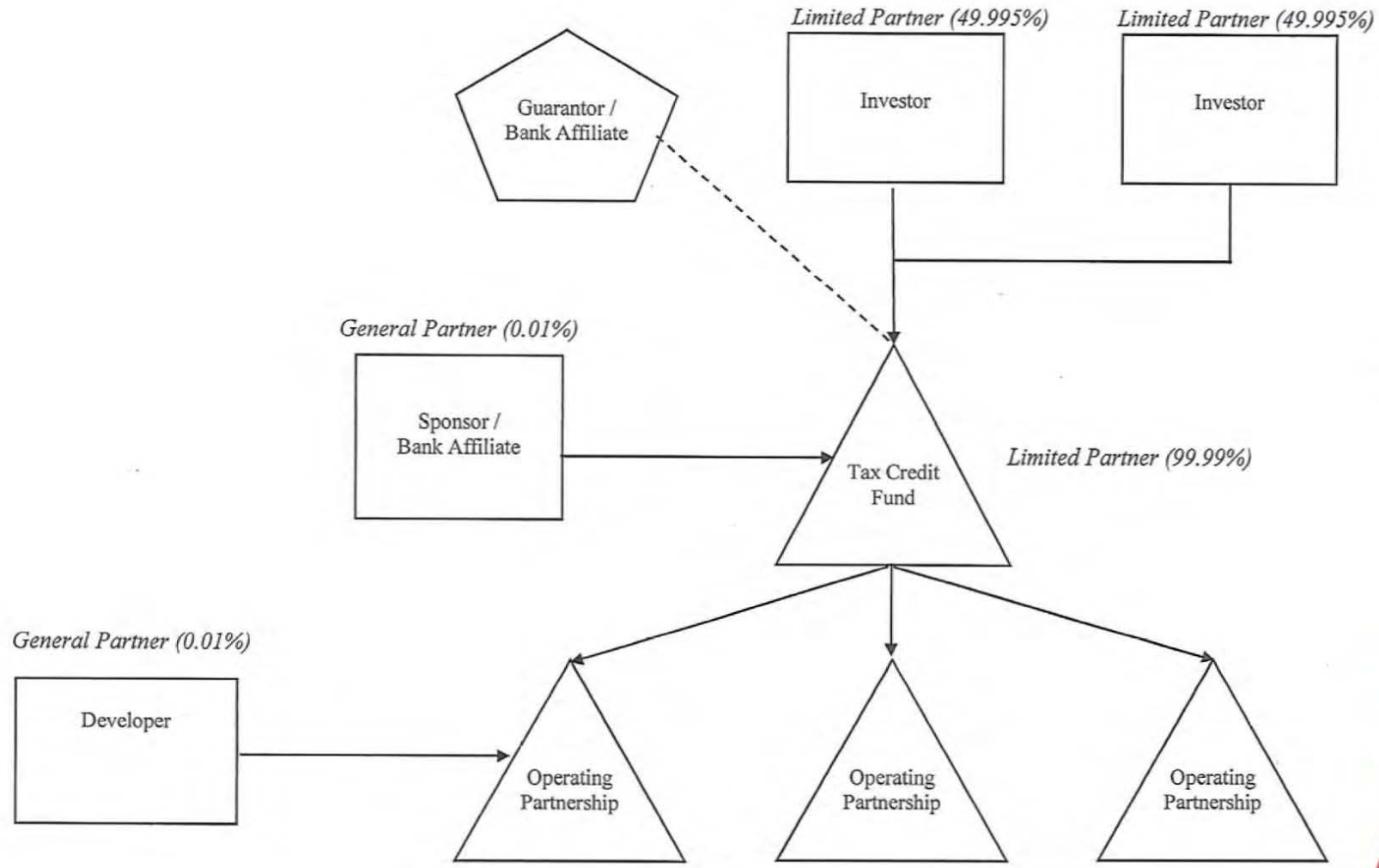
Thank you for your time and consideration of these comments. If you have any questions or would like to discuss these comments further, please contact me or Karen Canon, Associate General Counsel (612-303-7808).

**U.S. BANCORP COMMUNITY
DEVELOPMENT CORPORATION**

By: 
Name: Zachary Boyers
Title: Chairman and Chief Executive Officer

Attachments

ATTACHMENT 1
Diagram of a Typical Tax Credit Structure



ATTACHMENT 2

Expanded Overview of LIHTC, NMTC, and HTC Programs

LIHTC Program

The federal government initiated the LIHTC program in 1986 which subsidized equity investment in affordable housing through federal tax credits. Investors invest equity in affordable residential rental projects in exchange for tax credits and other tax benefits. By pricing the tax credit and other tax benefits stream on a present value to current market yields, equity investors receive a market-rate return on their investment. The LIHTC program has a remarkable track record of success. The LIHTC program has been successful because investors have developed a high degree of confidence that they will receive the tax benefits promised. A recent Ernst & Young study estimated that more than \$75 billion had been invested in LIHTC transactions between 1987 and 2008. Since the inception of this program, more than 99% of the investments have been successful in terms of compliance with Section 42 of the Internal Revenue Code ("IRC") and with debt service payment requirements.

Affordable housing developments lease rental units to low-income individuals at below-market rental rates. As a result, these properties would generally fail to attract private investment without government intervention. However, the invested capital reduces the amount of debt required to finance the development and ultimately the needed cash flow to support operations and debt service. Thus, the projects are deemed feasible and find stability even though they rent affordable units below the market rate.

Administration of the LIHTC program is delegated to the states and each state is allocated a certain amount of annual tax credit allocation authority, which is stipulated in IRC Section 42. The state agency, acting under federal guidelines, is responsible for creating a qualified allocation plan ("QAP") that prioritizes the allocation of these credits to serve the greatest housing needs of the state. The QAP provides the basis for which the state will allocate the tax credits to qualifying low-income projects. A project owner, usually a developer, must apply for an allocation of LIHTC by proposing a rental development that complies with the guidelines set out in the QAP. After reviewing all applications, the state agency will award the best applicants with an allocation of annual tax credits.

LIHTC projects are designed to operate near break-even. They produce benefits from the awarded tax credits and taxable losses from depreciation and interest expense. A limited partnership or limited liability company is usually created as the owner of the project, with the developer acting as the general partner or managing member. The developer will often sell at least a 99% ownership interest in the project. The developer is willing to do so in order to create the necessary equity to finance the construction of the development. The developer may also earn various management fees in their capacity as the general partner.

Investors can invest directly in low-income projects, but will normally indirectly invest in several Operating Partnerships through a syndicator (or sponsor). A syndicator acquires and combines an interest in multiple low-income projects into a separate pass-through entity (the "Tax Credit Fund").

ATTACHMENT 2

Expanded Overview of LIHTC, NMTC, and HTC Programs

Then, the syndicator will sell at least a 99% ownership interest in the Tax Credit Fund to investors. Therefore, the investors receive the majority of the tax benefits generated from the projects and the syndicator earns a management/syndication fee.

NMTC Program

During 2000, Congress, as part of an overall appropriations bill, passed legislation to create the NMTC program to encourage investment in low-income communities. Because the LIHTC program has such a remarkable track record of success, Congress built the NMTC program by combining the discipline and efficiency of the capital markets (found in the LIHTC program) with the community development goals of the NMTC program. The NMTC program is a tool that the Clinton Administration foresaw would help lower-income communities overcome false perceptions of market risk and facilitate additional capital going to entities with good investment records. The NMTC program has generated roughly \$32 billion in private equity investments in businesses of low-income communities. NMTC investments are deemed successful if there are no events of tax credit recapture during a seven year compliance period. As of the date of this letter, no NMTC investment has experienced a credit recapture event because of noncompliance.

The administration of the NMTC program is performed by the Community Development Financial Institutions Fund ("CDFI Fund"), and IRC Section 45D permits a limited amount of allocation authority. The CDFI Fund, under federal guidelines, is responsible for prioritizing the allocation of these credits to serve the greatest low-income development needs of the nation. A Community Development Entity must apply to the CDFI Fund for an award of NMTCs. After reviewing all applications, the CDFI Fund will award the best applicants with an allocation of tax credits. The CDE then raises capital by seeking Qualified Equity Investments ("QEI") from taxpayers that want to receive NMTCs and provides Qualified Low-Income Community Investments ("QLICI") to Qualified Active Low-Income Community Businesses ("QALICB").

CDEs use their local knowledge and expertise to invest, by providing equity or below market-rate loans, in QALICBs. Generally, a QALICB is a business that operates in a low-income community. Typical QALICBs include small technology firms, inner-city shopping centers, manufacturers, retail stores or micro-entrepreneurs. These businesses would generally fail to attract private investment without government intervention. The NMTC program, provided for in Section 45D of the Internal Revenue Code, is an indirect subsidy that encourages private sector investments in low-income communities. The NMTCs are earned over a period of 7 years.

Often times, the taxpayer mentioned above is a Tax Credit Fund comprised of a managing member and one or more investors. The Tax Credit Fund typically uses Investor capital and the proceeds from a loan to make QEIs. The equity portion of the QEI reduces the Tax Credit Fund's weighted average cost of capital and enables it to charge below market interest rates on the loans provided to QALICBs.

ATTACHMENT 2

Expanded Overview of LIHTC, NMTC, and HTC Programs

HTC Program

Since 1978, when the first federal tax incentives for historic rehabilitation were passed, these incentives have rehabilitated more than 31,000 historic properties, stimulated the private rehabilitation of more than \$31 billion and, nationwide, restored old, deteriorating buildings to commercial viability. The National Park Services ("NPS"), which administers the application and approval process of the federal historic tax credit, characterizes the Federal Historic Preservation Tax Incentives program as one of the most successful and cost-effective community revitalization programs. It has been effective in revitalizing distressed areas through the fostering of private sector investment, creating jobs and renewed commerce to the historic cores of cities and towns, increasing property values in these areas, and helped create additional alternatives for affordable housing. HTC investments are deemed successful if there are no events of tax credit recapture during a five year compliance period. Since the inception of this program, more than 99% of the investments have been successful in terms of compliance with Section 47 of the Internal Revenue Code ("IRC") and with debt service payment requirements.

Investors invest equity in historic rehabilitation projects in exchange for tax credits and other tax benefits. By pricing the tax credit and other tax benefits stream on a present value to current market yields, equity investors receive a market-rate return on their investment. HTC investments produce benefits from the awarded tax credits and taxable losses from depreciation and interest expense. A limited partnership or limited liability company is usually created as the owner of the historic project, with the developer acting as the general partner or managing member. The developer will often sell at least a 99% ownership interest in the historic project. The developer is willing to do so in order to create the necessary equity to finance the construction of the development. The developer may also earn various management fees in their capacity as the general partner.

A project owner, usually a developer, must either obtain a building listed in the national registry as a certified historic structure or obtain such certification for the structure before rehabilitating it. Then, the developer completes an application for historic tax credits, and it is reviewed by NPS. Upon approval, the developer may begin rehabilitating the project.

Investors can invest directly, or indirectly through a syndicator, in HTC projects. A syndicator acquires and combines an interest in multiple tax credit projects into a separate pass-through entity (the "Tax Credit Fund"). Then, the syndicator will sell at least a 99% ownership interest in the Tax Credit Fund to investors. Therefore, the investors receive the majority of the tax benefits generated from the historic projects and the syndicator earns a management/syndication fee.

ATTACHMENT 3

LOW-INCOME HOUSING TAX CREDIT

Assessment of Program Performance & Comparison to
Other Federal Affordable Rental Housing Subsidies



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SPECIAL REPORT

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Low-Income Housing Tax Credit Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies

By Novogradac & Company LLP



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About This Report

Novogradac & Company LLP undertook this study (the “Special Report”) to assist the Housing Advisory Group (HAG), a coalition of housing interests dedicated to protecting and improving affordable housing programs, in the analysis of the performance of the Low-Income Housing Tax Credit (LIHTC) program. This special report compares the performance of the LIHTC program to the performance of other federal government subsidies of affordable rental housing. The scope of the comparison was limited to supply-side federal policies. Supply-side policies, as opposed to demand-side policies, increase the supply of affordable housing, whereas demand-side policies reduce the cost of rental housing for low-income renters. The LIHTC program is the centerpiece of the supply-side federal programs.

Novogradac & Company LLP would like to thank HAG, and especially Robert Moss and David Gasson of Boston Capital, for supporting this project. We also appreciate the invaluable comments of Richard Goldstein, Nixon Peabody LLP; Glenn Graff, Applegate & Thorne-Thomsen, P.C.; and Peter Lawrence, Enterprise Community Partners, Inc. The authors particularly thank Ethan Handelman and David Smith at Recap Real Estate Advisors for their insights throughout the process of writing this Special Report.

Novogradac & Company LLP and HAG are pleased to make this Special Report available to help reinforce not only the maintenance of the LIHTC program, but also its continuation as the foremost supply-side affordable rental housing program. This report highlights the LIHTC program’s unique strengths and ability to work with other affordable rental housing programs, which makes it invaluable in serving low-income renter households.

Novogradac & Company LLP

Michael J. Novogradac

May 2011

Limiting Conditions

Additional information about the engagement which resulted in the creation of this Special Report is detailed in the letter agreement (the Agreement) between the Housing Advisory Group (HAG) and Novogradac & Company LLP, a national certified public accounting and consulting firm. The sufficiency of the procedures performed is solely the responsibility of HAG. Consequently, Novogradac & Company LLP makes no representation regarding the sufficiency of the procedures either for the purpose for which this Special Report has been requested or for any other purpose.

The engagement described in the Agreement did not constitute any form of attestation engagement, such as an audit, compilation or review. Novogradac & Company LLP therefore did not issue any independent accountants' reports, findings, or other work product including a compilation, review, or audit report connection with this engagement. Because the engagement described in the Agreement does not constitute an audit or examination, we did not and will not express an independent accountant's attestation opinion on the Special Report. The Special Report is intended solely to provide a general discussion of the topics discussed therein. Any federal tax advice that may be contained in the Special Report is not intended to constitute a covered opinion pursuant to regulation section 10.35 of IRS Circular 230 or is it to be used for the purpose of (i) avoiding tax-related penalties under Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any tax-related matters addressed therein. In exchange for our provision to you of a free copy of this Special Report, you agree as a condition precedent to the limitations and conditions described in this paragraph. If you do not wish to accept these limitations and conditions, please do not use this Special Report.

Table of Contents

ABOUT THIS REPORT	III
LIMITING CONDITIONS	IV
EXECUTIVE SUMMARY	1
LOW-INCOME HOUSING TAX CREDIT: ASSESSMENT OF PROGRAM PERFORMANCE & COMPARISON TO OTHER FEDERAL AFFORDABLE RENTAL HOUSING SUBSIDIES	2
I. LIHTC Track Record	3
Foreclosure Rate	3
Compliance History	4
Credit Allocating Agency Review Experience	4
Year 15 Opt-Outs	5
Investor Portfolio Analysis	6
Conclusion	7
II. Reasons for Successful Track Record of LIHTC	7
Large-Dollar Investments from Third-Party Investors (Non-Federal Sources)	7
Screening of Properties before Development by Third-Party Investors	7
Economies of Scale and Uniform Practices	8
Construction and/or Reconstruction Risk and Lease-Up Risk Borne by Investors and Developers	9
Tax Credits Received for Performance over Time	10
State-Level Allocation, Customization and Oversight	11
Regulatory Guidance from the IRS and Enforcement by IRS Auditors	13
Conclusion	14
III. Other Supply-Side Government Program Track Records	14
Section 221(d)(3) Below Market Interest Rate Program	14
Section 236 Program	16
Section 515 Program	17
Project-Based Section 8 Rental Subsidies	18
Section 202 Program	19
Conclusion	20
IV. Role of the Section 1602 Exchange Program	21
Conclusion	22
V. Comparison of the LIHTC Program to the Section 1602 Exchange Program	22
Conclusion	24
VI. Efficiency of Program at Reduced Tax Credit Equity Prices Versus the Exchange Program	24
Conclusion	25
VII. Conclusion	25
APPENDIX	26
LIHTC Overview	26
BIBLIOGRAPHY	30

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EXECUTIVE SUMMARY

The low-income housing tax credit (LIHTC) is a federal income tax credit that incentivizes the development of affordable rental housing for low-income families.

- **The LIHTC has a successful track record.** The LIHTC program has low rates of foreclosure and noncompliance with program rules and is maintaining affordable rental housing stock over the long-term. The LIHTC's successful track record can be attributed to the involvement of third party for-profit partners, the placement of construction, lease-up and occupancy risk on the sponsors and investors instead of the federal government, the delivery of LIHTC benefits over time, and state and federal oversight.
- **The LIHTC program has a more successful track record than other supply side affordable rental housing programs.** Other supply side federal government programs have experienced high default and foreclosure rates.
- **The Section 1602 exchange program is no longer needed.** During the Great Recession of the late 2000s, the federal government provided cash grants in lieu of LIHTCs with the enactment of Section 1602 from the American Recovery and Reinvestment Act of 2009. Although these grants helped stalled developments during difficult economic times, the program did not include some of the safeguards of the LIHTC program that have made the LIHTC program successful. The equity markets have recovered. Thus, the Section 1602 exchange program is no longer needed.
- **The LIHTC program can be used to enhance other government housing programs.** Combining the LIHTC program with other affordable rental housing programs strengthens those other programs and enables the LIHTC to serve even lower income families and seniors and/or provide more services to tenants.

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Low-Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies

By Novogradac & Company LLP

The low-income housing tax credit (LIHTC) is a federal income tax credit that for nearly 25 years has been incentivizing the development of affordable rental housing for low-income families and seniors.¹ This report analyzes the performance of the LIHTC program and compares its performance to the performance of other federal government subsidies of affordable rental housing.

Government policies designed to help low-income families access affordable rental housing can be segregated into supply-side and demand-side efforts.² Supply-side policies increase the physical supply of affordable rental housing through production incentives to develop new and/or rehabilitate existing rental housing. Demand-side policies reduce the cost of rental housing to low-income families through direct tenant-based rental subsidies. For nearly 25 years, the LIHTC has been the centerpiece of supply-side solutions to the lack of affordable rental housing.³ Tenant-based Section 8 rental vouchers are the foremost demand-side effort. Both the LIHTC and Section 8 rental vouchers can be effectively combined with numerous other subsidies, including each other,⁴ to provide affordable rental housing to those in need. It is important to note that the LIHTC and tenant-based Section 8 rental vouchers are not the sole supply-side and demand-side tools, rather they are the centerpieces.

Supply-side efforts are a better hedge on inflation⁵ and have a more predictable budgetary impact than demand-side policies. Supply-side efforts also have an indirect effect of lowering market rents through the increase of the overall supply of housing.⁶ Because supply-side efforts are location specific, they can have the positive impact of contribut-

1 For a more in-depth look at the technical aspects of the LIHTC, see Novogradac & Company LLP Low-Income Housing Tax Credit Handbook, 2011 and the Appendix.

2 Other ways to classify government policies designed to help low-income families access affordable rental housing include:

1. The owner of the rental housing subsidized:
 - a. government (e.g., housing authorities),
 - b. nongovernment entity (e.g., non-profit entities and for-profit private parties), or
 - c. government private joint ventures (e.g., housing authority partnership with private entity); and
2. The type of subsidy provided:
 - a. direct cash benefit (e.g., grant and beneficial loan terms),
 - b. tax benefit (e.g., income tax credits and tax-exempt bonds),
 - c. nontax regulatory incentive (e.g., density bonus), or
 - d. regulatory mandate (e.g., inclusionary housing).

When the government provides a direct cash grant, it can be in the form of ongoing periodic payments or up front acquisition and development cost subsidies.

3 The LIHTC was created by the Tax Reform Act of 1986 (P.L. 99-514). Other supply-side efforts include project-based Section 8 rental contracts, capital grant programs such as Section 202, and below market interest rate loans.

4 The U.S. Government Accountability Office (formerly, the General Accounting Office) has noted that the LIHTC can be combined with Section 8 vouchers to serve incomes as low as those in public housing. U.S. General Accounting Office, 1993.

5 McClure, Housing Vouchers versus Housing Production: Assessing Long-Term Costs, 1998.

6 Apgar, 1990.

ing to the redevelopment of a particular area.⁷ Supply-side efforts have significant local economic impact through job creation, income generation and increase in tax revenue.⁸

Demand-side efforts can have an indirect effect of increasing market rents through subsidizing the demand for housing without increasing the supply of housing.⁹

Both supply-side and demand-side policies are needed to contend with the lack of affordable rental housing in the United States. In 2009, there were 17.9 million affordable rental housing units for 18 million low-income renter households. Of these 17.9 million units, only 11.9 million were available to rent.^{10,11} This shortage was exacerbated by an increase in the number of renter households; between 2005 and 2009, the number of renter households rose by more than 2.5 million.¹² Moreover, during the same time period, 25.3 percent of movers consolidated households or “doubled up.”¹³

This paper is segregated into six sections. First, the track record of the LIHTC is reviewed. Second, there is a discussion of the major reasons for the observed successful track record of the LIHTC program. Third, the track records of other supply-side government programs are analyzed. Fourth, there is a discussion of the role of the Tax Credit Exchange Program (exchange program) from Section 1602 of the American Recovery and Reinvestment Act of 2009 (Recovery Act). Fifth, the LIHTC program’s efficiency is compared to the estimated efficiency of the exchange program, and sixth, the efficiency of the LIHTC program at reduced tax credit equity prices is compared to the exchange program.

This paper also has an appendix that provides background on the LIHTC.

I. LIHTC Track Record

The LIHTC has been the centerpiece of supply-side rental solutions for nearly 25 years. There are many ways to assess the track record of LIHTC-supported rental housing. The following items are important means to analyzing whether the program is achieving its intended results of providing affordable rental housing to low-income families and seniors:

1. Foreclosure rate
2. Compliance history
3. Credit allocating agency review experience
4. Year 15 opt-outs
5. Investor portfolio analysis

Foreclosure Rate

The rate of foreclosure is one way to assess the LIHTC program. Although the existence of the LIHTC as part of the financing structure lowers the amount of debt required to de-

7 A. E. Schwartz, et al, 2006.

8 Housing Policy Department, 2010.

9 Deng, 2005.

10 Joint Center for Housing Studies of Harvard University, 2011.

11 Available units are vacant or rented by households with incomes no higher than 50 percent of HUD-adjusted area median family income.

12 Joint Center for Housing Studies of Harvard University, 2010.

13 Collinson and Winter, 2010.

velop this housing, mortgage debt is still a portion of the financing in almost all cases and failure to pay that debt indicates a serious financial problem that can lead to foreclosure. Low foreclosure rates mean the program is subsidizing affordable rental housing and the housing is not being lost to foreclosure. As such, the rental housing remains available to low-income renters for longer periods of time. The LIHTC program has experienced a significantly low foreclosure rate relative to other real estate asset classes. In a survey of 15,174 properties, respondents indicated that only 129 of the properties had been foreclosed between 1991 and 2006, which translates to a 0.85 percent total foreclosure rate or 0.08 percent on an annualized basis. By comparison, the annualized foreclosure rate for non-LIHTC apartment properties was 0.27 percent.¹⁴ These figures suggest that the foreclosure rate for LIHTC properties is approximately three-tenths of that for non-LIHTC apartment properties. In addition, as we will discuss later, other government supply-side affordable rental housing subsidy programs that are designed differently than the LIHTC program experience a considerably higher rate of foreclosure.

Compliance History

Tax credit recapture generally occurs in the LIHTC program when units are rented to over-income tenants or to tenants at rents above the rent-restricted rates. Recapture also occurs if the property does not remain a low-income housing property (due to foreclosure, damage, or other reasons). Therefore, tax credit recapture is a measure of compliance with the LIHTC program and indicates whether the program is providing affordable rental housing to low-income families.

Although there are not many statistics publicly available on LIHTC recapture, it appears that the LIHTC program has experienced extremely low levels of tax credit recapture during its history, and the Internal Revenue Service (IRS) has generally found very good compliance by LIHTC properties with the program requirements.¹⁵

Credit Allocating Agency Review Experience

Another measure of adherence with the program is the number of compliance issues that credit allocating agencies have with the properties in their jurisdiction. Each credit allocating agency is responsible for allocating their area's pro rata share of LIHTC on an annual basis and is able to set preferences for affordable rental housing development by emphasizing or de-emphasizing certain items in its qualified allocation plan (QAP). Similar to the tax credit recapture history of the program, credit allocating agencies have also reported a strong record of LIHTC properties' compliance with credit allocating agency requirements. A poll of a sample of credit allocating agencies revealed that only a small percentage of properties received noncompliance notifications. For example, on a yearly basis, only approximately 5 percent of the active properties in California receive an IRS Form 8823.¹⁶ Furthermore, while IRS Form 8823s are issued each year, the most common reasons are relatively minor infractions such as missing income verifications and minor maintenance

14 Ernst & Young LLP, 2010.

15 Robinson, 2010.

16 IRS Form 8823 "Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition" is the form that credit allocating agencies are required to complete to fulfill their responsibility to notify the IRS of noncompliance by properties with the LIHTC provisions of Section 42 of the Internal Revenue Code.

or physical condition violations. The relatively small number of IRS Form 8823s issued in a year and the fact that the most common issues tend to be minor indicates a track record of compliance with the LIHTC program.

Year 15 Opt-Outs

It is also important to look at the period of time that properties remain income restricted to understand the amount of time that the government receives a benefit from the tax credit. Under federal rules for the LIHTC program, property owners can “opt out” of the program after 15 years.¹⁷ However, credit allocating agencies can, and many do,¹⁸ require that property owners waive this option in order to receive an allocation of LIHTCs. Thus, a majority of LIHTC affordable rental housing stock is preserved for 30 years or longer.

If after year 14 a property owner wants to sell the property and the owner has not previously waived the right to opt out, then the owner has the ability to request that the credit allocating agency assist in finding a buyer of the property at the “qualified contract” price.¹⁹ If the credit allocating agency cannot locate a buyer for the property after one year, any extended affordability restrictions on the property expire.²⁰ Typically, the qualified contract price is equal to the outstanding debt secured by the property, plus capital invested adjusted by a cost-of-living factor,²¹ reduced by distributions or funds available for distribution.²²

After the statutorily mandated 15-year compliance period of the LIHTC program, LIHTC investors often prefer to exit the transaction expeditiously to “close the books” on their investment. After the exit of the LIHTC investor, owners have several different options for their properties. In many cases the property will require some amount of rehabilitation work or repair after 15 years. For those properties for which a qualified contract option exit is available,²³ the property owner may attempt to convert the property to market-rate rents to generate increased cash flow. However, one study showed that only 5 percent of properties reaching year 15 opted out and converted to market-rate housing. Instead, 42 percent of properties were resyndicated with tax credits to rehabilitate the property, 15 percent were maintained as affordable rental housing and refinanced without tax credits, and the remaining 38 percent pursued other disposition options.²⁴ Although the study did not discuss the reasons for the low percentage of properties opting out, likely reasons include the affordability restrictions placed upon many properties either by the Internal Revenue Code (IRC) (15 year additional restriction) or a longer restriction designated at the state level. Additionally, certain transaction participants such as cities or municipalities may impose

17 Prior to Public Law No: 101-239, LIHTC properties were required to be in compliance with IRC §42 for 15 years. On 12/19/1989, Public Law No: 101-239 created IRC §42(h)(6), which requires properties to commit to at least 15 additional years of compliance, but also provided for exceptions including the ability to “opt out,” as discussed in the next paragraph.

18 The U.S. Government Accountability Office reviewed 20 credit allocating agencies and found that most allocation plans gave preference to applications that commit to compliance periods longer than 30 years and/or waive the right to “opt out.” U.S. General Accounting Office, 1997.

19 IRC §42(h)(6)(I).

20 IRC §42(h)(6)(E)(i)(II).

21 The cost-of-living factor is based on changes in the Consumer Price Index. IRC §42(h)(6)(G)(i)(II), referencing §1(f)(3).

22 IRC §42(h)(6)(F).

23 Including those 1987-1989 properties for which a qualified contract is not required to convert to market rents.

24 Ernst & Young LLP, 2010.

longer-term affordability restrictions on a property in exchange for low-interest financing. In addition, not-for-profit organizations that are general partners in an LIHTC operating partnership generally tend not to opt out in furtherance of their mission to provide affordable rental housing. These factors are some of the elements that influence an owner's decision about whether to keep properties as affordable rental housing at the end of the 15-year compliance period.

The low opt-out rate indicates that the LIHTC program is subsidizing affordable rental properties that remain as affordable rental housing for extended periods of time.

Investor Portfolio Analysis

An LIHTC investor's ability to receive tax credits depends on a property's successful operation for 15 years. As such, prior to investing, investors take actions to mitigate risk. These actions include ensuring the development team has adequate resources to build and operate the property, as well as requiring development and operating guarantees. Investors also negotiate the right to step in and manage the property if the property's sponsor/general partner is unable to meet commitments or commits some type of malfeasance.

Given the high cost to an LIHTC investor of a property failing to continue to operate as affordable rental housing for 15 years (i.e., tax credit recapture), the LIHTC investor typically takes all measures necessary to continue to operate a property as affordable rental housing and avoid foreclosure. These measures include, if necessary, removing the sponsor/general partner and either replacing them or managing the property themselves. As such, the cost of LIHTC investments to tax credit investors should be viewed not only in terms of the amount of dollars directly invested in LIHTC properties or investment funds, but also in terms of the asset management resources the investor commits to managing its LIHTC portfolio to mitigate and avoid any potential operational issues.

These risk mitigating features have helped the LIHTC program evolve into a predictable investment for its investors. The evolution of the predictability of the program is well-illustrated by the yield variance for its investors, or, in other words, the difference between the projected yield and actual yield of an LIHTC investment. As of 2006, the program's predictability had evolved to the point of approximately 0.0 percent median yield variance.²⁵ The fact that the LIHTC program has demonstrated predictable returns points to the maturation of the industry. Investors and developers have become more sophisticated and have streamlined their processes. In turn, this predictability has led to more competition and thus, higher credit prices. From a public policy standpoint, this is positive because it means investors, instead of the government, are funding more of a property's costs and bearing more of the performance risks. As discussed later in the report, other housing programs have demonstrated less consistent track records because of issues inherent to those programs; most notably, a lack of continued property monitoring and the upfront funding of the applicable public subsidy.

25 Ernst & Young LLP, 2010.

Conclusion

In summary, the LIHTC program has a demonstrated track record of low foreclosure rates (both on an absolute basis and a relative basis to other classes of real estate), high compliance rates, and a stable investment track record for its investors. The above analysis indicates that the LIHTC has a track record of successfully providing affordable rental housing over extended periods of time.

II. Reasons for Successful Track Record of LIHTC

There are several components that contribute to the successful track record of the LIHTC:

1. Large dollar investments from third-party investors (non-federal sources)
2. Screening of properties before development by third-party investors
3. Economies of scale and uniform practices
4. Construction and/or reconstruction risk and lease-up risk borne by investors and developers
5. Tax credits received for performance over time
6. State level allocation, customization and oversight
7. Regulatory guidance from the IRS and enforcement by IRS auditors

Large-Dollar Investments from Third-Party Investors (Non-Federal Sources)

A recent Ernst & Young study estimated that more than \$75 billion had been invested in LIHTC transactions between 1987 and 2008. The vast majority of properties receive well in excess of \$1 million in tax credit equity. The study also found that the industry has moved from an investor pool composed of individuals to a pool of more sophisticated institutional investors.²⁶ Because LIHTC transactions involve significant dollar investments and the investors are generally sophisticated institutional investors, LIHTC transactions have more oversight than other supply-side affordable rental housing efforts. Because of the significant amount of investment capital, investors constantly monitor their LIHTC assets. Moreover, investors generally require additional testing and auditing beyond what is required by the LIHTC program or the credit allocating agency. Adding another party to the transaction helps add experience, different perspectives and different motives to help assure a property's success.

Screening of Properties before Development by Third-Party Investors

The financial health of an LIHTC property is very important to the investor. If an LIHTC property is lost to foreclosure, the investor could face the recapture of its LIHTCs and the loss of its other benefits. Thus, investors will generally step in to save a troubled property before it is lost to foreclosure. This also causes investors to spend significant time underwriting and screening properties for quality and sustainability before investing in an LIHTC transaction.

26 Ernst & Young LLP, 2009.

Although credit allocating agencies carefully screen properties, third-party investors also spend considerable time reviewing and assessing the financing, market forecasts, and forecasted operating cash flows of the LIHTC properties in which they are investing. This review by third-party investors often results in a more durable financial structure, such as funding of additional cash reserves. By bringing in an experienced profit-motivated investor, the LIHTC transaction is strengthened by the investor's expertise. This additional screening is important in maintaining a low foreclosure rate for the LIHTC program.

Economies of Scale and Uniform Practices

There are countless third-party investors that have invested in LIHTC properties since the inception of the program. While some of these investors make direct investments in LIHTC properties, many rely on third-party syndicators to pool properties together into investment funds. Third-party syndicators market LIHTC properties to tax credit investors and ultimately place them into investment funds. The number of LIHTC properties in an investment fund can range from as few as one property to as many as several hundred properties, thus accommodating varying investment appetites of tax credit investors. By investing in affordable rental housing via an investment fund, a tax credit investor has the flexibility to diversify or concentrate its investment to varying types of properties. For example, certain investment funds have been created that invest solely in LIHTC properties in a single state; other investment funds specifically invest in geographically diverse properties nationwide. Investment funds also focus on specific financing aspects of LIHTC properties; an investment fund might invest solely in properties with U.S. Department of Agriculture (USDA) Section 515 financing or U.S. Department of Housing and Urban Development (HUD) project-based Section 8 vouchers.

The use of investment funds as ownership vehicles has allowed investors with dedicated LIHTC investment and compliance departments, as well as those who simply invest alongside other more knowledgeable investors through syndicators, to generate economies of scale and investment diversification. Because of the sizable capital invested by tax credit investors in LIHTC funds, many uniform practices have developed regarding how to underwrite LIHTC investments, value the associated financial benefits, and manage the ongoing compliance. Proof of this trend can be seen in the existence of the Affordable Housing Investors Council (AHIC). AHIC is a not-for-profit organization formed by affordable housing investors for the specific purpose of developing industry standards, sharing information on specific issues relevant to the LIHTC program and affordable rental housing, and educating members on all aspects of the LIHTC program, including investment underwriting guidelines, and recommended asset and portfolio management strategies for existing investments.

Through the proliferation of common underwriting and reporting guidelines, such as those used by AHIC members, LIHTC properties are held to much more consistent standards both before and after completion than they might be otherwise. Proposed developments with certain flaws that might otherwise qualify for other types of federal financing are generally restructured at the behest of LIHTC investors to address the nature and inherent risk of those flaws. For those properties that are funded, this results in a higher long-term success rate and more predictable investment yields for LIHTC investors. As mentioned earlier, a 2010 Ernst & Young study highlighted that the expected yield variance for prop-

erties that closed between 2005 and 2006 was approximately zero.²⁷ This suggests that common underwriting standards, among other factors, have helped make LIHTC properties predictable for investors, and thus, a key part of their total investment portfolios.

Construction and/or Reconstruction Risk and Lease-Up Risk Borne by Investors and Developers

During the life of a property, the riskiest period from a financial standpoint is the construction or rehabilitation phase. One important dynamic of the LIHTC program is that the federal government is not subject to construction and lease-up risk because LIHTCs are not earned until a development is completed, placed in service and leased up with qualified tenants. Major construction risk is borne by the developer, and to a somewhat lesser extent, the LIHTC investor, the construction lender and/or the letter of credit provider when applicable. On a typical LIHTC property, a developer is generally required by its tax credit equity investor to guarantee completion of construction or rehabilitation of the housing property. The developer generally is liable for completion of the property and any associated cost overruns. This typically heightens the developer's motivation to oversee the contractor during the construction process. With some exceptions, an LIHTC property's funding sources are usually fixed. A permanent lender will only lend up to an appropriate amount of debt that is supported by the property's forecasted net operating income based on a requisite debt service coverage ratio. Tax credit equity investors stage their capital contributions based on various benchmarks and are protected from having to increase their total capital contributions by LIHTC adjuster provisions in the partnership agreement. Such provisions state that the investor's capital contribution may be decreased if the amount of LIHTCs generated is less than previously forecasted when the transaction closed. These LIHTC adjuster provisions are typically backed by guarantees from the developer/sponsor.

If a property has funding issues, the federal government is protected against significant variability in the amount of tax credits it has committed in its budget. For 9 percent LIHTC transactions,²⁸ the amount of LIHTCs generated cannot exceed the reserved amount of credits, so the federal government is protected against having to provide additional credits for the same amount of affordable rental housing generated. For 4 percent LIHTC transactions, the amount of LIHTCs generated by the property can be higher than the reserved amount of credits to the extent of additional eligible basis, depending on the procedures of the particular state allocation agency. However, the credit allocating agencies have a statutory obligation to ensure that the property does not receive more LIHTCs than are needed for financial feasibility. As such, the credit allocating agency has the ability and obligation to ensure that only the LIHTCs needed to make a property viable are granted. For instance, many credit allocating agencies have limits on the amount of construction costs that can be included in tax credit eligible basis.

Under the LIHTC program, the federal government is protected against the prospect of having financed the construction of affordable rental housing units that are never rented to low-income tenants. In the initial lease-up period, LIHTCs are calculated based on the ap-

²⁷ Ernst & Young LLP, 2010.

²⁸ See Appendix for an introduction to 9 percent and 4 percent LIHTCs.

plicable percentage of the qualified basis of a qualified low-income building.²⁹ In addition, an LIHTC building must reach its agreed-upon low-income housing occupancy percentage by the end of the first year of the credit period or the property will not receive the full amount of allocated LIHTCs. If a building has an increase in qualified basis after the first year of the credit period, the applicable percentage for the increased qualified basis is two-thirds of the otherwise applicable percentage. Accordingly, for an LIHTC property to claim the maximum available amount of LIHTCs, the low-income portion of the building(s) must generally be 100 percent leased as of the close of the first year of the tax credit period. This requirement strongly incentivizes LIHTC property owners to ensure that the property is 100 percent leased to qualifying low-income tenants as quickly as possible after it is placed in service. This requirement also protects the federal government from providing indirect funding (through LIHTCs) for properties that are not fully used by tenants. In addition, the investor will agree on an adjuster with the developer based on how many LIHTCs are delivered in the first year. As such, to the extent that a developer does not meet this requirement (because of slow lease up) the developer will often be liable for any tax credit shortfall in the initial lease-up year. Thus, this penalty incentivizes the developer to lease up the property in a timely manner.

Another key risk to consider is conversion risk. That is, the ability of a real estate transaction during the initial lease-up stage to convert the construction loan into a permanent loan. To the extent that a property goes into foreclosure because of the sizing of the permanent loan, the federal government does not lose money. This is because the property has generated tax credits only for units that have been rented to low-income tenants, and only for the time period the units are so rented. Again, the developer, investor, and possibly the lender are the players that take on this risk in the LIHTC industry. However, the adjuster clauses and the guarantees from the developer generally prevent these properties from going into foreclosure.

Tax Credits Received for Performance over Time

Investors do not receive their tax credits unless the housing is suitable for occupancy and rented to low-income families at restricted rents during the initial 15-year term. As previously discussed, the large-dollar investments in LIHTC properties means that private sector participants have significant “skin in the game” and thus a vested interest in the ongoing operations and compliance of LIHTC properties. The fact that credits are earned over time is a large incentive for continued program compliance. To continue to claim credits over the credit period, a property must stay in compliance. Furthermore, if a property falls out of compliance, it can face tax credit recapture. There are two types of recapture in the LIHTC program: full and partial. Full recapture occurs when a property’s occupancy falls below its elected income set-aside (40/60 or 20/50)³⁰ for tenant occupancy. In a full recapture, all credits stop being generated and there is recapture for previous credits taken. Partial recapture generally occurs when any unit that was projected to be rented to a qualifying low-income tenant is rented to a non-qualified tenant. In that situation, only a proportional amount of the credit is recaptured based on the extent that the units are not rented to LIHTC qualified individuals. In addition, the developer often provides a guarantee, through

29 IRC §42(a).

30 See Appendix for more information on income set-asides.

adjusters, to deliver tax credits to the investor for the 15-year compliance period. Thus, a developer would have to return equity to the investor, which highly incentivizes the developer to keep the property in compliance with all of the LIHTC rules.

Another dynamic that is helpful in ensuring that recapture is relatively rare is that the investor is the one who must pay the taxes to the government associated with the recaptured tax credit. As mentioned earlier, large publicly traded banks and corporations are the main investors in the LIHTC industry. Collecting from these investors is relatively easy. The investor may then seek reimbursement for the cost of recapture from the developer. However, the government is not involved in that process. Collecting from large publicly traded corporations is generally much easier than collecting from small private developers. This is a significant difference when compared to an upfront cash grant program.

With such a high price to pay for noncompliance, LIHTC investors have dedicated asset management resources to monitor both the operations and LIHTC compliance of their LIHTC investments. As discussed previously in this section, organizations such as AHIC have developed asset management and portfolio management guidelines that are used by many LIHTC investors to monitor their portfolios. Asset management functions include site visits, reviewing the certification of tenants, restricting cash reserves for proper use, operational oversight, construction oversight, and designing work-out solutions for troubled properties. Because of this property-level oversight and high cognizance of tax credit recapture risk, LIHTC investors often identify struggling properties earlier on, allowing increased time to assist the sponsor with operational issues or even support the property financially through a temporary economic downturn. In properties with critical issues, the LIHTC investor may remove or replace the general partner/developer in an effort to maintain compliance and avoid tax credit recapture. In essence, the investor serves as a back-stop if the developer encounters financial problems while operating the LIHTC property. One of the reasons for the low foreclosure rate in the LIHTC industry is that investors can prevent a foreclosure from happening by removing the general partner/developer and funding the operating deficits themselves. While the intent behind such oversight on the part of the LIHTC investor is self-serving in nature, the end results are increased oversight of LIHTC properties, lower foreclosure rates and a more stable affordable rental housing property for tenants.

State-Level Allocation, Customization and Oversight

Credit allocating agencies³¹ allocate the LIHTC among applicants based on agency determined housing needs and generally do not complete the entire process of issuing the LIHTCs until a property is leased up and permanent financing is in place. Following the allocation, credit allocating agencies monitor the awardees for 15 years of compliance beginning in the year a property is placed in service (or the year after, at the election of the owners).

One of the hallmarks of the LIHTC program is that while it is a federally funded program governed by rules and regulations contained in the IRC, the actual administration and

³¹ References to credit allocating agencies include allocating agencies responsible for awarding LIHTCs in the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, American Samoa, Guam, Northern Mariana Islands and the cities of Chicago and New York.

compliance monitoring of the program is generally administered at the state level. This helps ensure that the program is sensitive to local needs and political differences. Each state or geographic region:

- receives an allocation of LIHTCs each year from the U.S. Treasury equal to the greater of \$2.15 multiplied by the state's population or \$2,465,000 to be allocated to 9 percent LIHTC properties³² (Note: Tax-exempt bond financed 4 percent LIHTC properties have no limit on the amount of tax credits allocated in a given year, but are effectively limited by the total volume of tax-exempt private activity bonds that can be issued);
- is required to develop and update a QAP that outlines policy priorities and targeted housing needs and how it intends to address them through its allocation of LIHTCs;³³
- allocates LIHTCs through one or more funding rounds;
- is required to administer an LIHTC compliance monitoring program;³⁴
- is required to ensure that the credits are allocated to a property only to extent that the property has an economic need for the credit (i.e., the property is not feasible without the credit);³⁵ and
- is required to ensure that the property receiving the credits is viable under the agency's underwriting standards.³⁶

By providing for state³⁷ participation in defining the selection criteria, approving applications, and monitoring compliance, the LIHTC program enables credit allocating agencies to have significant input regarding the types of affordable rental housing properties that are built in their domain, minimizing the required oversight at the federal level. Because QAPs are updated annually, credit allocating agencies are able to respond swiftly to dynamic market conditions by emphasizing or de-emphasizing specific application criteria, thus forcing developers to be sensitive to wanted criteria. As a result of communication and collaboration between credit allocating agencies, some program characteristics are common across the majority of jurisdictions – maximum fee limits on developer and contractor fees, minimums and caps on construction or rehabilitation costs per unit, and annual replacement reserve requirements, to name a few.³⁸ However, the LIHTC program enables states to address their local economic climate by defining their own requirements and scoring systems for successful LIHTC applicants. Credit allocating agencies can emphasize where housing is needed, but not with impunity. For example, even though a state wants to emphasize a specific region, market studies are a required factor in site selection to ensure that properties are built where there is adequate demand to support the prop-

32 IRC §42(h)(3) and Revenue Procedure 2010-40.

33 IRC §42(m)(1)(B).

34 IRC §42(m)(1)(B)(iii).

35 IRC §42(m)(2).

36 IRC §42(m)(2).

37 This reference includes cities, districts and U.S. possessions, namely the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, American Samoa, Guam, Northern Mariana Islands and the cities of Chicago and New York.

38 National Council of State Housing Agencies, 2010.

erty. Credit allocating agencies also have the ability to support a specific type of housing (e.g., family, senior, special-needs), and to monitor construction, lease up, and permanent financing. In addition, credit allocating agencies perform ongoing compliance monitoring for at least 15 years. They also often perform periodic on-site inspections (all credit allocating agencies visit all properties at least once every three years) to check for suitability for occupancy and renting to low-income families at restricted rental rates. Notably, this monitoring is supported by fees from the LIHTC properties. Ultimately, the credit allocating agency serves as an underwriter and compliance monitor (along with the construction lender, permanent lender, syndicator, and investor) to ensure that the property is successful.

Regulatory Guidance from the IRS and Enforcement by IRS Auditors

To be eligible to claim the LIHTC, property owners are required to submit documentation to the credit allocating agency regarding the completion of construction or rehabilitation, most notably an audited cost certification certifying the amount of eligible basis that was incurred for construction or rehabilitation. If approved by the credit allocating agency, the property will receive signed IRS Form 8609s (from the credit allocating agency) and be eligible for LIHTCs. Subsequently, an LIHTC property is required to annually certify that the property has not experienced any decrease in qualified basis on IRS Form 8609-A, filed with the ownership entity's tax return. Such decreases would result from either compliance issues that decreased the property's qualified occupancy percentage for the year or from casualty losses or other reductions in the property's eligible basis. In addition, when credit allocating agencies discover that properties are not compliant with LIHTC rules, they issue IRS Form 8823, which is sent to the IRS. The IRS then has notice of the possible need to follow up. These filing requirements, along with a handful of other filings that are required by the IRS, keep them well informed of problems with specific properties. This oversight is valuable in keeping property owners compliant with the rules.

The result of states playing such a large role in the administration of the LIHTC program is that the IRS is left to monitor the program at a higher level by focusing on the technical requirements of the program, such as which costs are included in eligible basis, as well as program compliance at the property and credit allocating agency levels. Ernst & Young reported that only 31 IRS audits were reported out of its survey of 12,462 stabilized properties, of which only three reported a reduction in LIHTCs.³⁹ The study acknowledges that the remaining respondents included both those who positively indicated that they had not been audited and those who chose to remain silent on the issue, indicating that the number could possibly be underreported. There have been audits of LIHTC properties but many such audits ended after the initial contact by the IRS. These audits were probably not included in the Ernst & Young study. While data from the IRS would shed more light on the issue, the fact that what data is available shows such a small percentage of properties experiencing a loss of credits indicates that the LIHTC program has a good record of properties being compliant.

39 Ernst & Young LLP, 2010

Conclusion

The previously discussed seven factors provide an important part of the checks and balances of the LIHTC program, and collectively, they form a powerful system that is not seen in other affordable rental housing programs. This public/private partnership brings together the strengths of each partner to generate the successful track record of the LIHTC program. Some of the failures of other government supply-side programs are considered in the next section, failures that could have been alleviated by partnering those programs with LIHTCs.

III. Other Supply-Side Government Program Track Records

The track record of other supply-side government programs has been mixed at best. The following is a summary of some of the major supply-side efforts in affordable rental housing and their track records.

Section 221(d)(3) Below Market Interest Rate Program

Overview

The 221(d)(3) below market interest rate (BMIR) program was originated in 1961 and funded approximately 184,000 units.⁴⁰ The program enabled developers to obtain FHA-insured mortgages at a below-market interest rate, typically 3 percent, from private lenders, who would subsequently sell the mortgages to Fannie Mae. As designed, the program would enable the developer to obtain below-market interest rates, a property owner could charge less rent and attract median income families squeezed out of the rental marketplace – certain families had incomes too high to qualify for public housing but their incomes were not sufficient to afford rent in a property funded by market-rate debt. Rents were sized to cover operating expenses, debt service payments on the 3 percent mortgages, and a 6 percent limited dividend for the property owner. The BMIR program was designed to use the strength of the government's balance sheet to mitigate risk for transaction participants but minimize the initial cost outlay to the government. The government would incur significant outlays only if there was a default on the loan and it was required to make the private lender whole.

Track Record

A combination of structural issues plagued the program from inception, and by 1975, one-quarter of all BMIR property owners had defaulted on their loans.⁴¹ In addition, a lack of eviction thresholds meant that over time, the tenant base in the properties often became more affluent, creating an opposite stigma from the public housing properties at the time: that the program was providing reduced-cost housing for those who did not need it. Also, the government's guarantee meant that for properties that fell into default, the government was required to take over management of the property, creating an unanticipated cost to the government

40 Aaron, 1972; A. F. Schwartz, 2006.

41 Achtenberg, 1989.

resulting from the asset management of properties that went into default and had to be foreclosed.

Finally, and most importantly, the basic design of the program was flawed because the subsidy was provided in full and up front to the developer/sponsor in exchange for minimal risk, nominal compliance requirements, and insubstantial incentives for the ongoing monitoring and success of the property. There was no private market participant besides the developer to monitor the feasibility and operational health of such properties. Developers/sponsors were essentially incentivized to create as much housing as possible to generate success fees for development completion. As such, given the guarantee of the government, the developers were able to obtain higher levels of debt financing than they could absent the government's guarantee, providing additional upfront cash flow to the developer. Because developers were limited to a 6 percent operating dividend, it is clear that they were much less motivated by property operations than by property completion. Subsequently, the risk of the property's operational success was shifted to the government due to a lack of operational guarantee required of the developer. Additionally, softer prepayment and affordability restrictions allowed a developer with a property that substantially appreciated in value to prepay the loan, convert the property to market-rate housing and realize significant profits from the refinancing.

However, the Section 221(d)(3) program did provide significant value to the affordable rental housing marketplace. Below market rate debt financing enables a developer to rent to lower-income tenants that might otherwise be unable to live at the property. In addition, when there are liquidity issues in the broader financial market, government insured loans may be the only financing available to an affordable rental housing developer regardless of the economics of the underlying property.

Had the LIHTC program been in existence when the Section 221(d)(3) program was initiated, one solution would have been to tie the Section 221(d)(3) program to the LIHTC program so that the BMIR program could have benefited from the components that contribute to the success of the LIHTC program. For example, an LIHTC property goes through a feasibility review by the credit allocating agency to ensure that the property is reasonably sourced and not over-subsidized. If LIHTC properties are deemed to be over-subsidized, the credit allocating agency will require the reduction of sources or reduce the amount of LIHTCs allocated to the property. In addition, third-party investor oversight would also examine sourcing and reasonableness of debt service. Furthermore, combining with the LIHTC program would have helped address the issue that all of the benefits from the Section 221(d)(3) program were provided in full and up front because LIHTC benefits are earned over time. Moreover, for many current properties, a portion of the developer fee is paid out of cash flow, incentivizing developers to manage operations. Finally, as described earlier, investors help provide an additional backstop to foreclosures, along with additional oversight and monitoring. Thus, combining the LIHTC and Section 221(d)(3) programs could have provided a strong approach to funding affordable rental housing.

Section 236 Program

Overview

As a result of fundamental issues with the 221(d)(3) BMIR program, Congress replaced it with the Section 236 program as part of the National Housing Act of 1968. The Section 236 program financed more than 544,000 units⁴² by providing an annual subsidy, called an interest reduction payment (IRP) to reduce the annual debt service costs of a typical private mortgage to the costs of a 1 percent interest mortgage. The IRP built upon two specific lessons learned from the 221(d)(3) program. First, by providing the IRP on an annual basis to the property owner, it both minimized the budgetary impact to the government and engendered a longer term focus and greater incentive for the developer/sponsor to focus on the operational success of the property. It is important to point out, however, that substantial developer operating guarantees were not yet prevalent under this program. Second, in exchange for the larger subsidy provided (subsidizing interest down to 1 percent instead of 3 percent), the government required the property rent units to lower income tenants (up to 80 percent of median income) and thus charge lower initial rents. Similar to the Section 221(d)(3) program, rents were sized to pay for operating costs, debt service on a 1 percent mortgage, and a 6 percent limited dividend to the property owner.

Track Record

While it addressed several key issues with the Section 221(d)(3) program, the results of the Section 236 program still looked somewhat similar. By 1975, one-tenth of properties funded by Section 236 were in default.⁴³ The results of a 1980 U.S. Government Accountability Office (GAO) study⁴⁴ indicated that within the Section 236 program, the subset of substantial rehabilitation family housing with for-profit sponsors experienced foreclosure/assignment rates of 31.3 percent and similar properties with not-for-profit sponsors had a 65.1 percent foreclosure/assignment rate. Properties in this subset of the program were characterized by neighborhoods with declining income that would not support high enough rents to cover increasing operating costs. Taking into account all subsets of the Section 236 program, the GAO study indicated that approximately 15 percent were in foreclosure by 1978. While the funding for the Section 236 program was provided on an annual basis, the program was still characterized by sufficient incentive for developers to produce housing without the assumption of operational risk commensurate with their upfront profits – again shifting the operational burden onto the government. The private lenders providing financing considered the strength of the government's balance sheet in sizing their debt and essentially allowed developers to borrow against the IRP revenue stream, increasing upfront cash flow to the developer and increasing operational risk due to the higher degree of leverage on the property. In addition, while the program was designed to serve lower income tenants than the 221(d)(3) program, the increased rents associated with higher operating costs,

42 Olsen, *Housing Programs for Low-Income Households*, 2003.

43 Achtenberg, 1989.

44 U.S. General Accounting Office, 1980.

both based on the property needs and the inflationary marketplace at the time, meant that maintaining high occupancy was a constant issue and Congress was forced to authorize HUD to provide rental assistance payments to help low-income families afford the basic property rent.

Despite the aforementioned issues, below market rate debt financing of the Section 236 program as designed would enable a developer to rent to lower-income tenants that might otherwise be unable to live at the property. Similar to the BMIR program, and if it were possible, combining the LIHTC program and the Section 236 program could have helped finance the operations of a successful affordable rental housing property due to the benefits of investor oversight and because LIHTC properties have to demonstrate to the credit allocation agencies their economic need for their LIHTC subsidies.

Section 515 Program

Overview

In 1962, Congress created the Section 515 program for rental housing located in rural areas. The program is administered by the USDA, Rural Development (originally by USDA's Farmer's Home Administration and its successor agency, Rural Housing Service) and provides direct loans at an interest rate of 1 percent with a 50-year amortization period.⁴⁵ Congress subsequently enacted a rental assistance program called the Section 521 program that provided subsidies to property owners to cover the difference between 30 percent of tenants' adjusted income and the budgeted property rents.

Track Record

The Section 515 program was plagued by similar issues as the Section 221(d)(3) and Section 236 programs, including the absence of affordable rental housing preservation requirements and/or prepayment restrictions (for properties prior to 1989), as well as little incentive to plan for future renovations and repairs. Notably, a 2004 study commissioned by USDA found that none of the properties had sufficient reserves, or future provisions for reserves, to address physical needs and future required renovations. This same study also predicted that without changes to the program requirements or additional subsidies, most properties would default.⁴⁶ Since then, the program has gone through various changes to address some of its issues, most notably the ability to prepay the Section 515 loan, which if done, removes any requirements to serve low-income tenants. While the program's intent to preserve rural rental housing is noteworthy and would seem essential to a successful affordable rental housing program, its track record underscores the issues resulting from providing the majority of the government subsidy upfront and the importance of incentivizing transaction participants to remain involved in the ongoing operations and planning of the property. Because LIHTC properties

45 7 CFR 3560.67(c).

46 ICF Consulting, 2004.

are characterized by the tax credits being claimed over a 10-year period, as well as a 15-year compliance period and additional 15-year extended use period, the transaction participants have a vested interest in ensuring properties perform well, maintain adequate reserves for future repairs, and remain part of the nation's affordable rental housing stock.

Notwithstanding certain issues with the program, the Section 515 program plays a very important role in the affordable rental housing marketplace because of its focus on funding properties in rural areas. Given a choice between investing in an urban or suburban property versus a similar rural property, LIHTC investors typically would select the urban or suburban property based on factors such as overall population migration toward urban and suburban areas and greater rent-level stability. In addition, property owners who are able to combine programs such as Section 515 with the LIHTC can create strong affordable rental housing developments. The inclusion of LIHTCs brings with it lower debt service payments, which decrease rent requirements, as well as the credit allocating agencies' monitoring of the property funding needs requirement, and ongoing property monitoring and management by the LIHTC sponsor and investor to ensure optimal performance of the property.

Project-Based Section 8 Rental Subsidies

Overview

The Section 8 New Construction and Substantial Rehabilitation program, also known as the project-based Section 8 program,⁴⁷ began in 1974 as a subsidy paid to the owners of a property to help subsidize the cost of fair market rent for low-income tenants. Owners received an amount based on the difference between the tenants' portion of their rent, which was 30 percent of their income (originally 25 percent), and fair market rent. As the tenants' portion of their rents increased or decreased due to the change in their income, the Section 8 subsidy adjusted to cover the difference between the tenant portion and fair market rent. In addition, if fair market rents increased, the Section 8 subsidy increased as well. Because this program was a rent subsidy, property developers had to obtain financing, which could be market-rate financing from traditional private lenders. In the end, the program was terminated in 1983, although funding continued for properties with existing contracts and those that were in the pipeline. Ultimately, more than 850,000 units were subsidized.⁴⁸ Although there have not been any new Section 8 contracts, a limited form of project-based vouchers still exists in renewed contracts and from housing choice vouchers provided by HUD to housing authorities.

Track Record

On a stand-alone basis, the project-based Section 8 program had many of the

47 Note that project-based Section 8 means that tenants occupying units in the property are entitled to Section 8 rental subsidies. As such, project-based Section 8 is a supply-side subsidy. Conversely, tenant-based Section 8 is a demand-side subsidy, as the tenant has the right to the subsidy and can choose which rental property to live in.

48 Olsen, *Housing Programs for Low-Income Households*, 2003.

benefits of the LIHTC program. The subsidy was provided on an annual basis to the extent that the units were made available to low-income tenants at restricted rents that helped maintain compliance with the program's regulations. However, the program was often paired with government-guaranteed debt. When combined with this debt, the program faced issues much like BMIR debt programs in that if the government chose to not continue the Section 8 rental payments, there was the threat that owners would allow their properties to go into foreclosure. If this situation were to happen, the loan the government guaranteed would go into default and the government would be forced to suffer losses honoring their debt guarantee. Thus, the government was under substantial pressure to maintain the Section 8 contract.

The project-based Section 8 program also ran into budget issues. Increasing rents and long-term contracts created pressures on HUD to shorten contract terms so as to limit the effect of the contracts on their budget. As long-term contracts and new short-term contracts began to expire in the same year, the cost to renew contracts significantly increased almost to the point of absorbing HUD's entire budget.⁴⁹ Moreover, studies on the program suggested that tenant-based Section 8 provided housing at a lower cost than project-based Section 8, which influenced the termination of the program.⁵⁰

By combining LIHTCs with project-based Section 8 funding, owners would be less likely to let properties go into foreclosure when losing their project-based Section 8 funding since foreclosure would also require the recapture of the LIHTCs. Furthermore, combining the two programs can help developers reach areas where LIHTCs alone would not support a property. In addition, a combination of the funds could help reach lower income tenants. When used in connection with the LIHTC, particularly to serve tenants with extremely low incomes, the project-based Section 8 program can be an integral component of a successful affordable rental housing property.

Section 202 Program

Overview

Established as part of the Housing Act of 1959, the Section 202 program is the oldest federal program that provides funds to not-for-profit organizations to help house and support the elderly. In addition, some funding is provided to assist disabled persons as well. Originally, the program provided 40-year loans to properties, but in 1990, the program was changed to provide grants. Generally, grants are provided to cover the complete cost of construction, although the program has allowed additional funding, including LIHTCs, so that developers can provide additional or better quality units.⁵¹ A property must stay in compliance with Section 202 rules for 40 years or face recapture of the grants. The Section 202 program also provides project-based rental assistance, much like the project-based Section 8 program. Section 202 properties are usually newly constructed properties rather than re-

49 A. F. Schwartz, 2006.

50 Olsen, *The Cost-Effectiveness of Alternative Methods of Delivering Housing Subsidies*, 2000.

51 A. F. Schwartz, 2006.

habilitated properties. In general, they are elevator equipped mid- and high-rise buildings averaging 45 units. An estimated 80 percent of the properties are located in metropolitan areas.⁵² Elderly properties require significant supportive services not found in typical affordable rental housing properties such as healthcare services, housekeeping, and transportation. These types of services are provided in Section 202 financed developments.

Track Record

Section 202 has enjoyed fewer defaults and greater financial stability than most other federal housing programs.⁵³ In 2007, the Congressional Budget Office estimated that Section 202 loans have an annual default rate of 0.25 percent.⁵⁴ Even though the program has experienced notable stability, it has suffered from a relatively slow production of units, especially in relation to the number of applicants waiting for homes. In 2008, HUD estimated the wait time for a new applicant to be longer than two years.⁵⁵ A GAO study found, and HUD confirmed, that properties were sometimes delayed due to stringent development cost limits and thus inadequate funding. This added to development times because sponsors would have to find alternate sources of funds.⁵⁶

GAO also found that the program may be more expensive than tenant-based Section 8, however Section 202 properties have more amenities and services that meet the needs of the elderly than what might be found in other properties used by tenant-based Section 8 voucher holders. Because tenant-based Section 8 is a demand-side policy, it does not have a large effect on the types of properties built, so elderly tenants often live in properties that do not have services they need. Because elderly tenants require additional support and services, tenant-based Section 8 may not be the best choice for situations where tenants need assistance, supportive services, or are at risk of being institutionalized.⁵⁷

In recent years, because of the low amount of funding for the Section 202 program and allocation issues discussed previously, the program has seen more small inexperienced sponsors producing small developments. This situation has contributed to the program's inefficiencies and disbursement delays.⁵⁸ Many of these issues could be addressed by encouraging the combination of Section 202 funds with LIHTCs. LIHTCs will help leverage Section 202 funds to build larger developments while bringing in more experienced sponsors and additional oversight. In addition, credit allocating agencies can effectively control costs using their QAPs.

Conclusion

The track record of other supply-side government programs has been mixed at best.

52 DiPasquale, Fricke and Garcia-Diez, 2003.
53 Haley, et al., 2008.
54 Congressional Budget Office Cost Estimate, 2007.
55 Haley, et al., 2008.
56 U.S. General Accounting Office, 2003.
57 Haley, et al., 2008.
58 Haley, et al., 2008.

These programs if combined with the LIHTC would have had more successful track records. If combined with LIHTCs, these types of programs would benefit from stronger controls on construction and operating costs, better compliance with program requirements and lower foreclosure rates. In addition, these types of programs, when blended with LIHTCs, allow developers to serve extremely low-income tenants or tenants with special needs.

IV. Role of the Section 1602 Exchange Program

To address the market disruption that began in late 2008, the Recovery Act included a tax credit exchange program commonly referred to as the Section 1602 LIHTC exchange program. This program appropriated funding to the credit allocating agencies to be used as grants to finance the construction of, or acquisition and rehabilitation of, qualified low-income building for low-income housing in lieu of the LIHTC. Each state was appropriated up to 100 percent of its unused 2007 and 2008 LIHTC allocations and a maximum of 40 percent⁵⁹ of its 2009 LIHTC allocation in exchange program funds. As of December 31, 2010, the Treasury Department had authorized \$5.7 billion in exchange program funding awards to credit allocating agencies.⁶⁰ Each credit allocating agency subsequently makes subawards to property owners, which subjects the property owners to the same requirements as the LIHTC program under IRC Section 42. Prior to receiving a subaward, also called a grant, the property owner must demonstrate a good faith effort to obtain a tax credit investor. The goal of the program was to temporarily fill the gap left by the reduction in investor demand for the LIHTC that was itself a result of the broader financial market problems that began in 2008.

While some have argued for an extension of the exchange program, such a measure would not necessarily have a long-term positive effect on the LIHTC industry. In the short term, the exchange program has succeeded in financing some stalled LIHTC properties, thereby achieving its objective. There are several reasons to believe, however, that in the long term there would be issues with an extended exchange program.

First, a long-term exchange program would dilute the effectiveness of the previously discussed LIHTC underwriting and screening procedures that have been honed over the life of the LIHTC program. With exchange funds making up what was traditionally the private sector's stake in a property, grant-funded properties would have a lack of private capital in their capitalization. The industry would suffer due to the loss of the benefits of having a third-party profit-motivated investor who analyzes the property's underwriting.

Secondly, the industry would suffer from the loss of the investor's asset management. Without the asset management and monitoring traditionally borne by the private sector, responsibility shifts to the public sector, specifically to the credit allocating agencies. While many properties funded solely with grants have subcontracted asset management services from the private sector, it is unclear how strongly such properties would be managed

59 According to discussions with congressional staff, the exchange percentage limit of 40 percent was chosen to help fill a shortfall in equity investor demand caused in part by Fannie Mae and Freddie Mac's withdrawal from the investor market. Fannie and Freddie are widely believed to have been about 40 percent of the investor market prior to their withdrawal from the market.

60 U.S. Department of the Treasury, 2011.

when the managers only have a contractual interest in the property, as opposed to a direct ownership interest as with the LIHTC program.

Finally, with the financing from the government being provided up front, there is the concern that properties that use only exchange funds could see a rise in foreclosures now that the investor is not in the transaction as a backstop. As discussed previously, when a property owner is underperforming, the investor will often step in not only to manage the property, but also provide additional financing to prevent the property from losing its tax credits. Without the third-party investor, this additional safeguard from foreclosure will be absent.

Several credit allocating agencies, through informal surveys, communicated that they see somewhat more risk in properties receiving exchange program funding. While respondents indicated confidence in the strength of their respective underwriting procedures and the financial feasibility of exchange program properties relative to LIHTC properties, each respondent acknowledged that the absence of the traditional tax equity investors from the transaction would not go unnoticed. Respondents were concerned about the lack of additional underwriting, additional property monitoring and the additional backstop at the sign of trouble. Despite these reservations, respondents indicated cautious optimism about the exchange program.

Conclusion

The exchange program was an extremely important piece of legislation and helped absorb the adverse effect on the demand for LIHTCs caused by the withdrawal of Fannie Mae and Freddie Mac from the investor market and the extraordinary financial collapse of the banking industry. However, the LIHTC program has been very successful and extremely efficient in less turbulent times. Starting in 2010 and continuing in 2011, the industry has seen a resurgence in the number of LIHTC investors and the amount of investment. As such, the exchange program should be allowed to phase out because investors have returned to the LIHTC market.

V. Comparison of the LIHTC Program to the Section 1602 Exchange Program

Comparative measures of efficiency of the LIHTC program to the Section 1602 exchange program require addressing the estimated present value of projected future costs of the LIHTC program compared to the estimated present value of projected future costs of the exchange program. One key difference is that with the LIHTC, private investors, not the government, provide the upfront capital necessary in exchange for a 10-year government subsidy. The LIHTC program has future costs that are fairly simple to measure and demonstrate to the federal government, namely the stream of tax credits allowable to investors. Under the tax credit program, credits are awarded to a property and the property is then constructed or rehabilitated. If one assumes a discount of the tax credits at a 3.5 percent

borrowing rate, an estimate of the cost of borrowing for the federal government,⁶¹ then the implied cost of a 10-year stream of tax credits at \$1 million a year is roughly \$8 million (at a 4.5 percent borrowing rate approximately \$7.6 million). If one assumes that the federal tax credits sell for 75 cents,⁶² then \$7.5 million in investor equity comes at a present value cost of approximately \$8 million. In addition to the \$7.5 million in equity, the investor has additional costs in asset management and other oversight services performed. Furthermore, equity is generally provided up front during the construction and lease-up phase of a property's lifecycle. The cost to the government is only borne if the affordable rental housing is delivered and kept in compliance; otherwise, the LIHTCs are not provided or they are recaptured.

For the exchange program, there are direct costs—the costs of the grant—and indirect costs. The initial direct costs are straightforward, namely the amount funded by the federal government. If one assumes the same \$7.5 million in equity that was raised in the LIHTC example is raised via an exchange grant, then the government will fund \$7.5 million over the construction period. Using the same assumptions, this grant translates into a present value cost of approximately \$7.4 million. However, the exchange program imposes asset management costs on credit allocating agencies.⁶³ These asset management costs would normally have been incurred by tax credit syndicators and investors when LIHTCs are awarded. Assuming 50 basis points as the annual asset management costs over the 15-year equivalent LIHTC credit period, the additional present value costs are approximately \$0.5 million over 15 years.⁶⁴ Purely grant-based properties will have a higher default rate and additional costs to the federal government because they lack the public-private partnership of the LIHTC, and the grants are provided up front instead of over time. One possible estimate of the default rate would be the rates from the Section 221(d)(3) and Section 236 programs, which range from 15 to 25 percent. In addition, the loss rate to the government on a defaulted exchange program property is assumed to be about 50 percent because most developers will not have the funds to guarantee the grant money. Using a 15 percent default rate along with a 50 percent loss rate and an average loss in year 7, an additional loss of about \$0.4 million would be expected.⁶⁵ The combination of loss on default and asset management increases the present value expected cost to approximately \$8.3 million. Based on these rough estimates, the exchange program costs approximately 3 percent more than the LIHTC program when tax credits are sold at 75

61 The average borrowing rate for five-year Treasuries over the last four years has been 3.5 percent. It was 2.5 percent the last two years; 3.5 percent the last five years; and 3.9 percent over the last 10 years. A higher discount rate reduces the present value cost of discounted cash flow streams; a lower discount rate increases the present value of discounted cash flow streams.

62 The actual observed tax credit prices are averaging higher than 75 cents, and in many markets have reached the mid to high 90-cent range.

63 The exchange program also places additional burdens on credit allocating agencies and the Treasury Department in awarding and disbursing funds. Furthermore, the Treasury Office of Inspector General has requested additional funding as it anticipates a significant increase of related criminal investigations. Fiscal year 2012 Budget in Brief: Office of Inspector General available at: http://www.novoco.com/hottopics/resource_files/fy12_bib_oig.pdf.

64 The study looked at fees from 13 credit allocating agencies. The amount of asset management fees being charged by each state varied significantly with the higher end potentially being over 30 basis points. Although these are the estimated asset management fees charged by the credit allocating agencies, once everything is factored in, the cost may end up closer to 50 to 100 basis points. 50 basis points is closer to the LIHTC industry average. Credit allocating agencies will have additional costs from government salaries and overhead along with less expertise and economies of scale.

65 The 50 percent loss rate is on the conservative side; it is expected that if an exchange program property were foreclosed upon, very few developers would have the funds to repay the exchange funds. The property would then go into foreclosure and end up the property of the mortgage lender. Year 7 was used because it is the midpoint of the 15-year compliance period.

cents. If a 25 percent default rate is used along with 100 basis points for the asset management costs, then an additional loss of about \$0.7 million along with asset management costs of \$1 million would be expected and the combination of loss on default and asset management increase the present value expected cost to approximately \$9.1 million. With this estimate, the grant program would be approximately 13 percent more expensive than that of tax credits sold at 75 cents.

Conclusion

Although the exchange program comes at a higher cost than LIHTCs, there was a need for the program in the affordable rental housing industry during 2008 and 2009. In extraordinary times, there is a need for the exchange program to help build desperately needed affordable rental housing in markets where there are sourcing gaps. Now that the industry has seen a resurgence in LIHTC investment, the exchange program should be allowed to phase out.

VI. Efficiency of Program at Reduced Tax Credit Equity Prices Versus the Exchange Program

The keystone to the success of the LIHTC is the contingent nature of the tax credits and the subsequent risk of recapture to tax credit investors, combined with investor, IRS and credit allocating agency oversight. A question for policymakers is at what tax credit price does the program cease to be cost-effective? Investors in LIHTC properties provide two key components: (1) capital for construction and renovation of affordable rental housing; and (2) oversight of the construction and renovation of the housing for at least 15 years of operations. In exchange, the federal government provides LIHTCs over 10 years. The question can be simplified as a cent-per-dollar price, but it should be noted that this is merely a simplification. Credit prices are a mechanism investors use to distill expected benefits and costs for a proposed LIHTC property into a single pricing factor that can be used as a starting point to analyze any LIHTC transaction. Credit prices vary based on an LIHTC investor's perception of risk assumption, the internal rate of return projected for the property, returns on alternate investments, and other factors important to particular investors (e.g., property size, geographic location, type of property, etc.).

Clearly, if the tax credits were sold for a negligible amount, the government would be giving away subsidies for *de minimis* capital and simply for ongoing oversight. As compared to prior supply-side programs, a theoretical price can be estimated as the break-even point for the analysis.

As estimated in previous examples, at a tax credit equity price of 75 cents, the exchange program is roughly 3 to 13 percent more expensive than the LIHTC program. To the extent the credit price falls to 72.5 cents (for the first example) or 66.3 cents (for the second example), based on the implicit assumptions in the comparative analysis, the LIHTC and exchange programs would be projected to be equivalent in cost.

However, to the extent actual asset management costs are higher or loss rates on the grants are higher, actual costs of the exchange program will be even higher. In that case, lower LIHTC equity pricing would be more efficient than the exchange program.

It can also be noted that to the extent the LIHTC program is combined with other soft financing and those programs can rely on the asset management of the LIHTC investor, then the relative efficiency of the LIHTC program at even lower tax credit equity pricing would be strong due to the benefits accruing to the lenders of the soft financing by the participation of the LIHTC equity investor.

Conclusion

Based on our examples, LIHTC pricing would need to fall to around 70 cents before the exchange program would become as efficient as the LIHTC program at building affordable rental property. To the extent our estimates for the cost of asset management functions or losses on the exchange program are higher than estimated, LIHTC pricing would need to fall even further before the exchange program is equally efficient. Although the exchange program may be just as efficient as the LIHTC program around 70 cents, it would have additional qualitative differences such as higher default rates, more maintenance problems or be less compliant with Section 42, which would still make the LIHTC more attractive.

VII. Conclusion

We believe that the LIHTC program has demonstrated a strong track record of success funding affordable rental housing properties since its inception and remains the foundation of the affordable rental housing industry. The program has been the most successful to date at increasing the affordable rental housing stock in a stable and ongoing partnership between private and public resources. In addition, its ability to seamlessly work in tandem with other government housing programs, including the temporary exchange program, strengthens the LIHTC program benefits, the benefits of the other programs, and increases the affordable rental housing stock throughout the United States.

Appendix

LIHTC Overview

The LIHTC was enacted by the Tax Reform Act of 1986 and is an indirect federal subsidy used to finance affordable rental housing.⁶⁶ Eligible taxpayers receive the subsidy by claiming a tax credit on their federal income tax returns. The LIHTC generally offsets taxes dollar for dollar because it is a tax credit, not a tax deduction. Unlike most tax shelters, Congress controls the amount of tax expenditures by the amount of LIHTC allocated each year. Congress created the LIHTC as an incentive for private developers and investors to provide more affordable rental housing.

The LIHTC, which is claimed *pro rata* over 10 years, can be used in connection with both newly constructed and renovated residential rental buildings. The total amount of credit available is subject to certain caps. Within the general guidelines set by the statute, credit allocating agencies administer the credit allocation process, setting their own allocation criteria. Taxpayers must apply to the applicable credit allocating agency to obtain an allocation. Credit allocating agencies are responsible for allocating the limited quantity of credits to low-income housing properties. The LIHTC provides credit allocating agencies with more than \$5 billion in annual budget authority that they can use to leverage a vast magnitude of private capital to fill affordable rental housing needs.

Once a property is placed in service, it generally is eligible for the tax credit every year for 10 years. To continue generating the credit and to avoid tax credit recapture, an LIHTC property must satisfy specific low-income housing compliance rules for a full 15-year period. Moreover, an LIHTC building must satisfy specific tax credit compliance rules for a minimum of 30 years. The compliance period is often longer than 30 years when an extended low-income housing commitment agreement is entered into with a specific credit allocating agency. This agreement requires low-income use for such building in accordance with a stipulated “extended use period” specified in that agreement.

The LIHTC is generally designed to subsidize either 30 percent (otherwise known as the 4 percent credit) or 70 percent (otherwise known as the 9 percent credit) of the costs of the low-income units in a property. The 30 percent subsidy is used for new construction with tax-exempt bond financing and for the cost of acquisition of existing buildings. The 70 percent subsidy is used for new construction without tax-exempt bond financing. The term “new construction” includes the costs of rehabilitating an existing building if a minimum per unit expenditure threshold is satisfied. Similarly, to qualify for a 30 percent subsidy for acquiring an existing building, a minimum threshold of rehabilitation expenditures generally must be satisfied.

The 30 percent or 70 percent subsidy is realized by claiming federal income tax credits every year for 10 years. The actual amount of the annual credit is calculated to yield a present value of either 30 percent or 70 percent of certain building costs.

66 For a complete discussion of the LIHTC, see Novogradac & Company LLP, *Low-Income Housing Tax Credit Handbook*, 2011.

In exchange for this credit, the property owner must agree to rent units to low-income individuals at income-based restricted rental rates. Theoretically, the LIHTC is designed to provide the additional return that is necessary to compensate low-income building owners for reduced rental income. The effect of reduced rental income stream must be factored into the analysis. General economic principles influence where tax credit subsidized low-income housing will be built. Absent additional subsidy and competitive criteria established by credit allocating agencies, such housing generally would be located where the land costs are relatively low and the LIHTC allowable rents are relatively higher.

The LIHTC program provides numerous social and economic benefits. The LIHTC program fosters increased affordable rental housing targeting very low- to low-income populations by offering residents income based restricted rents. The credit can address special needs by targeting housing for seniors, physically challenged individuals, and families. Rental units can include special accommodations, amenities, facilities, services and transportation serving chronically mentally ill individuals, the developmentally disabled, the burgeoning senior population, female-headed single-source-income families, physically disabled persons, HIV households, homeless persons and families with several children.

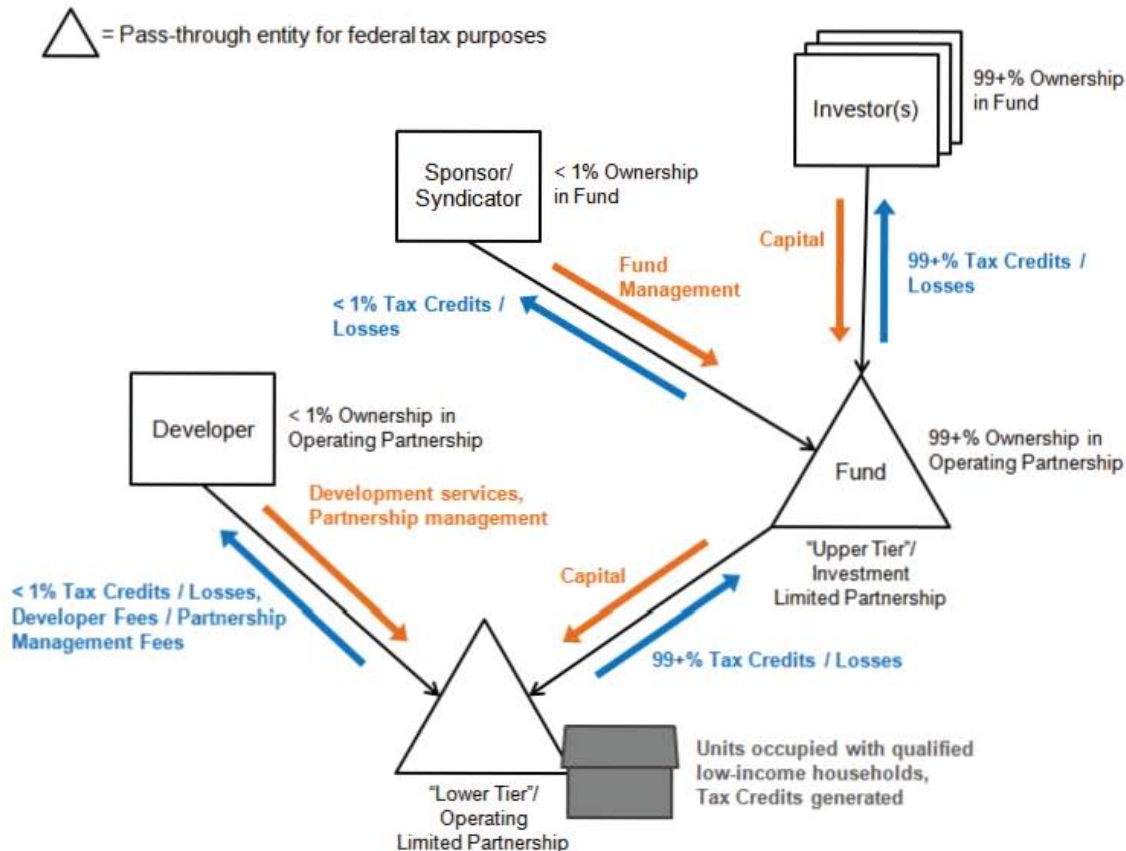
The LIHTC program helps stimulate a local economy. It fosters community renewal and attracts job opportunities to the surrounding neighborhood, while providing increased purchasing power from new tenants. At the same time, unused or abandoned land, as well as inefficiently used other real estate, can be put to productive use. The LIHTC program encourages private individuals and corporate investors nationwide to invest billions of dollars in affordable rental housing.

The LIHTC has eased government's burden to provide housing by enabling private investors nationwide to support critical community renewal developments by investing heavily into equity funds. Rehabilitation of rental properties, often central to community redevelopment of depressed downtown economies, can use the benefits of the LIHTC program. In addition to being an investment, many banks target lending activities toward affordable rental housing to satisfy Community Reinvestment Act (CRA) requirements. Moreover, the credit has permitted lenders and investors to use proceeds from LIHTC-type investments to lend money for community development activities and required public welfare service programs.

For almost all LIHTC properties, including both new construction and acquisition/rehabilitation developments, a special-purpose entity (SPE) is created to own the property, usually a limited partnership or a limited liability company. Usually the developer of the property, or an affiliate thereof, is the general partner or managing member of the SPE and an investment fund is the limited partner or member of the SPE. The limited partner (investment fund) contributes capital to the SPE in exchange for a 99 to 99.99 percent ownership interest of the profits, losses and tax credits generated by the LIHTC property. The developer contributes a nominal amount of capital in exchange for its 0.01 to 1.00 percent ownership interest. The investment fund is typically organized as a limited partnership or limited liability company that is owned 99 to 99.99 percent by the tax credit equity investor and 0.01 to 1 percent by a syndicator sponsor. The syndicator sponsor is a company that aggregates (syndicates) LIHTC investments together on behalf of tax credit equity investors based on the investors' investment preferences. For example, some types of funds

include single investor (private label) or multi-investor funds, funds that invest in only one state or nationwide, or funds that invest only in new construction developments. Alternatively, some LIHTC investors prefer to invest directly in properties to ensure control over investment terms and investments tailored to their desired portfolio characteristics. Such investors will invest directly in the SPE as the limited partner (or through a single-member LLC that is disregarded for federal income tax purposes) and typically perform in-house many of the services of the syndicator sponsor.

Figure A – Sample LIHTC Fund Structure



An LIHTC property is required to make an irrevocable election that it will satisfy one of the two minimum set-aside tests: the 20/50 test or the 40/60 test.⁶⁷ Under the 20/50 test, a minimum of 20 percent of the residential units must be both rent-restricted and occupied by tenants with incomes at or below 50 percent of the area median gross income (AMGI).⁶⁸ Under the 40/60 test, a minimum of 40 percent of the residential units must be both rent-restricted and occupied by tenants with incomes at or below 60 percent of the area median gross income (AMGI). If an LIHTC property falls out of compliance, such as by renting vacant units to market-rate units so that the applicable set-aside test is no longer met, and such deficiency is not corrected within a reasonable amount of time, the owner of the LIHTC property is subject to tax credit recapture (i.e., a loss of tax credits), in

67 For New York City properties only, there is a 25/60 set-aside test.

68 The LIHTC rules use a definition of AMGI that is based on the HUD methodology used for the Section 8 program.

addition to an associated interest charge.⁶⁹ As an incentive to increase the percentage of units rented at restricted rents to low-income families, property owners can only claim tax credits on the percentage of the property that is rented to low-income families at restricted rents. As a result, the majority of LIHTC developments rent 100 percent of their units to low-income families at restricted rents.

As part of their compliance requirements, LIHTC properties must annually recertify their tenants to ensure they remain eligible for the LIHTC program.

69 Novogradac & Company LLP, 2011.

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