

BOARD ACTION REQUEST
June 25, 2009

Action Item

Presentation, consideration, and possible action to adopt a policy regarding the Exchange of Tax Credits and the process for allocation of funds received under any Exchange.

Required Action

Approve, amend, or take no action on the proposed policy. In light of the complexity of this issue, the need for public input, and the fact that guidance from Treasury is evolving rapidly, staff recommends a discussion and public comment and that formal action be addressed at the July 15, 2009, meeting of the Governing Board

Summary

To begin the 2009 year tax credit allocation period, Texas posted for the round \$87,759,608 in tax credits available for distribution to the 2009 applicants. This amount is less than the amount currently calculated to be available based on new population figures and additional returns. The current amounts by category are:

State Annual Ceiling	\$51,086,645
HR 3221 Additional Credits (2008 HERA bill)	<u>\$ 4,865,395</u>
Total regular allocation of	\$55,952,040 ^a
Bonus Ike Credits provided in 2009 for 2009	\$14,906,160 ^b
Traded Ike Credits and 2008 Ceiling Carry forward	\$16,639,664 ^c
Prior year Returned Credits (pre-exchange program)	<u>\$ 4,785,148^c</u>
Total Returned and Ike Credits	\$36,330,972

These funds are committed to applications received prior to February 27, 2009, and are part of the standard 2009 allocation round. These have been regionally allocated and function just like any other tax credit round except for the Bonus Ike Credits in 2009 which must be used in the Hurricane Ike regions.

Of these funds 40% of the \$55,952,040 or \$22,380,816 worth of credits are available from the 2009 regular allocation for credits to participate in the Tax Credit Exchange Program authorized under the American Recovery and Reinvestment Act of 2009, PL 111-5 (“ARRA”). In addition, the traded Ike credits and 2008 ceiling carry forward and the prior year exchanged credits are available for or \$21,424,812 are available for the

^a 40% of these credits can be exchanged

^b Currently none of these credits can be exchanged

^c 100% of these credits can be exchanged

exchange program. When multiplied by the exchange rate, this brings the total funds, if the Board desires to maximize the exchange program for 2009, to \$372,347,839.

In addition, with the passage of HB 4275, the Board will have the option to exchange returned 2007 and 2008 credits and offer these funds in a second round. The amount of these funds is not yet known as the awardees have not returned their funds for participation in the exchange program. Unlike 2009 credits, for which only 40% can be exchanged, 100% of these credits may be exchanged. All credits exchanged are exchanged at a rate of \$.85 on the dollar times ten (since credits are used over a ten year period), or \$8.50 in cash to be allocated in exchange for each dollar of credits returned.

Policy issues to be addressed as policy in formulating policy for the Exchange Program include:

1. Does the state want to participate and, if so, at what level?
2. Certain 2008 and 2009 developments were awarded Hurricane Ike credits. Those credits may be returned and re-allocated, but they may not be exchanged under the ARRA exchange program
3. Should the state treat the rounds separately or after awards make all awardees wishing to compete apply to the same "exchange pool" Within two pools or a single combined pool, how will competition be structured and which developments and factors will be assigned priority?
4. Are we going to open the exchange pool up to people who have not received (and therefore will not return) tax credits?
5. Should we consider directing applicants to the TCAP policy over the exchange for mixed deals where a syndicator is present?
6. What aspects of this require re-application and/or re-underwriting?
7. How will fees be structured to ensure that the Department's cash flows and operations remain stable?
8. What sorts of legal structures will best protect the Department since it will be assuming a new, and still evolving, responsibility for asset management and potential liability for recapture.
9. Timelines and oversight during development: How will the Department be able to ensure that the rapid timeframes mandated by ARRA are achieved?
10. Asset management questions, what happens to developments that do not meet the timeline or compliance standards?

1. At what level does the state want to participate?

The state has the ability to exchange credits and receive cash, up to the maximums identified above currently as \$372,347,839, plus any additional returns from the 2007 and 2008 rounds multiplied by 10 and then multiplied by .85.

A major factor in deciding whether to exchange all or a portion of the exchangeable credits is assessing whether the awarded developments returning credits and therefore receiving exchange proceeds can be expected to complete the expenditure of those funds

by year-end 2010. Funds not expended by the deadline must be returned to Treasury, meaning that incomplete developments will need to be finished using some other source(s) of funds.

Another major factor to take into consideration is deciding the state's level of participation is the new and as yet largely unknown possibilities and potential liabilities that the Department would be assuming:

- In a typical syndicated tax credit transaction the syndicator takes primary responsibility for asset management, assuring the IRS that the buildings are in compliance with the program requirements of 26 USC §42 and the 8823 Audit Guide. Under the exchange program the Department takes on this asset management responsibility.
- The department monitors syndicated tax credit developments and if it identifies uncorrected compliance issues, it files form 8823 with the IRS, alerting the Service to the need to pursue possible recapture. Under the exchange program, any recapture would become a Department responsibility (and, therefore, a potential liability).

A third major factor is the state of the tax credit market. The disruption in the financial markets, especially at Fannie and Freddie, has resulted in their being a greatly reduced market for tax credits. This is compounded by broader economic issues driving investors to gravitate to the lowest risk investments and to project limited need for tax credits in the near term. As attractive as these developments may be, enhanced yield alone is likely not enough to create or restore a robust market for tax credit investments; so exchange funds are an increasingly "key" tool to keep the affordable rental housing market active.

2. What to do with 2008 and 2009 Hurricane Ike awarded developments that are not eligible for the credit to dollars exchange program?

Congress made additional credits available for areas impacted by Hurricane Ike. These credits were provided annually on a "use them or lose them" basis. IRS guidance has since changed and the credits from 2008 may be able to be carried forward. This places the 2008 Ike credits in an unfavorable position for exchange as a result of the decision to trade "regular ceiling" credits for Ike credits. Because we carried these forward, the Ike credits also could be re-allocated to normal credits and use the same "carry forward credits" that are accounted for in the 2009 Allocation pool. There is also a possibility that the developments that have applied for these credits could be first in line for less restrictive CDBG funds in the second round of Ike/Dolly CDBG disaster funding for affordable rental housing stock.

3. Should the state treat the rounds separately or after awards make all awardees wishing to compete apply to the same exchange pool and, if so how should the competition be structured and which developments will be favored?

This presents two different issues. As stated above, the credits may be exchanged by the State of Texas, not individual applicants. HB 4275 allowed us to add in an additional

round outside the normal tax credit process where 2007 and 2008 applications and even non-awarded applications could be considered even after the deadline.

One method could be to take the \$372,347,839 available to the 2009 round and develop a policy for how to apply the exchange funds to the “2009 only” applicants that would provide for who received priority within the round for the exchange funds requested by the Department. Several alternatives could exist including the highest scoring applications, a regional allocation of funds based on the regional allocation formula (“RAF”), or largest amount of return for investment per unit built. Set asides for rural and at-risk could be established, or these could be factored into the regional allocation process.

A second method would be to award all the credits for the entire 2009 round (a total of \$92,283,013) and then allow anyone who desired to compete for the exchange program to return credits and compete in an open competition with everyone who desired to apply. If all applications desired to compete, the exchange funds would not provide for sufficient coverage of all applications and credits would be carried forward into 2010 (except the Hurricane Ike 2009 credits) but not all applications that returned credits would receive exchange funds as there are \$48,477,384 in credits for 2009 that are not eligible for exchange.

Additional points for rural or at risk could also be provided depending on if the funds are returned by region or a statewide pool to make these frequently lower scoring applications more competitive. We could also award additional points for applicants that demonstrate they have ready to develop plans, zoning, or other solutions to potential time delays that might jeopardize development completion within the allowable time frame.

Another possibility is to not require points but establish a policy for 2009 on who gets to exchange based on area and highest points and allow the 2007 and 2008 rounds to be open to a direct exchange without competition based on their level of return and the amount that they determined was needed for construction. An example would be if they returned \$1.2 million in credits, multiplied by 10 and then multiplied by .85 would equal \$10,200,000. If the application only called for 82 cents for each tax credit, they would get \$9,840,000, the difference would remain in the exchange pool and potentially be used to fund other transactions.

4. Are we going to open the exchange pool up to people who have not received tax credits (and therefore have not contributed to the “exchange” pool)?

No additional preference would be required for those awarded if the applicant pool was limited to only those developments that have awards. There are applications that have been terminated for a variety of reasons that may be shovel ready and supported that could complete the development within the allotted time period where an awarded applicant may not be able to meet this time frame.

5. Should we consider directing applicants to the TCAP policy over the exchange for mixed deals where a syndicator is present?

Regardless of whether the Board selects one or two rounds of applications, there could be provisions that provide the Department the most units by changing the point values based on the presence of a syndicator and whether the development could be completed within the required placed in service deadlines. For example, 2007 deals that did not receive some form of extension for a natural disaster (or other extension), that still maintain credits are to be placed in service by December 2009. Obviously this cannot be done if the property has yet to begin. Therefore, more units may be produced by giving a preference to 2007 deals so that they can place in service by December of 2010. On the other hand, by requiring credits to be included in any substantial amount, you will be directing that the 2007 deals should not be part of the exchange program since they can not use the credits and place in service in a timely manner.

It might be to the Department's benefit to direct developments that have syndicators and could place in service in a timely manner, to the TCAP funds through a point structure.

6. What should be required by way of re-application and/or re-underwriting process?

A primary importance is the speed at which the developments need to be completed. To help front load this staff is recommending that regardless of the award process (one or two rounds, only awarded applications or any application) that on or before sixty (60) days from submission of an application an applicant would be required to have:

- Final construction plans;
- Final building permits; and
- Commenced required environmental work; and
- Met with all lenders and other financing sources to ensure that all funding sources will be acceptably coordinated and no further negotiations will be required in able for all funding sources, including Exchange, to move ahead in concert.

A completed application, together with an application fee of \$20 per unit for new applications would be due between September 1 and September 7. All applicants would be required to comply with all aspects of the QAP in the year they applied and documented good faith effort to utilize tax credits. For applicants that have existing 2007 or 2008 award of tax credits or a still active 2009 application, the majority of items could, at their election, be addressed by their prior application. This would include:

- All required notifications.
- Quantifiable community participation.

For these active developments, a simplified application identifying changes to the financing sources would be required. Any other amendments to the application would not be allowed except as provided for in the QAP § 49.17 (a) and (d). Any known

changes that are not approved prior to the allocation of Exchange funds may be grounds for termination or denial of the Exchange funds.

A priority would be awarded to any applicant that had returned 2007 or 2008 credits or had a 2009 application that was “in the money” (apparent score sufficient to qualify for an award within their region) based upon the Board action with the final allocation list on July 30, 2009. Any significant changes to the application may reduce or eliminate this point advantage at the discretion of the Board.

Staff will score and underwrite, in accordance with the QAP and the Department’s underwriting rules, the financing changes for each development which scores high enough to be funded based upon the amount of Exchange funds available. Applications for Exchange funds will be able to incorporate other sources of TDHCA funding but must be eligible for such funding. Should other TDHCA funding be necessary for financial feasibility but not be available, due to the lack of eligibility, the developments low score or rank in the other program’s selection criteria, the development will not be recommended for Exchange funds.

7. How will fees be structured to ensure that the Department’s cash flows and operations remain stable?

Since ARRA does not provide for charging specific fees for the awarding or administration of exchange funds but does provide for the charging of asset management fees, there might be two separate aspects to the fee structure: Application fees similar to the commitment fees for tax credits and asset management fees, especially if any third party asset management provider is procured. The commitment fee would ensure a stable source of funding for necessary activities the Department must carry out, and an asset management fee would ensure that the Department did not end up having to subsidize these transactions from limited general revenue. Any recommendations for asset management fees would be brought back to the Board at a later date in connection with any recommendations on use of a third party provider.

8. What sorts of legal structures will best protect the Department since it will be assuming a new, and still evolving, responsibility for asset management and potential liability for recapture?

The actual structure of the funds continues to be in flux in that the Treasury has released guidance saying that all funds must be in the form of a grant; however it is believed that this does not necessarily preclude some form of special limited partner role for the Department. Furthermore in recent conference calls, Treasury officials have suggested that a loan after the 15 year compliance period could exist.

HB 4275 provided the state with flexibility to own property for as long as recapture or repayment is an element of risk to the state by allowing ownership interests, restrictive covenants filed in the real property records, and/or liens filed on a property for which the

applicant has accepted funds. This allows the Department to negotiate ownership interests of development based on the amount of equity being placed in the deal for both TCAP and the Exchange Program. Preferences for profits, losses and property may be part of these negotiations if desired by the Board.

Federal direction is still moving around on this issue and we believe we should provide for maximum flexibility, but allow the state to participate in ownership if allowable at the federal level.

9. Timelines and oversight during development

The timelines would be different based on the type of rounds selected by the Board. The following identifies the key deadlines needed if a single round is selected:

- Award of all 2009 credits as statutorily required, July 31, 2009
- TCAP application deadlines
- Date certain for return of credits
- Process for Exchange funds – notice to return and application for exchange (August?)
- Scoring and underwriting is completed and awards are considered by the Board
- Commitment notices or similar award letters distributed
- Ownership interests negotiated and awards closed by December 31, 2009 including target dates for requests for funds and completion progress reports
- Supplemental rounds of Exchange awards would be considered, as needed, subject to availability of funds.
- After award or final agreement 60 day deadline for:
 1. submission of Final construction plans;
 2. Final building permits;
 3. Commenced required environmental work;
 4. Completion of all financing

Staff would monitor reports to ensure that development progress is being made to complete the development by 12/31/2010.

10 Asset management questions: What happens to developments that do not meet the timeline or compliance standards?

Each recipient of Exchange funds will be subject to asset management requirements to ensure that the development is, for the full required period, operated in compliance all applicable legal and contractual requirements, including, but not limited to:

- Operation in compliance with rent and income restrictions;

- Maintenance of the required number of accessible units and adherence to an affirmative marketing plan for accessible units;
- Affirmatively furthering fair housing in the marketing and rental of the development;
- Maintenance of all units in compliance with Uniform Physical Condition Standards;
- Compliance with other LURA requirements;
- Maintenance of all required records; and
- Timely filing of all required reports.

Adherence to these requirements will be subject to ongoing monitoring. The Department will establish reasonable fees to cover the costs of asset management and the developer will be required to pay these fees. Staff will also explore the ability to outsource these activities through the request for proposal of asset management services.

Other suggestions to assure could include the use of reserve funds as referenced above as part of the application for Exchange funds. In addition, at least 25% of the developer fee for all developments will initially be held in reserve until the property is stabilized and the short term reserve fund is fully funded. No reserve amounts may be funded with exchange funds. A recipient of Exchange funds will be required to establish and maintain reserves for:

- Lease-up and Short term operating needs (prior to lease up this fund will be required to support the operating budget of the development during lease-up, after lease-up this fund will require at least 6 month of operating expenses plus debt service to be fully funded);
- Long term capital maintenance (accumulated operating income to be \$250 per unit per year for new construction and at least \$300 per unit per year for rehabilitation developments unless recommended in underwriting); and
- Debt service (one year of debt service in addition to the short term operating reserve, if applicable).

The issue of possibly needing to create a source of funds for any potential recapture liability will be evaluated as the IRS makes clearer the nature and extent of possible recapture.

These funds will need active management which could be addressed through outsourcing with a trustee. Staff will continue to explore this possibility through the request for proposal of trustee services and as such a trustee fee may be required.

Any development that misses a target date for completion will need to submit a plan to demonstrate how they will be able to make up the missed performance, or begin to look to alternative funding to repay the grant. Any applicant that misses three consecutive deadlines will not be issued additional payments until such a time as the return to compliance with their targets dates to ensure completion by December 31, 2010.

Below to aid in discussion is a DRAFT that reflects staff's thoughts on the structure of the Exchange program.

Draft Exchange Program Policy

While guidance from Treasury and potential Congressional changes on a fair number of critical details of the program are still evolving, the Department's program will, if allowed, encompass the following key features:

- Eligible applicants for exchange will include only 2007, 2008 and 2009 tax credit awardees who return all credits (applicant who wish to return partial credits are encouraged to participate in the TCAP program). 2007 awardees who do not have a placed in service deadline extension will still have to place in service by December 2009 pursuant to section 42 and the QAP and may not be deemed feasible for Exchange if construction is not already underway and nearing completion.
- Eligible applicants must continue to follow the QAP under which they were originally awarded tax credits and must maintain their originally approved development plan, except for financing, unless an amendment is requested by the applicant and approved by the Department. An applicant will not be allowed to make an amendment request as part of an application for exchange.
- A normal tax credit commitment fee for all 2009 tax credit awardees will be required but no additional application or commitment fees for exchange will be required.
- With the intent to return and request to exchange notice, eligible Exchange participants will be required to provide updated financial information regarding the development, documentation of a good faith effort to place the credits, and certification that the exchange funds, if provided, could be fully spent by the Federal deadline.
- Within 60 days of an award of Exchange funds and prior to any release of said funds by the Department, the Exchange awardees will be required to provide any and all remaining conditions award including underwriting conditions that must be met prior to commencement of construction, proof of a final construction loan approval, construction set of architectural drawings, and final building permits. Construction must commence prior to December 1, 2009 and any extensions must be approved by the Board.
- Construction financing must be available for a minimum of 18 months with an option for at least a 12 month extension.
- If allowed by Treasury, Exchange funds may be used to initially acquire property, though such funds may later need to be replaced and exchange funds repositioned to fund only eligible basis costs. Subsequent draws may be made in coordination with the construction lender or on a fixed percentage of completion schedule as established by the Department.
- While forward permanent financing commitments will not be required to close on an award of exchange funds they are encouraged were possible, as is early pursuit of FHA permanent financing, where applicable.

- The amount of exchange funds awarded will generally be based upon Department underwriting up to the lesser of eligible basis or the gap of funds needed. The gap of funds will be determined based upon the sizing of permanent financing at a 1.25 debt coverage ratio with an 8% interest rate and 30 year amortization where permanent financing commitments are not provided or those provided terms that are less favorable to the development (higher interest rate or shorter amortization). The Department reserves the right to reduce the exchange funds recommended for all developments in order to accommodate requests of exchange funds from all applicants whose returned credits will be returned to Treasury to obtain Exchange funds.
- The development will be subject to all deadlines as required in §42 IRC and QAP including but not limited to 10% Test, placement in service and cost certification.
- The Department will conduct a normal cost certification review pursuant to the QAP, and a reconciliation of eligible basis or capitalized investment must document an amount equal or more than the exchange funds provided in the transaction, as may be further clarified as a result of additional Federal guidance. At cost certification, permanent funds must be committed and any excess sources of funds at that time may result in recapture of funds or funding of monitored reserves.
- Exchange participants will be subject to recapture provisions which will provide for the return to Treasury a prorata portion of funds for years within the compliance period (the first 15 years of operation after placed in service) that the property does not meet the minimum affordability requirements established by the Department in accordance with Treasury guidance. [This is an area that remains somewhat in flux but is likely to be percentage of restricted units can not be less than the percentage of exchange funds in the deal]
- Exchange participants may be required to enter into a partnership agreement with the Department or its designee as limited partner or special limited partner.
- Exchange participants will be required to pay the cost of asset management services and may be required to fund mandatory reserves out of operating income from the property with priority over any deferred developer fee or return to owner. In addition, the Department may require participation of up to 20% of any gross proceeds of any cash flow, refinance or sale proceeds.

Proposed timeline for the program would be as follows:

- June 25 Board approves draft policy and directs staff to begin implementation.
- July 20 Notice of intent to return and request exchange due for any 2008 Hurricane Ike area awardees.
- July 16 Board makes final adjustments to the policy and implementation plan.
- July 30 Board makes final 2009 allocation awards (with consideration of the requests for Ike return and exchange).
- August 3 -7 all other 2007, 2008 and 2009 awardees that are eligible for Exchange wishing to exchange must provide notice of intent to return and request exchange.

- August 10 October 2 Staff will conduct due diligence/underwriting review on all exchange requests.
- September 3 Staff may bring initial or discrete groups of exchange awards if available and analysis complete. Staff reports on exchange request to Treasury.
- October 15 Staff brings final Exchange award recommendations to the Board.
- October 16 Exchange award agreements sent to awardees,
- December 16 Exchange awardees meet 60 day deadline for final readiness to proceed.
- January 2010 Awardees provide confirmation of commencement of construction.
- January – December 2010 Status updates and funding draws.
- December 31, 2010 last day disbursements can be made for Exchange awardees, last date for placement in service for original 2008 awards and 2007 awards with placed in service date extensions.
- January 2011 return of any unused exchange funds to Treasury

Recommendation

Provide staff with direction to refine the Exchange Program policy to be brought back to the Board at the next meeting for further discussion and approval.