audit report
OFFICE OF INSPECTOR GENERAL

Issue Date	May 23, 1997
Audit Report Number	97-KC-117-0001

TO: Nicolas P. Retsinas, Assistant Secretary for Housing - Federal Housing Commissioner, H
Kevin E. Marchman, Acting Assistant Secretary for Public and Indian Housing, P
Jacquie M. Lawing, Acting Assistant Secretary for Community Planning and Development, D

FROM: Jose R. Aguirre, District Inspector General for Audit, 7AGA

SUBJECT: Review of Low Income Housing Tax Credits Program

We completed a study of the LIHTC (Low Income Housing Tax Credits) program to determine how well states administered the LIHTC program in combination with HUD funding and insurance.

Our objectives were to determine: if subsidy layering reviews prevented developer windfall profits when LIHTC were combined with HUD assistance; and if safeguards were adequate to control project development costs.

Within 60 days please furnish us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you have any questions, please call me or Jerry Saale, Assistant District Inspector General for Audit, at (913) 551-5870.

Executive Summary

We completed a multi-state review of the LIHTC program. Our overall objective was to determine how efficiently state credit agencies developed low income housing funded with LIHTC and various types of HUD financial assistance. Specifically, we assessed whether state credit agencies: limited LIHTC/HUD assistance to the amount necessary to develop the projects; and established controls over development costs.

This report contains one finding requiring HUD management decisions and actions and reports on other issues needing further study and consideration.

We performed our audit at four state credit agencies: Missouri, Ohio, Alabama, and Pennsylvania. The Department provided state credit agencies guidance for performing subsidy layering reviews on projects using FHA insurance. However, these guidelines were needlessly complicated and difficult to understand. In addition, the Department had not provided state credit agencies guidance for performing subsidy layering reviews on projects using funding from the Office of Community Planning and Development. In the period we reviewed, the two most common forms of HUD assistance combined with LIHTC were HOME and CDBG funds.

Nevertheless, we found the four states, with minor modifications, adopted standards recommended by the National Council of State Housing Agencies (NCSHA) to limit assistance, control development costs and prevent windfall developer profits by limiting:

- Developer fees and profits
- Contractor fees
- Per unit development costs.

We concluded NCSHA's standards accomplish the same thing as HUD's subsidy layering guidelines. However, states were not mandated to adopt the standards. We are recommending the Offices of Housing, Public and Indian Housing, and Community Planning and Development work with NCSHA and take the steps necessary to establish mandatory parameters for developer and contractor fees and profits that will have the same effect as subsidy layering reviews.

During our review we found two other potential weaknesses in the LIHTC program. However, these weaknesses will be best addressed by the Department of the Treasury and Internal Revenue Service since they are responsible for administering the LIHTC program. These issues deal with using LIHTC for transfer of physical assets (TPA) on properties with FHA insured mortgages and the lack of incentives for developers to maximize the proceeds from the sale of LIHTC. The General Accounting Office (GAO), which is performing a comprehensive review of the LIHTC program, was apprised of these issues for possible inclusion in their report.

We discussed the report issues with NCSHA and state credit agency officials. We requested comments on our draft report from the Assistant Secretaries of Housing, Public and Indian Housing, and Community Development and Planning. We received written comments from the Acting Assistant Secretary for Community Planning and Development and the Office of the Deputy Assistant Secretary for Legislation. Their comments were considered in completing this report and are included in Appendix 2.

Our study of the LIHTC program included subsidy layering reviews, syndication, HUD assistance with LIHTC, developer fees and profits, and contractor fees and profits. The study is in Appendix 1 of this report.

Table of Contents

Abbreviations:

CDBG	Community Development Block Grant
CPD	Community Planning and Development
FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
HOME	Home Investment Partnership Program
LIHTC	Low Income Housing Tax Credits
NCSHA	National Council of State Housing Agencies
PIH	Public and Indian Housing
TPA	Transfer of Physical Assets

Introduction

Appendix 1 to this report entitled ***Study of the LIHTC Program*** contains a comprehensive background of the tax credit program for low-income housing. The review of LIHTC was proposed as a task force study by the President's Council on Integrity and Efficiency. The task force members decided not to undertake the joint project. HUD OIG decided to do a limited review because the LIHTC had not been reviewed since we issued the Section 8 Moderate Rehabilitation Program audit report in 1989. The 1989 report showed that developers combined various forms of Federal assistance and received more assistance than necessary to develop a viable project (subsidy layering). Developers retained excessive subsidies as profit. The review evaluated the progress made to address subsidy layering issues identified in the 1989 report.

A. General Accounting Office Review

During our review we learned the GAO was also reviewing LIHTC. GAO's objectives were to determine:

- How well tax credits are targeted to meet affordable housing needs.
- If controls exist at the state level to ensure that tax credit proceeds are applied as intended and that project development costs are reasonable.
- The characteristics of properties supported by tax credits and how these characteristics are affected by additional subsidy sources.
- The characteristics of tenants who reside in tax credit supported projects and how these characteristics are affected by additional subsidy sources.
- If controls exist at the state allocating agency to ensure effective long-term compliance monitoring of the LIHTC program.
- If Internal Revenue Service controls ensure effective long-term oversight of the LIHTC program.
- The effectiveness of controls to ensure states do not over-allocate their LIHTC.

The General Accounting Office issued its report March 28, 1997.

B. Audit Objectives, Scope, And Methodology

Our overall audit objective was to evaluate state housing credit agency practices to limit Federal financial assistance to the amount necessary to develop a viable project.

To accomplish this objective, we reviewed four state credit agencies; Missouri, Ohio, Pennsylvania and Alabama. We selected these states because HUD records showed they had many projects combining LIHTC and HOME funds. At each state we selected six LIHTC projects using HUD funding. We selected projects with HUD funding in each year of our audit period from 1993 through 1995.

We discussed the review with HUD program staff and representatives from NCSHA, the General Accounting Office, the National Association of Home Builders, The Enterprise Social Investment Corporation, and congressional staff from the Joint Committee on Taxation and the Ways and Means Subcommittee on Oversight.

We performed the audit field work from February 1996 through November 1996. We conducted the audit in accordance with generally accepted governmental auditing standards.

Finding and Recommendation

Standards Adopted By NCSHA, If Mandatory, Could Be Used As Subsidy Layering Guidelines

The NCSHA adopted standards limiting developer fees and profits and have the same effect as HUD’s subsidy layering guidelines. However, NCSHA standards are not mandatory and unless made mandatory, state credit agencies could provide more assistance than is necessary to develop a viable project.

On January 20, 1995, Housing issued Notice 95-4 containing detailed instructions for state credit agencies and local field offices to use in performing subsidy layering reviews for LIHTC projects with FHA mortgage insurance. The Notice, with addendum, consisted of 104 pages was found to be very complicated by both HUD and state credit agency staff.

Community Planning and Development (CPD) issued Notice 94-24 to implement the requirements of the Cranston-Gonzales National Affordable Housing Act. The Act requires agencies administering HOME programs to evaluate projects to ensure that HOME funds, when combined with other government assistance, are not more than necessary to provide affordable housing. The CPD notice states agencies administering HOME can rely on State Credit Agencies to determine that HUD subsidies are not greater than necessary.

Our review at four State Credit Agencies showed that on June 7, 1993, NCSHA published voluntary Standards For State Tax Credit Administration. These standards addressed developer fees and contractor overhead, profit and general requirements. With minor modifications, all four State Credit Agencies reviewed had adopted the NCSHA standards. The adopted standards limited developer fees and profits; contractor fees, and per unit development costs. We concluded NCSHA’s standards, consisting of nine pages, accomplished the same objectives as HUD’s 104 page Notice.

However, NCSHA’s standards are not mandatory and State Credit Agencies could opt to adopt different standards which could result in providing subsidies in amounts greater than necessary to finance a viable project.

NCSHA officials commented on our draft report and stated: NCSHA has always believed that HUD’s subsidy layering review process in unnecessary because the Federal Housing Credit law requires states to consider all sources of funds in a Housing Credit property financing to assure that they award no more credit than necessary for the project's financial feasibility and long term viability. NCSHA officials suggested we support the repeal of the subsidy layering requirements under Section 102 of the HUD Reform Act of 1989.

Section 102 of the HUD Reform Act of 1989, stated "The Secretary shall certify that assistance within the jurisdiction of the Department to any housing project shall not be more than is necessary to provide affordable housing after taking account of assistance described in subsection (b)(1)." Subsection (b)(1) stated such assistance shall include, but not be limited to, any loan, grant, guarantee, insurance, payment, rebate, credit, tax benefit, or any other form of direct or indirect assistance.

We do not support the repeal of legislation Congress passed to address the "HUD Scandals." Rather, we support that HUD retain its subsidy oversight but recognize that if made mandatory, NCSHA's standards accomplish the same objectives as the subsidy layering review requirements.

CPD Comments

The Office of Community Planning and Development provided comments on our draft report consisting of the following major points:

- The report failed to distinguish whether the responsibility for subsidy layering reviews on various HUD programs was a federal or local responsibility.

- The report was not clear as to whether the recommendations apply only to tax credit projects or to all projects subject to subsidy layering guidelines.

- CPD believes making the NCSHA guidelines mandatory is contrary to the statutory intent of the National Affordable Housing Act.

- CPD believes there is merit to having CPD, PIH, and Housing issue consistent guidance to the extent that it is practical and permissible under various programmatic statutes.

OIG Evaluation of CPD Comments

We evaluated how states combined various forms of HUD housing assistance with LIHTC. We did not evaluate subsidy layering requirements on developments not using LIHTC. Accordingly, it was not our intention to make NCSHA guidelines mandatory on the Home program when Home funds are combined with other governmental subsidies, excluding LIHTC. We do believe some type of guidelines should be mandatory when HUD assistance is combined with LIHTC. Our recommendations apply only to LIHTC projects with HUD insurance and/or assistance and our draft recommendation was so clarified.

Other Management Comments

The Office of the Deputy Assistant Secretary for Legislation provided comments, against establishing mandatory parameters for developers' and contractors' fees, stating that:

- How much the developers and syndicators made should not be relevant if the market is working appropriately.
- Artificially setting mandatory parameters for developers' and syndication costs will only result in distortions.

OIG Evaluation of Other Management Comments

We concluded that mandatory parameters are necessary and, in turn, enhance accountability. We do not agree that HUD should rely on the market to determine developers' fees. While high market demand can limit developers' fees, low market demand can have the opposite effect. The excessive profit abuses in the Moderate Rehabilitation Program would not have occurred had mandatory parameters or subsidy layering reviews been required. A May 4, 1997 article in the *Kansas City Star* reinforces our conclusion. Market controls are also influenced by political influences. The article detailed potential wrongdoing by a state representative involving inflated construction material costs and the LIHTC program. According to the article, the representative addressed a state credit agency to oppose a staff proposal to limit *excessive* profits paid to developers, contractors, and subcontractors on LIHTC projects, hinting that the state credit agency could face repercussions in the State General Assembly should it adopt the regulations.

Our report does not recommend limiting syndicators' fees. In fact, our review showed that in those states where the percentage of syndication proceeds enhanced the developers' chances for receiving LIHTC, the net syndication proceeds were greater. We suggest further use of these incentives.

Recommendation

For LIHTC with HUD insurance and/or assistance, we recommend that the Offices of Housing, Public and Indian Housing, Community Planning and Development form a task force with NCSHA to draft legislation for mandatory parameters for developer and contractor fees that will have the same effect as subsidy layering reviews.

Internal Controls

In planning and performing our audit, we considered selected internal controls used by state credit agencies to administer the LIHTC program. Internal control is the process effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

In each of these three categories of objectives, organizations will establish their own specific control objectives and control procedures aimed at achieving these broad objectives. If organizations are to meet these control objectives, five components of internal control—control environment, risk assessment, control activities, information and communications, and monitoring—must be present. Control objectives in each category are inextricably linked with the five supporting components.

We determined that the following internal control categories were relevant to our audit objectives:

- Calculations of the amount of LIHTC necessary for project development
- Limitations on developer profits and fees
- Limitations on total development costs.

We assessed all the categories identified above. For the assessment, we obtained an understanding of the design of relevant policies and procedures and whether they had been placed in operation.

Our assessment did not disclose serious control weaknesses.

Issues Needing Further Study and Consideration

The following issues need further study and consideration by the Department of the Treasury, the Internal Revenue Service, the General Accounting Office, and HUD program management.

A. Need to Consolidate Compliance Reviews for LIHTC and State-Administered HOME programs

Both LIHTC and HOME require agencies administering these programs to perform periodic on-site monitoring for tenant eligibility and rents. State credit agencies administer LIHTC. Often a different state agency administers the HOME program. Combined monitoring of the two programs saves staff resources and is less disruptive of owner operations. HUD should formally encourage HOME recipients to work with the appropriate state agencies to coordinate on-site reviews when developments utilize LIHTC.

B. Potential Program Weaknesses in the Transfer of Physical Assets and Syndication Proceeds

The Department of the Treasury and the IRS have primary responsibility for administering LIHTC. During our review we identified potential program weaknesses dealing with TPAs on HUD-insured projects and net syndication proceeds. We discussed these two issues with GAO for consideration in their review of LIHTC.

1. TPAs Using LIHTC

Developers often use LIHTC to generate funds to rehabilitate HUD-insured projects as part of a TPA. This practice was especially prevalent in Alabama. In 1993, the Alabama Housing Finance Authority awarded LIHTC to a single developer for ten TPAs. The following year, the same developer received LIHTC for an additional six TPAs. During our audit period there was one LIHTC/TPA in Missouri and one in Ohio.

TPAs generally benefit tenants and the FHA insurance fund. HUD approved the transfers to raise funds to improve the project's physical condition; improve tenant living conditions; and in turn reduce FHA-insured mortgage default probability.

We reviewed one TPA in Alabama, an insured development with 100 percent Section 8 project based assistance. The only new source of funds to pay for development costs, including acquisition, were syndication proceeds ($379,170). Seventy-three percent of syndication proceeds were paid to identity-of-interest parties for property acquisition ($219,463), developer fees ($50,000), and contractor profit and overhead ($8,972). Only twenty-four percent of syndication proceeds paid for rehabilitation costs ($89,718).

Although not contrary to the rules and regulations governing the LIHTC program, we do not believe this is a prudent use of LIHTC. The owners realized a gain from the sale of the property and received various fees. However, the stock of low income housing did not increase. Tenants' living conditions improved through the $3,738 per unit spent for rehabilitation; however, this benefit will cost taxpayers $17,600 per unit.

Alabama defended this award because:

- It was allowable, preserved affordable housing and could prevent homelessness if the property fell into disrepair.
- Improved living conditions for lower-income households is the purpose of the program.
- Total per unit rehabilitation costs of $6,956 (which includes all costs except acquisition) fall within the guidelines outlined in Section 42 of the Internal Revenue code.

We concluded it was not a prudent use of LIHTC when only 24 percent of the credits are used for rehabilitation. In an Ohio TPA, a much higher percentage of the tax credits, 52 percent, was spent for rehabilitation.

We discussed this issue with the GAO for possible review and consideration in their report.

2. Net Syndication Proceeds

Net syndication proceeds varied widely among developments. However, in those states where the percentage of syndication proceeds enhanced developers' chances for receiving LIHTC, the net syndication proceeds were greater.

The profit a developer receives on a project is not directly related to effective LIHTC marketing. Developer profit is part of the developer's fee. The developer's fee is a percentage of development costs. Increased net syndication proceeds do not affect development costs, and therefore do not affect the developer fee. Increased proceeds pay for a greater portion of other development costs. This, in turn, can result in lower rents and a more competitive proposal.

The following table compares the average state net syndication proceeds with how they handle syndication proceeds during the application process and during development:

STATE	RETURN	PRACTICE IN 1995
OHIO	62.4%	Required a minimal return of 55 cents on the dollar.
ALABAMA	58.1%	Assumes return of about 50 cents on dollar. If proceeds greater, developer can use for additional project amenities or place in project reserves.
PENNSYLVANIA	52.8%	Used as application ranking factor.
MISSOURI	52.8%	State anticipated proceeds of from 42 to 52 cents on the dollar, if proceeds greater state reduces tax credits.

This table shows that practices in Ohio and Alabama served as an incentive for developers to maximize net syndication proceeds.

However, states cannot force a developer to maximize net syndication proceeds when the market for LIHTC is not very competitive. An Ohio state official advised their market was very competitive and resulted in higher net syndication proceeds because the state had three times as many applications as they could fund. Alternatively, the Executive Director in Missouri said they fund all approved applications.

Developers, with no incentives to maximize net syndication proceeds, can negotiate with syndicators to structure deals to their advantage. Our review of two LIHTC projects with HOME funds in Missouri showed unusual syndication agreements.

- These agreements provided for a management incentive fee for the developer. The incentive fee was funded with $113,500 in syndication proceeds the developer returned to the syndicator. If the developer complied with the terms of the management incentive agreement, the syndicator would pay the developer the $113,500, with interest, over the next ten years. The developer did not report $113,500 to the state as syndication proceeds. Had the developer reported the fee, the state would have reduced the LIHTC by a corresponding amount.

- During syndication, the developer normally sells 99 percent of all ownership benefits to limited partners. In the cases mentioned above the developer sold 99 percent of the tax benefits, but only 30 percent of any operating cash distribution and about 30 percent of proceeds from any property sale. We believe these provisions also reduced net syndication proceeds by an undetermined amount.

We believe programmatic incentives such as those that enhance the chance for getting a LIHTC project should be encouraged so that developers maximize net syndication proceeds. Increased net syndication proceeds would reduce the amount of LIHTC needed for project viability and in turn make more LIHTC available for the production of low-income housing. We concluded states need to take advantage of syndicator competition to increase net syndication proceeds.

GAO advised they would consider addressing this issue in their report. We have no specific recommendations for HUD on these two issues.

Auditee Comments

The Office of Community Planning and Development and Office of the Deputy Assistant Secretary for Legislation provided comments on our draft report. The major points in these comments were:

- While the suggestion that on-site compliance reviews be coordinated may make sense, Section 42 does not require the IRS to conduct on-site reviews.

- The authors of the report indicate they do not believe the use of LIHTC forTPAs is a prudent use. If Congress wanted to barTPAs it could easily have done so.

OIG Evaluation of Auditee Comments

Our comments about on-site compliance reviews did not apply to the IRS, but rather coordination between state agencies when the state administers HOME monies.

We believe LIHTC are a good funding mechanism for TPAs, as we found in Ohio. We stand by our position that the one case we reviewed in Alabama was not a prudent use of LIHTC because most of the syndication proceeds went to investors.

Appendix 1

Study of the LIHTC Program

The Tax Reform Act of 1986 created the LIHTC program. Congress designed the program to increase the supply of affordable rental housing for low-income families. Before 1986, the Tax Code had other incentives for low-income housing. LIHTC replaced these incentives. The credit has emerged as the primary tax incentive for stimulating low-income housing. One out of five apartments constructed and nearly all new apartments built for low-income renters used LIHTC.

The U.S. Treasury and state credit agencies administer the program. Each state receives annual credit authority equal to $1.25 per capita. State housing credit agencies award LIHTC to developers for specific projects through an application process. State credit agencies reserve ten percent of each year's allocation for projects developed by non-profit organizations. LIHTC give developers a 10-year tax credit for units housing low-income renters for at least 15 years. For new construction and rehabilitation expenses, the credit is designed to return to the taxpayer over 10 years up to a maximum of the present value of 70 percent of the allowable cost for the project. For acquisition costs (except land acquisition) the credit can return the present value of 30 percent of the allowable costs over 10 years.

Before 1989, there were no limits on the LIHTC states awarded developers. Sometimes LIHTC and other financing exceeded development costs resulting in excessive developer profits. Since 1989 Congress, HUD, state credit agencies, and the National Council of State Housing Agencies (NCSHA), have tried to eliminate excessive profits. There were seven major steps in this evolutionary process.

1. The 1989 Tax Code Amendments required that credit allocations not exceed the level necessary for the project's financial feasibility.

2. Section 102 of the HUD Reform Act of 1989 required:

- A source and use of funds statement for each HUD project.
- The developer to show all sources of other government assistance.
- The Secretary to certify, based on a subsidy layering review, that HUD assistance was not more than necessary to provide affordable housing, after considering other government assistance.

3. Section 911 of the Housing and Community Development Act of 1992 allowed the Secretary to delegate subsidy layering review authority to the state credit agencies.

4. In May 1993, the National Council of State Housing Agencies (NCSHA) adopted voluntary LIHTC standards for their members known as ***Standards for State Tax Credit Administration***, including:

   - *Per Unit Cost* standards, based on building construction and land costs in the state, which usually fell within Section 221(d)(3) mortgage insurance limits.
   - *Developer fees* usually no more than 15 percent of total development costs.
   - *Contractor Fees* limited to a percentage of construction costs: profit - 6%; builder's overhead - 2%; and general requirements - 6%.

5. Tax Code amendments in 1993 required states to consider the reasonableness of development and operating costs as additional factors in awarding LIHTC.

6. HUD issued, on December 15, 1994, final regulations implementing Section 911 of the Housing and Community Development Act of 1992 to delegate subsidy layering to HUD field offices and subsequently to the states. The regulations limited contractor and developer fees, but were difficult to interpret.

7. On January 20, 1995, HUD issued Housing Notice 95-4, ***Subsidy Layering Reviews (SLRs) - Implementing Instructions***, for Section 911 of the Housing and

Community Development Act of 1992. These instructions covered Field Office processing of mortgage insurance applications with other government assistance, especially LIHTC. The notice authorized credit agencies to accept and conduct subsidy layering reviews.

During our review we evaluated how HUD assistance was combined withLIHTCs in the following areas:

- Frequency
- Developer Fees/Profits
- Contractor Fees/Profits

A. <u>Frequency</u>

Projects combining various forms of HUD assistance with LIHTC represent a significant portion of LIHTC projects in the states we reviewed. The following table shows how frequently HUD assistance was combined with LIHTC from 1993 through 1995:

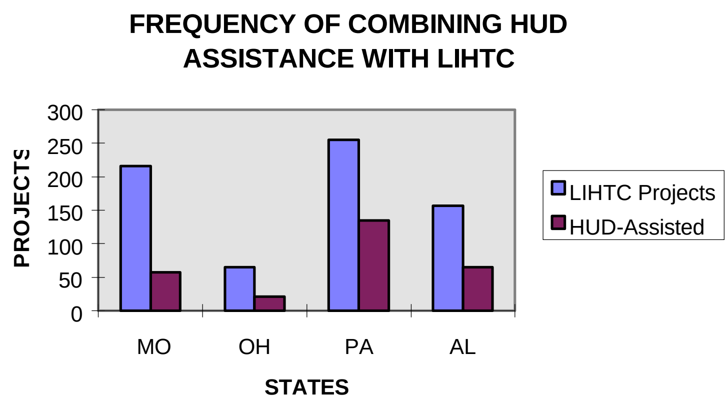


Chart includes only projects with 75 or more units for Ohio.

These figures are not representative of the entire nation. We selected the four states for review because HUD records showed they frequently used HOME funds with LIHTC during the audit period.

Developers combined many sources of HUD funding with LIHTC to provide affordable housing. Often a development used more than one type of HUD funding.

HOME and CDBG were the major types of HUD assistance combined with LIHTC. FHA insurance was primarily used in transfers of physical assets on insured developments. The following schedule shows the types and number of times HUD assistance was combined with LIHTC:

ASSISTANCE	MO	OH[1]	PA	AL	ALL[2]
HOME	36	17	55	45	153
CDBG	18	4	101	2	125
Insurance	1	1	0	18	20[3]
Other CPD	3	2	7	0	12
PIH Grant	1	0	0	0	1

[1] Schedule includes only projects with 75 or more units.
[2] Often projects receive more than one form of assistance.
[3] Except for one case, FHA insurance involved an assumption of an insured loan.

B. Developer Fees/Profits

Before 1989, states often did not consider the net syndication proceeds as a source of funds available to pay development costs. Existing laws and regulations did not address the handling of syndication proceeds. Accordingly, developers often made windfall profits.

With minor exceptions, the four states we visited had adopted the NCSHA standards which limited developer fees/profit. The NCSHA standard allows a developer fee of 15 percent of total development costs. The NCSHA standards anticipate some instances where the fees/profit would be greater than 15 percent because of the project size (small), project characteristics (hard to develop, socially desirable) and location (difficult to develop areas).

The following table summarizes average developer fees/profit, as a percentage of total development costs less the developer's fees/profit, in each state for the six LIHTC/HUD projects we reviewed:

	AVERAGE NET	AVERAGE	RANGE OF

STATE	DEVELOPMENT COST	FEE	FEES
MISSOURI	$3,689,768[1]	13.3%	8.9% - 17.9%
OHIO	5,515,061	6.7%	5.0% - 09.6%
PENNSYLVANIA	5,709,356	9.5%	3.6% - 13.5%
ALABAMA	1,717,215	14.4%	5.3% - 20.0%
AVERAGE	4,157,850	11.0%	5.7% - 15.2%

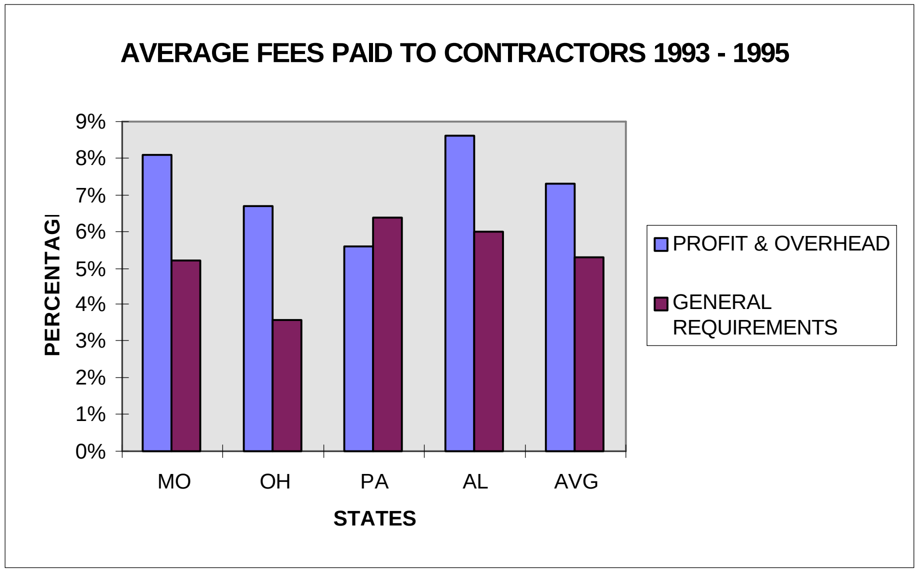
[1] Average development cost does not include one very large project which was not representative of the size of LIHTC developments in Missouri.

Despite variances of fees/profit between states, we concluded they were within acceptable limits. We found average developers' fees/profit tended to be higher, as a percentage of total costs, for the smaller projects.

We reviewed developers' estimates of project operating costs shown in their applications because inflated projections could generate excessive profits from operations. We compared developer projected operating expenses, shown on LIHTC applications, with HUD's historical operating cost data. This comparison showed developers did not overestimate projected operating costs. We also compared projected operating costs to the actual results of operations. These comparisons showed the projections were valid.

C. Contractor Fees/Profit

A developer can earn fees/profit by acting as the general contractor doing the actual construction. So we evaluated payments to contractors such as profit, overhead and general requirements. NCSHA recommended profit and overhead of 8 percent and general requirements of 6 percent of construction costs. These standards were effective for the 1994 and 1995 projects in our sample. The following table shows the average fees/profit paid to contractors during the three years ending in 1995.



Alabama officials advised us that all projects approved after 1993 complied with NCSHA standards.

We did not consider these states' contractor fees/profits excessive.

Appendix 2

Auditee Comments on the Draft Report

U.S. Department of Housing and Urban Development
Washington, D.C. 20410-7000

OFFICE OF ASSISTANT SECRETARY
FOR COMMUNITY PLANNING AND DEVELOPMENT

APR 16, 1997

Mr. Jose R. Aguirre
District Inspector General for Audit, 7AGA
Great Plains District, OIG
Gateway Tower II, 400 State Ave.
Kansas City' KS 66101 -2406

Dear Mr. Aguirre:

I have attached the Office of Community Planning and Development's comments on your DRAFT REPORT -- Review of Low Income Housing Tax Credits Program.

John Simmons, CPD's Audit Liaison Officer, talked to Jerry Saale of your office, who indicated the comments would be reviewed and considered in the final report.

If you have specific questions on the comments, please call Mary Kolesar, Office of Affordable Housing, (202)708 -2470, extension 4640.

Sincerely,

Jacquie Lawing
Acting Assistant Secretary

Note: This is a scanned document.

Comments on the OIG draft audit on the LIHTC program
Prepared by Mary Kolesar, 708 -2470
3/31/97

The report while containing some interesting observations failed to distinguish among the requirements for subsidy layering among the different HUD programs and whether the responsibility to perform the reviews was HUD's or a state/or local one. To the extent that the project is funded with HOME funds, the layering review responsibility is a state or local one. The sample of projects studied is heavily weighted to HOME and CDBG projects but the report makes the recommendation that NCSHA guidelines be made mandatory and adopted uniformly by HUD, without much study of projects directly financed by HUD. Also, it is not clear whether the audit report recommendation applies only to tax credit projects, or to all projects subject to subsidy layering reviews .

For the HOME Program, OAHP issued a notice, CPD -94-24, **Layering Guidance for HOME Participating Jurisdictions When Combining HOME funds with Other Governmental Subsidies,** providing guidance to participating jurisdictions on how to meet their responsibilities as described in Sec. 212(f) of the National Affordable Housing Act. OIG was provided with a copy of this notice. This section of NAHA states that the requirements of 102(d) of the Reform Act '...shall be satisfied by a certification by the participating jurisdiction to the Secretary that the combination of Federal assistance provided to any housing project shall not be any more than necessary to provide affordable housing.' While the notice provides key evaluation points when doing the review, it also recognizes and defers to other reviews that may be done by the tax credit allocating agency for tax credit deals or by HUD when it provides direct Federal assistance to a project. To the extent that state and local governments have adopted the NCSHA guidelines, they are already in use in lieu of CPD -94-24 for both state and local projects.

With respect to the HOME Program, CPD believes it has provided flexibility to HOME participating jurisdictions consistent with the spirit of the OIG recommendation but declines to make the NCSHA guidelines mandatory as we believe it is contrary to the statutory intent of NAHA. Nevertheless, we are of the opinion that there is merit to having CPD, PIH and Housing issue consistent guidance to the extent that it is practical and permissible under various programmatic statutes. We would have no objection to again encouraging HOME grantees to consider using the NCSHA guidelines when establishing their own policies.

While the suggestion on page 10 [draft report], that on -site compliance reviews for HOME and LIHTC should be coordinated may make sense, it should be noted that Sec 42 does not require the IRS to conduct on -site reviews.

Note: This is a scanned document.

U.S. Department of Housing and Urban Development
Washington, D.C. 20410-7000

OFFICE OF THE ASSISTANT SECRETARY FOR
CONGRESSIONAL AND INTERGOVERNMENTAL RELATIONS

MEMORANDUM T0: SUSAN GAFFNEY

FROM: JON SHEINER

SUBJECT: **COMMENTS - DRAFT REPORT, REVIEW OF LOW INCOME HOUSING TAX CREDITS PROGRAM**

DATE: March 12, 1997

I have recently read the draft report of Jose R. Aguirre, District Inspector General for Audit, (97-KC-117-0801) concerning the Low Income Housing Tax Credit. I feel a very strong connection with the LIHTC. I was Legislative Counsel to Congressman Charles Rangel from 1985 to 1995. I was directly and intimately involved in the original drafting of the LIHTC in 1986 and all of its subsequent amendments through 1993. I am entirely familiar with the debate over the subsidy layering rules and believe I know as well as anyone the intent of Congress with respect to the LIHTC.

TRANSFER OF PHYSICAL ASSETS

The authors of the draft report indicate that they do not believe the use of the credit for TPAs is a prudent use. I believe that this conclusion is a presumptuous substitution of the judgment of the authors for that of Congress. One of the strengths of the LIHTC is that Congress gave the states great latitude on how to allocate the credit and for what uses it could be allocated. Essentially, it made the allocation a local political decision. It is not for the federal government to substitute its judgment as to the housing needs of a state for that of the representatives in the state of the elected officials of that state. As long as the allocation process is open and there is due process in the application process Congress's primary concern are the income limits and the rehab threshold. There are also other criteria such as long term affordability and efficiency in development. But, if Congress wanted to bar TPAs, it could have easily done so. I can assure you that consideration was given to that thought and dismissed.

DEVELOPER AND SYNDICATION PROCEEDS

It is very clear that Congress wanted to develop a market driven program. I believe if you compare the LIHTC with its predecessor, the depreciation tax shelters, you will see that the federal government it is better served by the LIHTC. History bears out this conclusion. In the early years the 70% PV credit yielded about 40 to 50 cents on the equity dollar. Today it is yielding 58 to 67 cents on the equity dollar. At 70 cents it would be 100% efficient less the incremental transaction costs the LIHTC itself creates. The primary issue for the allocating agency should be how much housing is it getting for the credits it is allocating. How much the developer and syndicator are making should not be relevant if the market is working appropriately. As long as there is sufficient demand for the credits the amount of equity the credit raises and the efficiency in terms of developer and syndication costs will be properly costed. In other words, if there are enough people wanting to develop low income housing, we do not have to pay them as much as if there were many fewer interested.

Frankly, artificial setting of, or mandatory parameters for, developer and syndication costs will only result in distortions. The rational investor does not invest unless the return is reasonable. Limit the return below that level and he will not invest.

One of the goals of the drafters of the LIHTC was to avoid creating a bureaucracy such as the one at HUD. In 1985 HUD was a mess and Congress had no trust in its abilities. It is interesting to note that during the tenure of the great free market advocate Jack Kemp, HUD proposed rigid rates of return for developers and syndicators for its subsidy layering rules If you are operating a Soviet style, centrally planned economy it might be appropriate. However, if you design a program to work in free markets you will invariably end up with the correct price for these services.

cc: Nic Retsinas
Kevin Marchman
Howard Glaser
Michael Stegman

Note: This is a scanned document.

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