HOUSING

Tax Reform Uncertainty and the Low-Income Housing Tax Credit Market

Comprehensive tax reform is one of those things that politicians often talk about, but few in Washington actually believe will ever happen. After all, the last bipartisan comprehensive tax reform achievement occurred over 30 years ago, a distant past when politicians still reached across the aisle to pass major legislation. Now, with partisanship as strong and bitter as ever, it would take a myriad of factors to get to a place where tax reform is even a possibility. Setting the stage for comprehensive tax reform would likely require one-party control of both the House and the Senate, a president from that same party who is willing to take big risks, and a speaker of the house with a detailed plan. To the surprise of many, that's exactly where we stand as 2017 unfolds.

When Donald Trump was elected president and the Republican party maintained control of both chambers of Congress, comprehensive tax reform suddenly became a real possibility. Consequently, the low-income housing tax credit (LIHTC) market experienced a jolt of uncertainty that is affecting affordable housing deals from coast to coast.

Since 1993, corporations have been under the same tax structure, topping out at 35%, which has provided stability in the LIHTC market. That stability, however, was thrown into flux with the election of our 45th president.

According to President Trump's campaign rhetoric and the official White House website, the administration plans to enact massive tax cuts for both businesses and individuals. There has been no clear indication on what the corporate tax rate would change to, although it's been rumored to be between 15% and 25%.

Such a change would have a dramatic impact on LIHTC pricing, as a majority of credit buyers are large corporations. With lower taxes to pay, they would need less tax credits. Although stabilized today, almost immediately after the election the LIHTC industry saw a $0.20 drop in pricing across all markets and all projects.

For some states, this happened during critical timeframes for their application cycles. For example, Indiana had 9% LIHTC applications due on Nov. 7, one day before the election. This put the Indiana Housing & Community Development Authority (IHCDA) in a tough spot. They were sitting on 32 applications, none of which worked anymore because of the market uncertainty that followed the election. Many states had similar situations. Below are examples of how a handful of states have handled this issue.

- **California**: The state is allowing projects to convert to a 9%/4% structure to bring in additional 4% tax credit equity.
- **Connecticut**: The Connecticut Housing Finance Authority (CHFA) opted not to impose a fixed price assumption for LIHTCs in the latest 9% award cycle, nor did CHFA require any re-submissions. CHFA surveyed syndicators and investors and determined the impact on pricing to be $0.01 per 1% reduction in corporate tax rates. Their analysis included a corporate tax rate floor of 20%. Given that the application deadline was November 1 of 2016, the plan was to re-evaluate awards if needed during the carry-over process at the end of 2017.
- **Delaware**: The state imposed mandatory LIHTC pricing applications between $0.94 and $0.95.
- **Illinois**: The Illinois Housing Development Authority (IHDA) canceled its first round of LIHTC awards scheduled in early 2017. Instead, the second round will award a full year of credits. It is scheduled for September with the hope that the uncertainty will dissipate at least somewhat by that date.
- **Iowa**: The state is allowing developers to amend sources to try to fill any funding gaps.
- **New Jersey**: The New Jersey Housing and Mortgage Finance Agency (NJHMFA) imposed a firm pricing assumption of $0.95 on all applications. It also set a minimum number of credits reserved for all projects receiving awards.
- **New York**: The state requires timely investor letters addressing the state of the LIHTC market with all applications. It also eliminated LIHTC pricing and pay-in schedules from the scoring criteria.
- **North Carolina**: The state created a supplemental round of credits where $100,000 in credits from the 2017 allocation were awarded to developers to close 2016 deals. This will impact 2017 as less deals will be funded.

- **Ohio**: Ohio is taking the 2017 credits and making them available to 2016 projects. In addition, it postponed its February application to March to give developers more time to make any necessary changes.
- **Pennsylvania**: The Pennsylvania Housing Finance Authority (PHFA) cycle concluded before the election. As such, the pricing dropped substantially after the awards were announced. To counter this, the PHFA required resubmissions with new letters and updated financial feasibility analysis, effectively creating a second submission process.
- **South Carolina**: The state is working with developers on a one-on-one basis to make the 2016 allocations work.
- **Tennessee**: The state is working on a potential reduction in the number of units without a reduction in credit allocation (i.e., reduction in cost without reducing the sources).
- **Wisconsin**: Wisconsin delayed applications by one month to allow developers more time to amend projects.

Changing Course in Indiana

The reaction to the LIHTC market uncertainty in 2017 has been mixed. Some developers were able to adapt quickly while some struggled with the changes. Some states worked collaboratively while others went at it alone. One example of a state that has been transparent with its developers is Indiana. Alan Rakowski, the rental housing tax credit manager of IHCDA, shared some insights on how they attacked the problem.

"With the 9% applications due the day before the election, IHCDA had some inclination that there could be a jolt to LIHTC equity pricing," said Rakowski. "We had 62 applications, all around one dollar in equity pricing. The first thing we did was wait and hope it would get better. Obviously, that didn't pan out like we hoped."

The next step for IHCDA was to reach out to developers and market participants through the Indiana Affordable Housing Council (IAHC). Consideration was given to changing the award date, but ultimately the consensus from IAHC was to maintain the existing timeline.

"The IAHC provided some guidance on how to continue to process applications," said Rakowski. "We provided a draft policy with two weeks of comment period. For the last four years, we've limited the basis boost to 120%, so an increase to 130% was a quick fix. We also decided to forward allocate 2017 credit deals and use the 2016 development fund dollars to fund gaps."

In order to help projects move forward, IHCDA decided to waive certain fees and not impose a penalty for turning in 2016 credits and reapplying for 2017 credits. On Feb. 23, 2017, there were 16 awards granted. Also new, a waiting list was created in case an awarded deal didn't need the boosted credits or for deals that didn't work.

"Although it is still early to judge if the efforts have been successful, thus far the signs are positive," added Rakowski.

Agency Financing

Another way to help fund any financing gaps is to consider agency debt products, like the United States Department of Agriculture (USDA) Sec. 538 guaranteed loan program or the U.S. Housing and Urban Development (HUD)/Federal Housing Administration's (FHA) Sec. 223(f) or 221(d)(4) loan programs. These programs offer low rates and long terms, which can help fund a gap created by low equity proceeds. For example, the USDA Sec. 538 program has a 40-year term and amortization for both new construction and rehabilitation projects that are located in rural areas. USDA's definition of "rural" is less than 20,000 people, so many projects can benefit. Other benefits of this program include the fact that it can act as a permanent take-out loan and that it doesn't require Davis Bacon wages.

If a project has less than approximately $35,000 in repairs per unit, the FHA Sec. 223(f) program can be a great option. With the low, fixed interest rates and a 35-year term, a project can afford more debt while maintaining a conservative debt coverage ratio.

If more significant repairs are necessary, or if the loan-to-value (LTV) test is limiting loan proceeds, the FHA Sec. 221(d)(4) program can be an intriguing option. Since this program doesn't have an LTV test, it can provide a significant boost to loan proceeds for ceratin projects. These programs have other benefits for LIHTC projects such as abbreviated processing, but it's important to work with a lender that is intimately familiar with the tax credit market.

As we enter the second half of 2017, those in the affordable housing industry are hoping that some of the hesitation that LIHTC investors displayed in the wake of the election subsides. At this point in the year, tax reform passing in 2017 seems more unlikely than it did in January. In addition, a recent article in Affordable Housing Finance indicated that many LIHTC investors are hopeful that investment activity will increase, although investors will likely remain more cautious than they were under the previous administration. Either way, developers should stay informed of what's going on at the housing agencies in their states as adjustments are likely to continue throughout the year.

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