

MILLENNIAL HOUSING COMMISSION
PRODUCTION AND PRESERVATION TASK FORCES
BACKGROUND PAPER: POTENTIAL HOME / CDBG REFORMS
TO FACILITATE THEIR USE WITH LIHTC

OVERVIEW

Many, perhaps most, LIHTC properties involve other sources of subsidy as well, in order to produce the desired level of affordability for the intended resident population. Some conflicts between subsidy programs occur at the time of original development and financing. Other conflicts occur during operations. Various commenters identified conflicts and suggested methods for reducing or eliminating the conflicts.

There is a high degree of agreement with the intent of existing requirements (greater affordability, deeper targeting, ensuring benefits go to the intended households, good physical condition, ...). At the same time, there is considerable dissatisfaction with how the policy intent is translated into specific compliance requirements and specific monitoring processes.

HOME, in particular, is heavily used in the production and preservation of subsidized rental housing, often in combination with LIHTC¹. CDBG is also frequently used to supplement LIHTC. However, HOME and CDBG and LIHTC present some conflicts when used together in the same property. The purpose of this paper is to review the range of potential reforms and assess how they might improve production and preservation in the future.

This paper discusses potential reforms suggested by those who provided public comments to the Commission and by other affordable housing professionals interviewed for this paper. An assessment of each potential reform is provided in italics. Reforms are also evaluated for consistency with the Commission's Principles for Housing Resource Delivery. Finally, some additional reforms to programs other than HOME and CDBG are presented, to make those programs work better with LIHTC. HOME and CDBG grantees (state and local governments) are collectively referred to as "localities."

POTENTIAL REFORMS TO IMPROVE HOME-CDBG-LIHTC INTERACTION

1. **Remove CDBG Restrictions, for CDBG-LIHTC Properties.** *This clearly would facilitate production and is consistent with the Commission's principle of Devolution.*
 - 1.1. **New Construction.** Allow CDBG funds to be used for new construction when combined with LIHTC.
 - 1.2. **No "Re-Purchase" of Land is Required.** Clarify that CDBG funds can be used to repay indebtedness incurred in an earlier purchase of land (some localities require a new – artificial – purchase transaction).

¹ As of July 31, 2000, there were 15,427 completed HOME rental projects containing 127,826 units. 2,420 of these projects (15.6% of all projects) and 48,843 units (38.0% of all units) included LIHTCs as well as HOME funding.

2. **Align Certain HOME and CDBG Rules.** *For HOME and CDBG to have different requirements for choosing which initiatives to fund is one thing. To have different requirements for carrying out the same housing initiative does not seem appropriate. Correcting this discrepancy is consistent with the Commission’s guiding principle of Simplicity.* See item 3 below for a discussion of the particular rules that have been suggested for alignment. There are two alternatives for implementing a “single rule” approach:
 - 2.1. **Single Rule For All Housing Uses.** Provide that all HOME and CDBG funds used for housing will be subject to a single set of requirements². This would allow HOME and CDBG funds to be used interchangeably, and in combination, for housing purposes³. *This would be quite useful both to localities and to developers.*
 - 2.2. **Single Rule For LIHTC Properties.** An alternative reform is to provide in the CDBG and HOME (and, if appropriate, LIHTC) statutes that when these programs are used in combination with LIHTC, a single set of rules will apply and will be deemed to satisfy applicable LIHTC and HOME and CDBG requirements⁴. *This is in concert with the Commission’s guiding principle on Hierarchy of Compliance.*
3. **Factors to Consider, In A Single Set of Rules.** *Unless noted otherwise, these reforms are appropriate and are consistent with Hierarchy of Compliance. HOME is used as the example because it has more program-specific requirements, but the same approach could be used for CDBG-LIHTC properties.* The reforms noted with asterisks* could be applied only when HOME is combined with LIHTC, or to the HOME program generally. Other reforms (without asterisks) are applicable only in HOME-LIHTC properties.
 - 3.1. **Income and Rent Targeting.**
 - 3.1.1. **In General.** Each program’s targeting requirements would be taken into account at the time of development and financing. The State LIHTC allocating agency, locality and developer would agree on targeting that met the requirements of all subsidy programs. That agreement would be contained in the LIHTC Use Agreement (a covenant running with the land). That agreement would provide for a single set of compliance rules.
 - 3.1.2. ***Fixed and Floating HOME Units.** Provide an exception to the HOME requirement for “fixed” or “floating” units for HOME-LIHTC properties (i.e., compliance with the LIHTC “next available unit” rule

² This set of rules would be based on current HOME and CDBG requirements. New rules could be produced administratively by HUD by using the more stringent of the two existing sets of statutory requirements. Alternatively, Congress could enact statutory changes providing for a new single set of requirements that depart in some respects from existing HOME and CDBG statutory requirements. For example, a commenter suggested that Davis Bacon applicability be standardized to the HOME provision (Davis Bacon applies above 11 assisted units) rather than the more restrictive CDBG provision (Davis Bacon applies above 8 total units). Similarly, a commenter recommended the HOME requirements for environmental (NEPA) review as opposed to the CDBG requirements that the commenter finds less realistic and helpful.

³ A new single set of rules could be made applicable to other federal programs as well, for example LIHTC.

⁴ This set of rules would require some care in drafting. For example, HOME requires deeper targeting than LIHTC, and the single set of rules should not override that. Similarly, HOME requires more frequent monitoring than LIHTC, and it is not clear whether the HOME or LIHTC monitoring requirement should apply in the single set of rules.

- satisfies HOME).
- 3.1.3. * **High and Low HOME Rents.** Provide an exception to the HOME requirement limiting §8 rent to the High HOME rent, for HOME-LIHTC properties (the LIHTC rule allows the full §8 rent to be collected).
 - 3.1.4. **Requirements Concerning Household Income.**
 - 3.1.4.1. ***Certifications.** Provide that certifications and recertifications of household income (definition of income / assets / allowances, timing of recertifications, ...) in accordance with LIHTC requirements will satisfy HOME and CDBG requirements.
 - 3.1.4.2. ***Over-Income Households.** Provide that compliance with LIHTC requirements for households who go over-income (140% rule, next available unit rule) will satisfy HOME and CDBG requirements.
 - 3.2. **Monitoring.** Provide that, when HOME and CDBG are combined with LIHTC, the locality is relieved of downstream monitoring responsibilities, because equivalent monitoring is performed by the State allocating agency and IRS⁵. Provide that the State LIHTC allocating agency will provide copies of monitoring reports to the locality. *This change would remove an existing disincentive to use HOME funds for multifamily – the obligation to do long term monitoring without additional administrative fees.*
 - 3.3. **Reporting.** Provide that, when HOME / CDBG are combined with LIHTC, the owner may satisfy HOME / CDBG reporting requirements by providing to the PJ a copy of reports provided to the State allocating agency and IRS⁶.
 - 3.4. **Site and Neighborhood Standards.** Provide an exception to the HOME site and neighborhood standards (24 CFR 92.202) for HOME-LIHTC properties.
 - 3.5. **Environmental Review.** LIHTC does not require an environmental review. Developers report a nearly universal requirement from lenders and investors for Phase I / II reports. However, HOME requires a NEPA review under which the government must make a finding of no significant environmental impact. Alternative reforms include:
 - 3.5.1. **Single NEPA Review.** Provide that any NEPA review otherwise required under a HOME-LIHTC transaction (for example, for FHA mortgage insurance) will satisfy HOME requirements.
 - 3.5.2. **Substantial Equivalence.** Provide that reviews under substantially equivalent State or local environmental laws will satisfy HOME requirements.
 - 3.5.3. **Normal Environmental Review Is Sufficient.** For HOME-LIHTC properties, allow a Phase I / II report to satisfy the HOME requirement.

⁵ This not to suggest that the existing requirements are identical. For example, HOME requires annual physical inspections vs. the IRS requirement that specifies one inspection every three years. These differences should be reconciled in the process of developing the single rule.

⁶ A commenter stated that there is a HOME requirement to report on households below 30% of AMI, but there is no such requirement.

- 3.5.4. **No NEPA Review for LIHTC Properties.** Provide an exception to the requirement for HOME-LIHTC properties.
 - 3.5.5. **NEPA Review for All LIHTC Properties** Provide for a NEPA review for LIHTC properties whether or not HOME and CDBG are involved (conforming LIHTC to HOME and CDBG).
 4. **§108 Analogue for HOME.** Create a loan guarantee program (similar to §108) allowing localities to borrow against future HOME grants. *To the extent that §108 is deemed to be good policy, extending the concept to HOME is sensible. However, this sort of loan guarantee is counter to the Commission’s guiding principle of recognizing the full cost up front.*
 5. **Expand Allowable Uses for HOME Funds.** *In general, these reforms would permit HOME funds to be used more flexibly with LIHTC than in normal HOME transactions. This is sensible in that the logical role for HOME in HOME-LIHTC developments is for gap funding and uses that are difficult to fund in other ways. However, many of the suggested uses are not consistent with sustainability principles or appear to be second-best methods for achieving a sustainable outcome.*
 - 5.1. **Reserves.** Allow localities to commit HOME funds to establish replacement reserve and other reserve funds for HOME-LIHTC properties. *HOME funds can now be used to capitalize an initial operating reserve; no change needed.*
 - 5.2. **Operating Expenses.** Allow localities to commit HOME funds for operating subsidy for HOME-LIHTC properties (e.g., for properties whose operating costs – without debt service – exceed market rents). *The straightforward method for funding such properties is through a 100% up front capital grant plus a project-based §8 contract at the minimum (above market) rents necessary to support the property’s viability. Creating a sinking fund via HOME is a possible alternative strategy and is one example of how an up front reserve could be consistent with sustainability.*
 - 5.3. **Refinancing.** Allow localities to commit HOME funds for refinancing, for HOME-LIHTC properties. *If the refinancing is a preservation transaction and the property satisfies sustainability principles, using HOME funds for a below-market-interest-rate refinancing loan would be sensible. However, it is difficult to envision circumstances in which this approach would be optimal, by comparison to a straightforward debt restructuring transaction. A commenter expressed a concern over the use of HOME funds, at below market interest rates, to finance equity payments to sellers.*
 - 5.4. **Allow Project-Basing of HOME Tenant-Based Rental Assistance.** Allow HOME TBRA to be project-based in HOME-LIHTC properties. *If used to create mixed income communities, this could be sensible, although the same effect could be achieved through standard tenant-based assistance (through HOME or §8) and close coordination with the TBRA administrator. It may not, however, be realistic to expect many localities to make commitments for project-based assistance, given the potential that even a one year commitment may create a de facto multi-year obligation.*
 - 5.5. **Predevelopment Loans.** Under the status quo, localities may make predevelopment loans. However, the locality is liable for repayment if the project

does not go forward, except for predevelopment loans to CHDOs. As a result, in practice, most localities make these loans only to CHDOs. The Commission could recommend that localities be able to commit HOME funds for predevelopment, to all developers, without potential liability for repayment. *This potential reform is really a recommendation about the HOME program generally rather than for HOME-LIHTC in particular, because at the time the loan is made, it will not be known whether LIHTCs will actually be used. As such, this recommendation is beyond the scope of this paper.*

6. **HOME Linkage to HOPE VI.** Curing distressed public housing is often a locality's highest housing priority. Localities would prefer to be able to use HOME funds for this purpose, in the most flexible way possible. *This is consistent with Devolution.*
 - 6.1. **Remove Statutory Prohibition.** Provide that HOME funds can be used in conjunction with the Public Housing Capital Fund, while maintaining the current prohibitions against use of HOME funds for public housing operations. *The current prohibition (in §212d4 and d5 of the HOME statute) appears to be inadvertent, as it was imposed at a time when the Public Housing Capital Fund was not part of Section 9 of the US Housing Act.*
 - 6.2. **Provide Exception to One-For-One Requirement.** Provide that when HOME funds are used in conjunction with HOPE VI or with any other mixed-finance public housing redevelopment effort, the normal HOME one-for-one replacement requirement does not apply. *HUD Field Offices have the ability to provide an exception if there is an adequate supply of housing. The Commission could recommend that HUD provide a stronger safe-harbor or could recommend elimination of the one-for-one requirement in the context of public housing redevelopment.*
7. **HOME / CDBG Linkage to RHS Financing, With and Without LIHTC.** The discussion above regarding a single set of rules is equally applicable when non-RHS programs are combined with RHS financing. *Providing a safe-harbor single set of compliance rules is consistent with Hierarchy of Compliance.*
8. **HOME, CDBG and the 130% Rule.** Under current law, 9% LIHTC properties that utilize HOME loans at interest rates below the AFR⁷ cannot also utilize the 130% basis boost for Qualified Census Tracts and Difficult Development Areas. Conversely, in most instances a below market HOME loan is includable in LIHTC basis, whereas an otherwise similar CDBG loan is not includable in LIHTC basis. Provide that below-AFR loans under both programs are includable in LIHTC basis and do not affect eligibility for the 130% basis boost.

POTENTIAL REFORMS TO FACILITATE MIXED INCOME COMMUNITIES

9. No potential reforms were identified.

POTENTIAL REFORMS TO FACILITATE CAPITAL MARKET ACCESS

⁷ The Applicable Federal Rate published by the IRS. The AFR is the lowest interest rate that the IRS will respect as a market interest rate.

10. **Grant vs. Loan.** HOME and CDBG funds fund portions of development cost that are not economically supportable. A grant is the economically logical way to provide such funds. However, under current law, there is a strong pressure to structure HOME and CDBG funds as below-market-interest-rate loans instead of grants, for two reasons. First, a grant would generate taxable income to the developer. Second, a grant would not be includable in LIHTC basis. However, structuring these funds as a loan over-leverages the property⁸, reduces the developer's economic incentive⁹, and interferes with obtaining the first mortgage financing¹⁰.
 - 10.1. **Potential Tax Law Change for Grants.** If tax law allowed the developer to offset the grant against depreciable basis, this would facilitate treating the HOME / CDBG funds as grants instead of loans.
 - 10.2. **Definition of LIHTC Basis.** The definition of LIHTC basis could be changed so that LIHTC basis would not be affected by the grant vs. loan decision.
 - 10.3. **Allow Truly "Soft" Loans.** Alternatively, the definition of LIHTC basis could allow HOME / CDBG loans to be included as basis without regard to interest rate or repayment terms.

POTENTIAL REFORMS TO FACILITATE INTERACTIONS WITH OTHER PROGRAMS

11. **Income Limits Under Project Based §8.** Provide that owners may prioritize households with incomes lower than the income limit contained in the HAP contract (e.g., for a §8 / LIHTC property, if the HAP provides for eligibility up to 80% of AMI, the owner may prioritize applicants below 60% of AMI to mirror the LIHTC requirement). *This affects HOME / CDBG / LIHTC properties with project based §8 and is consistent with Hierarchy of Compliance.*
12. **Improve the HOME-CDBG-LIHTC Linkage to Vouchers.** Raise the percentage of HOME-CDBG-LIHTC units that are available to and occupied by voucher holders. *This is a consistent theme of many different Commission discussions.* This has at least the following aspects:
 - 12.1. **Statutes.** To the extent not already the case, applicable statutes should prohibit discrimination based on status as a voucher holder, for properties receiving federal financial assistance. *Unless limited, however, this could lead to concentrated-poverty communities instead of mixed income communities.*
 - 12.1.1. **Potential Limitation #1.** The foregoing anti-discrimination requirement could be lifted whenever a threshold percentage of units are actually occupied by voucher holders. The Commission's background paper on Mixed Income Housing indicates that a threshold

⁸ The over-leverage occurs because the aggregate principal amount of debt is far in excess of the property's economic value, thereby preventing – or at least inhibiting -- the property from refinancing.

⁹ Any cash flow applied to repay the HOME / CDBG loan is cash flow that is not available for developer return.

¹⁰ To the extent the HOME / CDBG loan requires cash payments, generally the first mortgage lender will reduce the amount of the first mortgage by a corresponding amount, so that the property has a sufficient debt service coverage ratio against all required debt service payments. Similarly, first mortgage lenders are likely to provide less favorable terms when there is subordinate mortgage debt, because such transactions have higher risks of failure. In summary, it is difficult to structure a HOME / CDBG loan that is "soft" enough not to interfere with the first mortgage financing but "hard" enough to qualify for inclusion in LIHTC basis.

- not higher than 20% might be appropriate, in the interest of creating and maintaining mixed income communities.
- 12.1.2. **Potential Limitation #2.** The limitation could be applied only to voucher holders below a stated income level such as 30% of AMI (a reasonable proxy for the poverty line).
- 12.2. **Coordination.** Owners of federally financed affordable units could be required to take affirmative steps to ensure that voucher holders are aware of the available units. Specific approaches include:
- 12.2.1. Participation in local registries might be one mechanism.
- 12.2.2. Obligatory notification to the PHA when vacancies occur might be another mechanism.
- 12.3. **Occupancy Requirement.** A percentage of units could be required to be actually occupied by voucher holders (subject to protections in the event an insufficient number of vouchers are in circulation¹¹). *This is consistent with Simplicity in that it uses an outcome-based compliance approach, leaving it up to the owner how best to achieve compliance.*
- 12.4. **Alternative: Project Basing.** Developers could be required to accept project based vouchers for a percentage of affordable units, thereby giving greater assurance that units will actually be occupied by voucher holders. *Traditional project basing is counter to the Commission’s principle of Reliance on Market Principles in that it restricts choice – a problem that is solved by the recent statutory change creating a hybrid form of project-basing that provides choice to residents while providing some of the benefits of project-basing to the owner. The argument against traditional project basing is along these lines: if voucher holders prefer the property, they will choose it if given the opportunity, and project basing is not necessary; and if voucher holders do not prefer the property, project basing inappropriately restricts their choices.*

POTENTIAL REFORMS TO PROGRAMS OTHER THAN HOME AND CDBG

13. **HUD Previous Participation (“2530”) Process.** Provide exceptions for large corporate investors to the current requirements that individual officers and directors provide previous participation information. *This reform would certainly eliminate a headache. Whether it would increase corporate investment in subsidized rental housing is debatable.*
- 13.1. **Exempt Officers and Directors of Large Corporations.** For example, HUD could provide that if a corporation’s stock is publicly traded, the officers’ and directors’ individual previous participation records could be deemed irrelevant.
14. **Eliminate Multiple Subsidy Layering Requirements¹².** Many affordable housing professionals express frustration with the subsidy layering process. They agree that someone, on behalf of government, needs to ensure that the amount of subsidy is reasonable. They do not believe, however, that more than one such review should be

¹¹ Reportedly, the recent “project based” voucher program includes a reasonable provision dealing with this contingency.

¹² HOME does not require a separate subsidy layering analysis, but other programs – for example, HUD’s Mark to Market program -- do.

made for any given transaction, and they do not believe that the current processes are good processes. *The current processes also are part of the status quo that, all too often, produces properties that do not meet sustainability principles. A single review is consistent with Simplicity. Making the process subject to sustainability principles is consistent with Sustainability.*

14.1. **Single Review.** Provide for a single review – by the State LIHTC allocating agency – and certification that the aggregate subsidies (from all sources) do not exceed the amount necessary to provide for the property’s feasibility. This review would be deemed to meet the subsidy layering requirements of all federal programs involved in the property.

14.1.1. **Sustainability.** This review should be made subject to sustainability principles.

OTHER SUGGESTED REFORMS NOT RELEVANT TO LIHTC COORDINATION

In addition, commenters suggested a wide variety of additional potential reforms to HOME and CDBG that are beyond the scope of this paper.

AUTHOR

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