United States General Accounting Office 139218

GAO Testimony

139218

For Release on Delivery Expected at 9:00 a.m. EDT Wednesday, August 2, 1989

Project Developer Cash Flows Under HUD's Section 8 Moderate Rehabilitation Progra

Statement of
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Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

O46110/139218

GAO/T-RCED-89-58

Mr. Chairman and Members of the Committee:

We appreciate the opportunity to assist the Committee in determining why developers found the Section 8 Moderate Rehabilitation Program so enticing that they were willing to pay substantial consultant fees to win projects. Although our work is not yet complete, we are able to provide preliminary information on this situation.

Briefly, our analysis of 8 projects showed that developers received between $250,000 for a 36-unit project to $2.1 million for a 352-unit project above the cost to acquire and rehabilitate these projects. These substantial proceeds were basically a direct result of the sale of these tax credit eligible projects to private investors. In this manner developers were able to realize substantial gains on their limited investments while undertaking very little risk. I should add that low-income housing tax credits were first introduced with the Tax Reform Act of 1986.

Aside from tax credits, the Moderate Rehabilitation Program grants developers a 15 year rent subsidy for units set aside for low income families. The HUD IG has stated that the rehabilitation costs upon which the rental subsidies were based were improperly inflated leading to excessive rental subsidy payments from HUD. According to the IG's April 1989 report on the Moderate Rehabilitation Program, for the eight projects we reviewed excessive subsidies could total up to $25 million over the 15-year period.

In summary, this situation evolved because multiple benefits were awarded to eligible projects by different administering agencies such as HUD, state tax credit allocation agencies, and local governments, with little or no centralized oversight of the total benefits package provided to individual projects. As a result, we believe some projects received more financial assistance than would have been required to encourage project rehabilitation.

Obviously, this situation has resulted in the expenditure of more federal funds for fewer subsidized or rehabilitated low income housing units at a time when the demand for such units far exceeds their supply.

To better understand our information, I believe it would be useful to first describe the Section 8 Moderate Rehabilitation Program and the low-income housing tax credits. I will also discuss our estimates of the cash proceeds to developers for the projects we reviewed.

MODERATE REHABILITATION PROGRAM

The Moderate Rehabilitation Program was designed to increase the supply of rental units for low-income families. Under the program, owners agree to upgrade substandard rental housing in exchange for guaranteed rental subsidies for 15 years. To qualify for guaranteed rental subsidies, an owner or developer must spend a minimum of $1,000 per unit in repairs or improvements to bring the unit into compliance with HUD's housing quality standards.

Once a project is selected for the program, the owner enters into a Section 8 rental contract that specifies the project unit's rent. Within specified limits, the rent is set at a level high enough to service the debt associated with the acquisition and rehabilitation cost of the project. The low-income family generally pays rent equal to 30 percent of its adjusted income and HUD subsidizes the difference between this amount and the contract rent.

The guarantee of a federal rental subsidy for 15 years provides the owners or developers with collateral that they can use to help them secure mortgage loans to finance the projects' moderate rehabilitation costs. In recent years, with the discontinuation of other HUD subsidy programs, such as the Substantial Rehabilitation Program, the Moderate Rehabilitation Program has also been used to help finance extensive project rehabilitation. In conjunction with the subsidies provided under the Moderate Rehabilitation Program, HUD also often provides additional assistance by co-insuring the project's mortgage. In the event of a default, HUD's insurance fund would pay about 80 percent of the outstanding mortgage, and the private co-insurer would cover the remaining 20 percent.

TAX CREDITS FOR LOW-INCOME HOUSING

The Moderate Rehabilitation Program has been coupled with tax credits for low-income housing. These credits were authorized in the Tax Reform Act of 1986 as a 3-year program, which, like the Moderate Rehabilitation Program, was intended to increase the supply of affordable rental housing for low-income persons. For low-income housing, where the prospects for other profit sources--cash flow from operations and gain on the sale of property--are limited by the nature of the operation, tax benefits have been critical in inducing developers to get into the low-income housing business. Prior to the 1986 act, accelerated depreciation was a primary tax incentive in real estate development.

The 1986 act eliminated almost all tax benefits for real estate development, while creating low-income housing tax credits. State credit allocation agencies were charged with the responsibility for establishing an allocation process to parcel out tax credits which are available to states at $1.25 per capita. The tax credit is computed at about 9 percent of certain construction and rehabilitation costs associated with bringing the housing on line. An additional tax credit of about 4 percent can also be obtained for project acquisition costs, exclusive of land costs. These credits are provided annually for 10 years. Because tax credits provide dollar-for-dollar reductions in tax liability, credit-eligible projects are commonly sold by the developer through syndicators to investors. In this way the developer, through syndicators, converts future tax credits into cash usually received within 3-4 years of project inception.

CASH FLOW ANALYSIS FOR SELECTED PROJECTS

The Congress appears to have intended that the state agencies allocating the tax credits limit the amounts awarded when other subsidies made the project feasible with less than the maximum eligible amount of credits. However, some developers requested and received from state agencies maximum eligible tax credits. These credits, which when combined with Moderate Rehabilitation Program subsidies, generated substantial cash proceeds.

For the eight projects we reviewed, we have attached pro forma schedules to my prepared statement. These schedules summarize the cash proceeds that developers received. In developing these schedules, we consulted with a variety of individuals recognized for their expertise in project development, real estate finance, and low-income housing tax credits. These experts agree that our schedules provide a fair and reasonable basis for estimating cash proceeds received by the developers.

The eight projects we reviewed included the three projects specifically requested by the Committee--Baltimore Gardens in Las Vegas, Nevada; Sierra Pointe in Clark County, Nevada; and Pebble Creek Apartments in Arlington, Texas. All eight were identified in the HUD Inspector General's report as having received excessive subsidies under the Moderate Rehabilitation Program. For instance, on one project the HUD Inspector General identified excessive rental subsidies amounting to about $329,000 annually, which could amount to $4.9 million over the 15 years that these subsidies are to be provided. While we did not attempt to validate the Inspector General's findings, to the extent that excessive or inflated costs are included in the costs associated with project acquisition and development, the cash flows to developers could be somewhat greater than what we have determined. Before proceeding, I would like to thank the HUD Inspector General's office for its cooperation and assistance in our examination.

Regardless of the extent of excessive costs, by combining proceeds from the sales of income tax credits with coinsured mortgage loans secured by moderate rehabilitation rent subsidies, developers were able to generate sizable cash proceeds. Tax credit awards for the eight projects ranged from about $896,000 on one project to about $5.8 million on another. When the developers sold their ownership interests in the projects along with the related tax credits, and these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds that greatly exceeded costs associated with acquiring and rehabilitating the properties. As I mentioned earlier, we estimate cash flows to developers on the eight projects ranged from about $254,000 for a 36-unit project to about $2.1 million on a 352-unit project. On a per-unit basis, the range was from about $3,500 to about $11,400.

The Committee was particularly interested in how programs intended to benefit low-income persons could generate sufficient cash proceeds to allow developers to pay large consultant fees to obtain HUD moderate rehabilitation subsidies. According to the HUD Inspector General's report, such fees have ranged from $500 to $1,500 per unit. With cash proceeds of $3,500 to more than $11,000 per unit that we have identified, it is evident that developers could afford these consultant fees to secure the moderate rehabilitation subsidies and still receive substantial cash proceeds.

OBSERVATIONS

Mr. Chairman, I would like to point out that neither the Moderate Rehabilitation Program nor tax credits provide developers incentives to minimize costs. In fact, there is an incentive to increase costs. Developers generally receive a fee for rehabilitating a project. This fee is generally a percentage of the rehabilitation costs, thereby providing an incentive to maximize these costs. Similarly, because the amount of tax credits is based on a percentage of rehabilitation and acquisition costs, developers have an incentive to increase expenses, either by inflating costs or incurring unnecessary costs. Without adequate oversight of these costs, the government is vulnerable to providing excessive subsidies. In fact, as I pointed out earlier, HUD's Inspector General found that inadequate HUD oversight contributed to its payment of excessive Moderate Rehabilitation subsidies. Effective management controls are clearly necessary to ensure that reported project costs are valid.

In addition to the need for better management controls within the Moderate Rehabilitation Program, we noted that no overall review of total benefits awarded to a project is presently required by HUD, state tax credit allocation agencies, and, where applicable, local government units. With no centralized oversight of the total "benefit package" provided to individual projects, there is a real opportunity for excessive benefits. Pending legislation now before the Senate Finance Committee would expand the number of projects eligible for tax credits. It would also require state tax credit allocating agencies to adopt plans allocating available credits among eligible projects. Along with other changes, it targets credits to projects serving those with the lowest incomes. It would also direct credits toward projects that produce the most units for the lowest tax credit expenditure. Finally, housing credit agencies would evaluate each project and only provide the amount of credits actually needed to ensure project feasibility over a lenghtened 30-year term. We agree that there is clearly a need for a centralized reviewing authority, and we are evaluating the merits of whether this authority should be placed within the states or HUD. In either case, this authority would help to ensure that limited federal funds are used to maximize the number of low-income housing units.

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Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Committee may have.

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS
PROJECT 1

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$5,811,300	
(B)	Tax Credit Proceeds (1)	2,174,623	
(C)	Other	174,647	
(D)	Owners Cash Investment (2)	14,690	
(E)	Total Sources of Funds		$8,175,260
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,464,500	
(G)	Development Costs (from HUD 2331A)	3,867,312	
(H)	Developers Fee (3)	773,462	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	87,170	
(J)	Gross Total Applications	7,192,444	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(348,139)	
(L)	Net Total Applications of Funds		$6,844,305
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$2,089,727
(N)	Estimated Proceeds To Developer Per Unit (202 Units)		10,345

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
   (A) Syndication proceeds equal 45% of awarded credits
   (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
   Actual tax credits awarded were $5,369,440
(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $350,322 in letters of credit.
(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.
(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 2

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$7,401,300	
(B)	Tax Credit Proceeds (1)	2,344,286	
(C)	Other	0	
(D)	Owners Cash Investment (2)	54	
(E)	Total Sources of Funds		$9,745,640

	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$3,700,000	
(G)	Development Costs (from HUD 2331A)	4,497,415	
(H)	Developers Fee (3)	899,483	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	111,020	
(J)	Gross Total Applications	9,207,918	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(383,855)	
(L)	Net Total Applications of Funds		$8,824,063

	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,821,006
(N)	Estimated Proceeds To Developer Per Unit (160 Units)		11,381

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
   (A) Syndication proceeds equal 45% of awarded credits
   (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
   Actual tax credits awarded were $5,788,360
(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $445,182 in letters of credit.
(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.
(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 3

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$1,214,100	
(B)	Tax Credit Proceeds (1)	362,941	
(C)	Other	0	
(D)	Owners Cash Investment (2)	60,937	
(E)	Total Sources of Funds		$1,637,978
	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$680,000	
(G)	Development Costs (from HUD 2331A)	686,862	
(H)	Developers Fee (3)	137,372	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	18,212	
(J)	Gross Total Applications	1,522,446	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(61,773)	
(L)	Net Total Applications of Funds		$1,460,673
	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$253,740
(N)	Estimated Proceeds To Developer Per Unit (36 Units)		7,048

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
   (A) Syndication proceeds equal 45% of awarded credits
   (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
   Actual tax credits awarded were $896,150

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $72,000 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATION OF FUNDS

PROJECT 4

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$6,549,000	
(B)	Tax Credit Proceeds (1)	2,078,602	
(C)	Other	0	
(D)	Owners Cash Investment (2)	45,882	
(E)	Total Sources of Funds		$8,673,484

	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,900,000	
(G)	Development Costs (from HUD 2331A)	4,021,947	
(H)	Developers Fee (3)	804,389	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	98,235	
(J)	Gross Total Applications	7,824,571	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(363,020)	
(L)	Net Total Applications of Funds		$7,461,551

	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,970,440
(N)	Estimated Proceeds To Developer Per Unit (209 Units)		9,428

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
  (A) Syndication proceeds equal 45% of awarded credits
  (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
  Actual tax credits awarded were $5,132,350
(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $392,940 in letters of credit.
(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.
(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 5

SOURCES OF FUNDS:

(A)	Mortgage Loan (from HUD Form 2580)	$4,181,100	
(B)	Tax Credit Proceeds (1)	544,834	
(C)	Other	200,782	
(D)	Owners Cash Investment (2)	80,569	
(E)	Total Sources of Funds		$5,007,285

APPLICATION OF FUNDS:

(F)	Acquisition Costs (from HUD Form 2264)	$2,457,000	
(G)	Development Costs (from HUD 2331A)	2,165,471	
(H)	Developers Fee (3)	433,094	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	62,717	
(J)	Gross Total Applications	5,118,282	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(193,043)	
(L)	Net Total Applications of Funds		$4,925,239

PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT

(M)	Estimated Proceeds To Developer (E-L+H-D)		$434,571
(N)	Estimated Proceeds To Developer Per Unit (122 Units)		3,562

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
 (A) Syndication proceeds equal 45% of awarded credits
 (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
 Actual tax credits awarded were $1,345,270

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $269,634 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 6

SOURCES OF FUNDS:

(A)	Mortgage Loan (from HUD Form 2580)	$5,975,000	
(B)	Tax Credit Proceeds (1)	1,362,404	
(C)	Other	33,003	
(D)	Owners Cash Investment (2)	248,361	
(E)	Total Sources of Funds		$7,618,768

APPLICATION OF FUNDS:

(F)	Acquisition Costs (from HUD Form 2264)	$3,715,000	
(G)	Development Costs (from HUD 2331A)	2,747,754	
(H)	Developers Fee (3)	549,551	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	89,625	
(J)	Gross Total Applications	7,101,930	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(242,998)	
(L)	Net Total Applications of Funds		$6,858,932

PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT

(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,061,026
(N)	Estimated Proceeds To Developer Per Unit (166 Units)		6,392

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
  (A) Syndication proceeds equal 45% of awarded credits
  (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
  Actual tax credits awarded were $3,363,960

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $361,500 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATED CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 7

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$8,097,900	
(B)	Tax Credit Proceeds (1)	2,358,437	
(C)	Other	436,170	
(D)	Owners Cash Investment (2)	85,688	
(E)	Total Sources of Funds		$10,978,195

	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$4,000,000	
(G)	Development Costs (from HUD 2331A)	5,121,087	
(H)	Developers Fee (3)	512,109	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	121,469	
(J)	Gross Total Applications	9,754,665	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(453,012)	
(L)	Net Total Applications of Funds		$9,301,653

	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$2,102,963
(N)	Estimated Proceeds To Developer Per Unit (352 Units)		5,974

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
 (A) Syndication proceeds equal 45% of awarded credits
 (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
 Actual tax credits awarded were $5,823,300

(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $487,782 in letters of credit.

(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.

(4) BSPRA = Builders and Sponsors Profit and Risk Allowance

ESTIMATE CASH FLOW - SOURCES AND APPLICATIONS OF FUNDS

PROJECT 8

	SOURCES OF FUNDS:		
(A)	Mortgage Loan (from HUD Form 2580)	$5,730,200	
(B)	Tax Credit Proceeds (1)	1,996,747	
(C)	Other	354,114	
(D)	Owners Cash Investment (2)	169,766	
(E)	Total Sources of Funds		$8,250,827

	APPLICATION OF FUNDS:		
(F)	Acquisition Costs (from HUD Form 2264)	$2,559,700	
(G)	Development Costs (from HUD 2331A)	4,060,607	
(H)	Developers Fee (3)	812,121	
(I)	Estimated Escrows and Prepaid expenses (1.5% of Mortgage Loan) (3)	85,953	
(J)	Gross Total Applications	7,518,381	
(K)	Less: BSPRA (from HUD Form 2331A) (4)	(358,105)	
(L)	Net Total Applications of Funds		$7,160,276

	PROCEEDS TO DEVELOPER AT COMPLETION OF DEVELOPMENT		
(M)	Estimated Proceeds To Developer (E-L+H-D)		$1,732,906
(N)	Estimated Proceeds To Developer Per Unit (207 Units)		8,372

(1) Cash value of tax credit proceeds result from developer sale of ownership interest in project. Tax credit data is not subject to 26 U.S.C. 6103. Assumptions regarding value of tax credits as follows:
   (A) Syndication proceeds equal 45% of awarded credits
   (B) Credit proceeds disbursed to project owner over three years, discounted at 10% per year.
   Actual tax credits awarded were $4,930,240
(2) Estimated cash requirements at initial endorsement exclusive of letters of credit required for mortgage closing. For this project, owner also provided $347,850 in letters of credit.
(3) Estimated amount on the basis of standard industry practice. Developers fee is 10% or 20% of development cost, depending on state tax credit agency policy.
(4) BSPRA = Builders and Sponsors Profit and Risk Allowance