# Travis County Housing Finance Corporation
## Agenda Request

**Meeting Date:** October 21, 2014

**Prepared By/Phone Number:** Andrea Shields, Manager/854-9116

**Elected/Appointed Official/Dept. Head:** Leroy Nellis, Acting County Executive, Planning and Budget/854-9066

**Commissioners Court Sponsor:** Samuel T. Biscoe, President

**AGENDA LANGUAGE:**
Consider and take appropriate action to approve the Travis County Housing Finance Corporation to act as the General Partner and related roles on 4% Low Income Housing Tax Credit/ private activity bond transactions.

**BACKGROUND/SUMMARY OF REQUEST AND ATTACHMENTS:** See attached.

**STAFF RECOMMENDATIONS:** Staff recommends approval.

**ISSUES AND OPPORTUNITIES:** See attached.

**FISCAL IMPACT AND SOURCE OF FUNDING:** N/A

**REQUIRED AUTHORIZATIONS:** Andrea Shields, Manager/854-9116; Leroy Nellis, Acting County Executive, Planning and Budget/854-9066

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To: Board of Directors of Travis County Housing Finance Corporation

From: Cliff Blount

Date: October 16, 2014

Re: Participation in multifamily housing developments in the role of general partner of the borrower partnership

Over the last 10 years it has become increasingly difficult for developers to build low and moderate income multifamily housing through the use of tax credits because of underwriting criteria. In fact, there was a period of three or four years where very few low and moderate income multifamily housing developments were built in the state. A primary cause is that construction costs have risen a great deal, thereby increasing the debt load that a project must take on once it becomes operational. Because of the limits on rents that are placed on these properties (not from the bond issuer but from the tax credit side of these transactions), the projected cash flow on these properties can be very tight. With increased costs and relatively flat revenues, these projects often times require a reduction in operating costs in order to underwrite.

The structure that staff is presenting to you involves a governmental entity (usually a wholly-owned and controlled limited liability company or public facility corporation of a housing finance corporation or housing authority) having an ownership interest in the borrower/owner entity in the form of a general partner interest. In addition, the governmental entity or an affiliate owns the land upon which the project is to be built and leases the land to the borrower partnership. This type of structure allows the benefit of an exemption from ad valorem taxes flowing from the tax exemptions granted to housing finance corporations and housing authorities (either directly or through a public facilities corporation).

This type of ownership has become common in Texas and quite a number of jurisdictions have become involved with these tax credit transactions in an ownership role. In fact, Strategic HFC of Travis County has participated in several of these developments. I am also familiar with similar transactions in the city of Austin (through the Austin Housing Authority) and the counties of Bexar, Dallas, Harris, Tarrant and Williamson.

Some of the advantages to participating as an owner to an entity such as Travis County HFC are:

1. The ability to become more directly involved in the ownership and operation of housing intended for residents at or below 60% of area median income as required to qualify for tax credits, or senior housing. The HFC would have control over services provided to residents of a particular development as the general partner of the owner.

2. The ability to receive a share of developer fees and net cash flow generated by these projects. The funds generated by the fees and the net cash flow could be used at the discretion of the HFC to assist Travis County residents with housing issues as the HFC deems appropriate from time to time. In most instances, the HFC would also receive an option to purchase the property at the end of the tax credit period at a price approximately equal to the debt on the property plus any exit taxes incurred by the tax credit investor (which will be a very favorable price with any appreciation in value of the property over that 15-year period). All of these sources of funds would provide resources to implement more in-depth housing programs. It is noteworthy that the fees netted by the HFC as general partner typically would exceed any ad valorem tax benefit, and unlike tax revenue which goes into the general fund, these revenues would be earmarked for affordable housing and assistance programs in Travis County.

3. There is some flexibility in how the ownership is structured. The ownership can be through an LLC to insulate the HFC from liability.

4. The financing can be structured as non-recourse so that the HFC entity and, therefore, the HFC, would not have any liability for the debt on the property (other than the property can be foreclosed if the loan payments are not made) except for some particular liabilities such as fraud or willful misconduct. TCHFC may further insulate itself from the financial and litigation risks associated with ownership and operation of multifamily rental property by creating a subsidiary entity to participate in a development. This would be a separate and distinct entity from the HFC to keep the financial and litigation risks at a single purpose entity level rather than at the HFC level.

Some issues that should be considered include:

1. There are no assurances that a property will perform and provide the cash flow that may be projected at the beginning of a development or that all of the negotiated developer fee will ultimately be paid. Likewise, there are no guaranties that the value of the property will appreciate (although there would be no liability to the HFC if the property were to perform extremely poorly or depreciate). The HFC would be taking some business risk at least from the standpoint of investing time and resources into a project which may not provide any return for a long period of time if ever.

2. The HFC staff has some experience in evaluating multifamily properties and tax credit structures but not necessarily in renovating or operating such properties although the hiring of construction consultants, property managers and other professionals can provide that experience.

These tasks could be performed by outside third parties and paid for by the partnership that owns the project or out of cash flow. This arrangement is common for small HFCs.

3. The primary reason that governmental entities, such as the HFC, are being afforded the opportunity to participate in this manner is to take advantage of the property tax exemption. *In most instances, the negotiated share of developer fees, cash flow and bargain purchase at the end of the tax credit period should outweigh the tax revenue loss to the governmental entity.* The HFC can always negotiate for the property owner to pay some or all of the property taxes or to pay particular jurisdictions if preferred.

4. The ownership of residential rental property does involve some risk through financial or tort liability from "slip and fall" type cases. In this case, it can be minimized or virtually eliminated by using separate "subsidiary" entities (such as a public facility corporation or limited liability company) to own the property and perform tasks and ensuring that there is adequate insurance to cover any and all liabilities that may arise.

# General Partner Role Information

Introduction

It has become increasingly difficult for developers to build low and moderate income multifamily housing through the use of tax credits due to underwriting criteria. A primary issue is that construction costs, both labor and materials, have risen significantly, thereby increasing the debt load that a project must take on once it becomes operational. Since rent limits are placed on these properties under Section 42 of the Internal Revenue Code, the projected cash flow is very tight on these transactions.

To address this, partnership structures have been developed that involve a governmental entity, usually a wholly-owned and controlled limited liability company of a Housing Finance Corporation (HFC), having an ownership interest in the borrower/owner entity in the form of a general partner interest. This type of structure allows the benefit of an exemption from ad valorem taxes because of the tax exemption granted to the housing finance corporation and its subsidiary entities, one which holds the land. *This structure also pushes liability down to the limited partner - the developer - since the limited partner is providing all guarantees.*

Under this scenario, it is also common for the HFC General Partner (GP) to be named the General Contractor (GC) in the partnership structure. This allows a sales tax exemption on construction materials, a significant savings typically in excess of $500,000. It is common for small HFCs to participate as supervising GC while an approved subcontractor performs actual GC duties. The HFC then contracts with a multifamily construction expert to perform consultation and inspection duties for oversight of the subcontractor. The consultant is paid from the GC fees in the deal.

This type of ownership has become common in Texas over the last decade as a number of jurisdictions, including Strategic Housing Finance Corporation, have become involved with these tax credit transactions in the GP/GC role.

Advantages to Undertaking the General Partner Role:

1. The ability to become more directly involved in the ownership and operation of housing intended for residents at or below 60% of area median income as required to qualify for tax credits and/or elderly housing, providing more leverage to require that services/programs be provided to residents of a particular development as the general partner of the owner.

2. The HFC, as General Partner, would have an even greater opportunity to ensure that the type and quality of housing truly meets the needs of low and moderate income Travis County residents.

3. The ability to receive a share of developer fees and net cash flow generated by these projects in addition to the annual issuer fee. These funds pay annually for 15-17 years or more and would provide a predictable revenue stream for

the HFC over time, allowing for better planning of programs/fund uses. The funds could be used to assist Travis County residents with housing issues based on the policy priorities approved by the Board.

4. Should the limited partner wish to exit the deal, the HFC would also receive an option to purchase the property at the end of the tax credit period (Year 15) at a price approximately equal to the debt on the property plus any exit taxes incurred by the tax credit investor (which will be a very favorable price, potentially cents on the dollar). The HFC would then sell the property at market value to an approved developer that would guarantee the property would maintain its affordability, thus maintaining the affordable housing stock in Travis County. The proceeds from the sale of the property could also be used to assist Travis County residents with housing issues based on the policy priorities approved by the Board. It should be emphasized that the HFC has no intention of retaining direct ownership of the asset.

5. There is some flexibility in how the ownership is structured. The ownership can be through an LLC to further insulate liability away from the HFC. *Both structures, GP and LLC, provide that the LP (the developer) is responsible for guarantees, therefore shifting liability downward to the LP.*

<u>Possible Disadvantages to Undertaking the General Partner Role:</u>

1. All tax credit transactions are vetted by multiple qualified parties, including TDHCA, lenders, syndicators and several legal teams, in an effort to mitigate concerns about property viability and performance. However, no one can absolutely guarantee that a property will perform and provide the projected cash flow at the beginning of a development. In addition to the significant vetting provided by multiple parties, partnering with an established developer with a proven track record can also help mitigate this concern. Staff will also perform due diligence before bringing any proposed project in front of the Board. Likewise, there are no guaranties that the value of the property will appreciate (although *there would be no liability to the county or HFC if the property were to perform poorly or depreciate*).

2. The HFC would be taking some business risk at least from the standpoint of investing time and resources into projects that may not provide any return for a long period of time or possibly ever. However, the same is true on any multifamily bond issue, regardless of the HFC's participation in the General Partner role. *Therefore, the risk to the HFC as GP is no different than the risk to the HFC of simply issuing bonds.*

3. Oversight of the construction process is within the purview of the GC function even if the HFC is pushing the construction responsibilities down to an approved subcontractor. Since the HFC and its staff lack direct construction experience, partnering with the right professionals, and retaining the services of a construction specialist to perform inspections and provide oversight on behalf of the HFC GC, mitigates the potential issues. The services of the specialist consultant are

paid through the GC fees within the deal.

4. The primary reason that governmental entities, such as the HFC, are afforded the opportunity to participate in this manner is to take advantage of the property tax exemption. While this could mean reduced property tax revenue, in most instances, the negotiated share of developer fees, cash flow and bargain purchase at the end of the tax credit period should outweigh the tax revenue loss to the governmental entity. Alternately, prior to closing, the HFC/GP could negotiate for the developer to pay some or all of the property taxes or to pay taxes related to particular jurisdictions.

## Policy Considerations

1. Participation as the GP/GC role would result in additional revenue through developer fees and potential cash flow for the HFC to fund additional activities and provide resources to further increase the supply of affordable housing in Travis County.
2. Acting at the General Partner would allow the HFC to have control of the non-profit role in the transaction and to ensure long-term viability of the project and to maintain the affordable housing stock in good condition for as long as possible.
3. The Board should consider whether the HFC should require the developer to show that the project will not underwrite without the tax exemption resulting from the HFC taking on the General Partner role.

Other Considerations

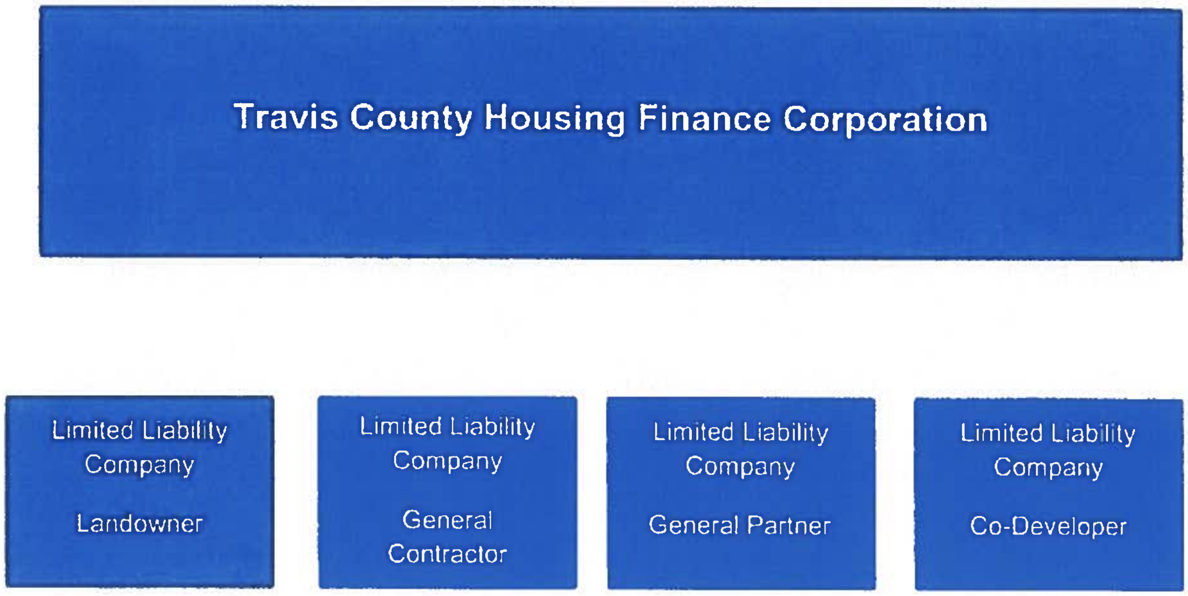
1. Should the Board wish to approve the HFC to participate in the General Partner role, staff is prepared and capable of performing significant due diligence of the budget and pro forma (we will pay particular attention to operating expense projections, especially maintenance reserves to ensure adequacy for any future repairs).
2. The Board should plan on little or no cash flow from these transactions until after the deferred development fee is paid in full. The HFC will require a General Partner Partnership Management Fee, typically in the amount of $10,000 a year. This fee will provide cash flow to the HFC's General Partner entity to cover expenses.
3. The HFC will need to create bank accounts, chart of accounts and budgets for each entity created for the transaction. Each LLC will need to be adequately capitalized to begin operations. Industry standard for initial capitalization for each LLC is around $10,000. These funds will come from existing HFC accounts for the first deal. The creation of these new accounts will be monitored closely by tax counsel, as well as the County Auditor's office to ensure all IRS requirements are met.
4. The developer will be required to provide guarantees for construction completion, lease up, operating deficit and possibly others, ensuring liability does not lie with the HFC/GP.
5. Having the right team in place is crucial to a successful deal. This includes staff, board members, bond counsel, tax counsel, partnership counsel, GP counsel, financial advisor, design and construction advisor, partnership accountants and HFC accountants.
6. As with the HFC's bond issues, a transaction with GP interest will only be brought before the Board for approval after vetting from staff and counsel. Only applications from strong development entities with known product quality will be considered. This will ensure that the professionals involved on the developer side in the transaction are knowledgeable and experienced.

Legal Structure

1. Establish subsidiary entities to minimize risk and liability. By creating single asset entities, ownership resides at that level and protects the parent corporation (the HFC). The LLCs must be created with the HFC as the sole member and the provision that all assets of the LLC revert to the member upon dissolution of the LLC. This is necessary to ensure that the tax exemption provided under Local Government Code 394.905 flows down to the wholly owned subsidiary LLC.
2. Must confirm with TCAD that they will accept the structure of a subsidiary LLC being the landowner instead of the HFC.
3. Must treat the subsidiaries as 115 entities or disregarded entities for IRS purposes.
4. The General Partner entity will be required by the investor limited partner to elect to be taxed as a taxable entity in order for the investor partner to receive the benefit of the accelerated depreciation schedule under IRS guidelines.

Business Deal Structure

1. Memorandum of Understanding. The purpose of this document is to provide a consistent framework for the initial discussion and negotiation of the partnership parameters. The basics of the partnership memorialized in the MOU will be carried into the Partnership Agreement. The MOU also outlines responsibility for payment of all fees related to the transaction.
2. For bond transactions, the HFC may need two business plans relating to the cash flow splits. Some investor tax counsels indicate that the fact the HFC would be the issuer of the bonds and the general partner in the partnership creates a "related party" situation under section 752 of the Internal Revenue Code. This situation will limit the HFC to 10% of the projected cash flow. This decrease in allowable cash flow can be offset by increasing the developer fee percentage, increasing the annual administrative fee to the issuer, or by inserting a higher ground lease payment which would start at the time the deferred developer fee is paid off.
3. The HFC should insist on a general partner "Partnership Management Fee" which will be paid higher in the "waterfall" to ensure its availability. The amount of this fee is typically around $10,000 a year.
4. The GP role also provides for a specific methodology to allow the non-profit general partner to acquire the property for the outstanding debt plus exit taxes. This option would allow the HFC to ensure affordability of the property past Year 15.


Travis County Housing Finance Corporation
Limited Liability Company
Landowner
Limited Liability Company
General Contractor
Limited Liability Company
General Partner
Limited Liability Company
Co-Developer