TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS

An Internal Audit of the Construction Cost Certification

Audit Report # 19-004

Executive Summary

The Office of Internal Audit (OIA) reviewed TDHCA's Construction Cost Certification function and its policies, procedures, and controls that are currently in place. Based on our reviews and testing the Asset Management has appropriate processes in place for the Construction Cost Certification function. We've identified some area for improvement, as described in the detailed report.

Findings, Observations, and Recommendations

- OIA recommends that Asset Management require developers to verify CPA firm's licenses validity, including any restrictions, before hiring the firm to perform the audit
- OIA Recommends that management consider establishing rules where the marketing Analysis and the CPA firm performing construction cost certification are not the same entity

Response:
Management agreed with our recommendations, and detailed responses are included in the body of the audit report.

Responsible Area:
Director of Asset Management

Objective, Scope and Methodology

Our scope included a review of the IRS §42, TDHCA's QAP, Asset Management's inernal control policies and procedures, as well as other applicable rules and regulations as they apply to LIHTC and Construction Cost Certification processes. Based upon our preliminary understanding of the Construction Cost Certification function we identified critical points and risk, to develop audit objectives and an audit program including methodology. The Texas Internal Auditing Act, Tex. Gov't Code §2102.005 requires testing of the controls of a state agency's major programs and systems, and the controls related to them.

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6/19/2019
Date Signed

June 19, 2019

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Board Members of the Texas Department of Housing and Community Affairs ("TDHCA")

RE: INTERNAL AUDIT REVIEW OF THE CONSTRUCTION COST CERTIFICATION FUNCTION

Dear Board Members:

This report presents the results of the Office of Internal Audit ("OIA") Review of the Construction Cost Certification function. This audit was included in the Fiscal Year 2019 Annual Audit Plan and was conducted in accordance with applicable audit standards. The Construction Cost Certification activity was identified during the 2019 Fiscal Year risk assessment due to its complexity of transactions and recent changes in management.

We reviewed the Asset Management Division's activities related to IRS§42 and Tax Credit certificates. Our scope included a review of the TDHCA's 2018 Qualified Allocation Plan (QAP), IRC section 42, and review of internal controls related to administration and processing of Construction Cost Certification documents and issuance of Tax Credit certificates. Based upon our preliminary understanding of the Construction and Cost Certification function, we identified critical points and risks, and developed our audit objectives and audit plan including methodology.

The amount of certified costs of a project determines the amount of tax credit funds which will be generated over a period of ten years. Therefore the cost certification process is a critical control for the Low Income Housing Tax Credit (LIHTC) program. We reviewed a report by the federal Government Accountability Office (GAO), dated September 2018. The GAO report described a nation-wide study of LIHTC costs, and other aspects of the program. According to the GAO report, Texas has the lowest cost per unit of the states reviewed.

Background

The IRC §42 Low Income Housing Tax Credit (LIHTC) was enacted by Congress as part of the Tax Reform Act of 1986 to encourage new construction and rehabilitation of existing buildings as Low-income rental housing for households within income at or below specified income levels. Under this act investors and developer are given incentives to make equity investments. In exchange for funding for projects, investors receive tax credits and other tax benefits associated with ownership of the project, such as losses and depreciation. Credits are claimed over a ten year period. The other tax benefits remain available as long as the ownership structure continues. These tax benefits, plus the possibility of cash proceeds from the eventual sale of the project, represent the investors' return on investment. The detail of the calculation of the Tax Credit amount is discussed in the later sections of this report.

According to IRC §42, the state agencies are responsible for determining which housing projects should receive tax credits and the dollar amount of tax credit allocated to each project. It also states that the state agencies must develop a Qualified Allocation Plan (QAP) that is approved by their governing body, and to be used for scoring and approval of each project during application and allocation process.

IRS requires the allocating agency to review the amount of Tax Credit at three points in time; application, allocation, and placed in service. For the purpose of this audit we reviewed the last phase of this process, which is also known as Construction Cost Certification process.

Asset Management division is responsible for the Construction Cost Certification function of the Low Income Housing Tax Credit (LIHTC) program at TDHCA. This includes oversight of properties and developers performances to ensure their compliance with objectives of TDHCA, as well as applicable rules and regulations set by IRS and any program related statutes. Asset Management is also responsible for issuance of IRS form 8609 (the Tax Credit certificate to the developers). TDHCA issues IRS form 8610 which is an annual form submitted to IRS at the end of each year that includes all IRS 8609s that have been issued during that calendar year.

Tax Credit Allocation

As noted previously, the state agencies are responsible for selecting which housing projects should be awarded tax credit, and the dollar amount of tax credit allocated to each project. Tax credits are awarded to eligible participants to offset a portion of their federal tax liability in exchange for the production or preservation of affordable rental housing. Investors in qualified affordable multifamily residential developments can use the LIHTCs as a dollar-for-dollar reduction of their federal income tax liability. Tax credit certificates are non-refundable. There are two types of Tax Credits: Competitive (9%) and Non-Competitive (4%). The 9% LIHTCs are designed to provide a 70% subsidy for developing or rehabilitating low-income units, and is based on industry estimates, and 4% LIHTC is providing a 30% subsidy.

The amount of credit the taxpayer can claim each year is determined as follows:

- Eligible Basis x Applicable Fraction = Qualified Basis
- Qualified Basis x Applicable Percentage = Annual Credit Amount

Eligible Basis is the total allowable cost associated with the depreciable residential rental project, which could be up to 130% of the actual costs if the building is located in a high cost area. **Applicable Fraction** is the portion of the rental units that are qualified as low-income units, and is determined as the lesser of square footage or number of units. The rent of low-income units must be restricted and cannot exceed 30% of the income limit applicable to the building location. **Applicable Percentage** is the percentage of basis that over the ten-year credit period provides credit amount equal to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing[1].

As a result of the Housing Assistance Act of 2008 Congress amended IRC§42 to provide a temporary minimum applicable percentage of 9% for new buildings regardless of the prevailing interest rate. In 2015 US Congress voted to permanently set 9% as minimum rate for applicable percentage. However, the 4% credit rate remained variable based on AFR. Tax credit calculations are discussed further towards the end of this report

Tax Credit Allocation Carryover

A project that has been awarded a competitive 9% tax credit allocation must be completed and occupied in the year that the allocation is received. However, it is common for the projects not to be completed and placed in service within that time frame. Therefore the state agencies issue **Carryover Allocations** that extended the required placed-in-service date to the end of the second calendar year after the allocation was issued. In order for a project to qualify for the carryover allocation a development must incur at least 10% of its anticipated costs within the calendar year in which the allocation was received.

Independent Auditor's Report

After completing the project (which has different deadlines depending on whether it is a 4% or 9% Tax Credit Property) the developers submit a packet to TDHCA that includes a certified report by an Independent Auditor who has reviewed the developer's eligible costs and financial records. This is known as Construction Cost Certification. Asset Management is responsible for reviewing the Construction Cost Certification packet and making recommendations to the Department's Executive Director for final approval of Tax Credit certificate.

The Construction Cost Certification is submitted to TDHCA in PDF and also Excel format for further review by Asset Management team. TDHCA has some built-in controls in the Excel spreadsheet formulas, such as maximum percentage of contractor's fees and developer's fees, to ensure that certain fees and costs are within TDHCA and underwriting rules. However, TDHCA doesn't seem to have any direct guidance in regard to selection of the CPA firm that performs the independent audit, nor does it provide instructions as to the process of the audit. The developers and CPA firms are instructed to refer to and follow IRS§42.

We reviewed and tested a sample of ten "Independent Auditor's report" and "Market Analysis" for each of the last three years. We found that in some cases the CPA firm that performed and provided the independent auditor's report was not licensed in the state of Texas. We also noted that in one instance the same entity provided both market analysis and the independent auditor's report for a project.

[1] 70% of the qualified basis of a new building that is not federally subsidized for the taxable year, and 30% of the qualified basis of all other buildings.

Issuance of IRS forms (8609 & 8610)

IRC §42 requires state agencies to submit annual reports to the IRS identifying the annual credit amount allocated to each building and project for the year, sufficient information to identify each building and the developer of each project, and other information needed for the administration of the program. The annual report is made by submitting IRS Form 8610, annual Low-Income Housing Credit Agencies Report, along with copies of the IRS Forms 8609 issued that year and Schedule A (Form 8610), and documenting credit carryover allocations, to the IRS by February 28th of the following year.

A copy of the signed IRS form 8609 for each building is forwarded to Multifamily Finance division (MF) at TDHCA, and the original is sent to the developer. Each year TDHCA prepares a Form 8610 for the IRS. This form reports all of the tax credits that were awarded for the year, which will be carried forward for ten years. The time between the award and the issuance of form 8609, the actual tax credit, varies. IRS Form 8609 will not be issued until the owner has provided evidence that all buildings have been placed in service by December 31st of the year the Commitment was issued or December 31st of the second year following the year the Carryover Allocation agreement was executed. TDHCA does not track the forms 8609 after that point.

Results

Our review of Asset Managements' procedures indicates that appropriate processes are in place for the Construction Cost certification function. We recommend that management establish procedures to ensure that the CPAs utilized by developers are in good standing with the Texas State Board of Public Accountancy (TSBPA).

Finding Item Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
19-004.01	OIA recommends that Asset Management require developers to verify CPA firm's licenses validity, including any restrictions, before hiring the firm to perform the audit	8/30/19	Rosalio Banuelos

Management response:

Finding Item Number 19-004.01 – Asset Management will implement the recommendation from OIA to require developers to verify CPA firm's licenses validity, including any restrictions.

Observation:

OIA Recommends that management consider establishing rules where the marketing Analysis and the CPA firm performing construction cost certification are not the same entity. Management agreed to evaluate the process further and discuss the recommendation with other divisions of the Department to determine if a change to the rules is warranted.

Tax Credit Computation

In this section we discuss computation methodology for calculating the tax credit allocations. The IRS prescribes from Section 42:

*"**Internal Revenue Code***
§42. Low-income housing credit
(a) In general
For purposes of section 38, the amount of the low-income housing credit determined under this section for any taxable year in the credit period shall be an amount equal to-
(1) the applicable percentage of
(2) the qualified basis of each qualified low-income building.
(b) Applicable percentage: 70 percent present value credit for certain new buildings; 30 percent present value credit for certain other buildings
(1) Determination of applicable percentage
For purposes of this section-
(A) In general
The term "applicable percentage" means, with respect to any building, the appropriate percentage prescribed by the Secretary for the earlier of-
(i) the month in which such building is placed in service, or
(ii) at the election of the taxpayer-
(I) the month in which the taxpayer and the housing credit agency enter into an agreement with respect to such building (which is binding on such agency, the taxpayer, and all successors in interest) as to the housing credit dollar amount to be allocated to such building, or
(II) in the case of any building to which subsection (h)(4)(B) applies, the month in which the tax-exempt obligations are issued.
A month may be elected under clause (ii) only if the election is made not later than the 5th day after the close of such month. Such an election, once made, shall be irrevocable.
(B) Method of prescribing percentages
The percentages prescribed by the Secretary for any month shall be percentages which will yield over a 10-year period amounts of credit under subsection (a) which have a present value equal to-
(i) 70 percent of the qualified basis of a new building which is not federally subsidized for the taxable year, and
(ii) 30 percent of the qualified basis of a building not described in clause (i).
(C) Method of discounting
The present value under subparagraph (B) shall be determined-
(i) as of the last day of the 1st year of the 10-year period referred to in subparagraph (B),
(ii) by using a discount rate equal to 72 percent of the average of the annual Federal mid-term rate and the annual Federal long-term rate applicable under section 1274(d)(1) to the month applicable under clause (i) or (ii) of subparagraph (A) and compounded annually, and
(iii) by assuming that the credit allowable under this section for any year is received on the last day of such year.
(2) Minimum credit rate for non-federally subsidized new buildings
In the case of any new building-

(A) which is placed in service by the taxpayer after the date of the enactment of this paragraph, and (B) which is not federally subsidized for the taxable year, the applicable percentage shall not be less than 9 percent."

The IRS program referred to as the "9%" tax credit program originally prescribed computing an amount of tax credits that would yield 70% of the qualified basis. The term 9% refers to an annual tax credit amount expressed as a percentage of the qualified basis. During the American Recovery and ReInvestment Act of 2008, a floor of 9% was set for the tax credit rate. This 9% floor was made permanent in 2015.

Based on our calculations, a 9% credit rate will yield 70% of the basis or greater until the applicable federal interest rate (or discount rate) rises to 7%. At that point, a tax credit rate of over 9% would be necessary to remain in compliance with Section 42.

The second tax credit scenario is the "4%" rate. For these noncompetitive tax credit deals, (where the tax credits pay for 30% of the qualified basis) the IRS calculates the "4%" tax credit rate on a monthly basis. The current tax credit rate is 3.25%.

Low-Income Housing Tax Credit Rates

The Internal Revenue Service each month publishes the credit percentages that apply to low-income housing tax credit buildings that are placed in service that month. There are two separate rates — one for 70% present value credit (PVC) and one for the 30% present value credit. NOTE: the 70% rate is currently fixed by statute at a floor of 9%. The 70% rate is available for low-income new construction and substantial rehabilitation expenditures that aren't federally subsidized (e.g.; funded with tax-exempt bond proceeds or with below market federal loans).

The maximum 30% rate applies to acquisition expenditures and to federally subsidized low-income new construction or substantial rehabilitation expenditures for low-income buildings.

LIHTC Rates[2]	*70% PVC*	*30% PVC*
June 2019	*7.59*	*3.25*
May 2019	*7.59*	*3.25*
April 2019	*7.63*	*3.27*
March 2019	*7.63*	*3.27*
February 2019	*7.64*	*3.27*
January 2019	*7.70*	*3.30*

[2] The monthly LIHTC rate are published by www.housingonline.com/resources/facts-figures/low-income-housing-tax-credit-rates

We performed re-computations of applicable tax credit rates and tax credit amounts. Based on our test sample, the computations of tax credits were accurate.

OIA extends our sincere appreciation to management and staff of the Asset Management Division for their cooperation and assistance during the course of this audit.

Sincerely,

Mark Scott

Mark Scott, CPA, CIA, CISA, CFE, MBA
Internal Audit Director

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