South Carolina Legislative Audit Council

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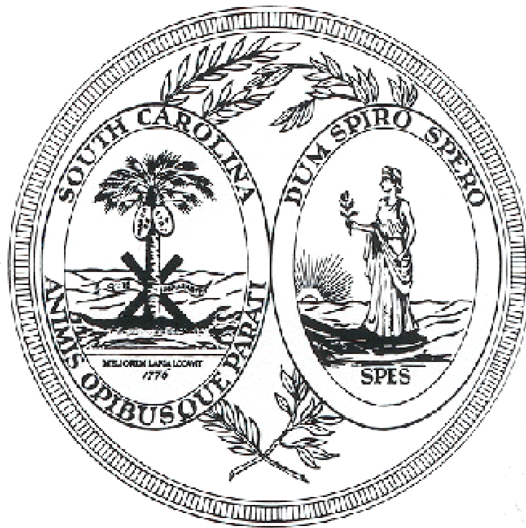
Report to the General Assembly

September 2001

A Review of the State Housing Finance and Development Authority's Low-Income Housing Tax Credit Program



Legislative Audit Council

1331 Elmwood Ave., Suite 315
Columbia, SC 29201
(803) 253-7612 VOICE
(803) 253-7639 FAX

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A Review of the State Housing Finance and Development Authority's Low-Income Housing Tax Credit Program was conducted by the following audit team.

Audit Team

Audit Manager
Priscilla T. Anderson

Senior Auditor
Walter C. Kannaday, III

Associate Auditor
Beverly T. Riley, CPA

Typography
Candice H. Pou
Maribeth Rollings Werts

Senior Legal Counsel
Andrea Derrick Truitt

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Synopsis

Members of the General Assembly requested that we conduct a review of the State Housing Finance and Development Authority's low-income housing tax credit program. The requesters were concerned about the authority's efforts to monitor compliance with program requirements and its role in reviewing and scoring applications for tax credits. In addition, the requesters asked us to determine whether the authority maximizes the use of tax credits. Our findings are summarized as follows:

- ❑ Authority staff has not provided adequate oversight to ensure that developers who successfully compete for tax credits comply with project plans and specifications. In evaluating proposals, the authority awards points based on the developer's plan to use certain materials and amenities. However, agency staff does not directly verify developer compliance with these requirements. We found that other states conduct on-site inspections of tax credit projects to verify compliance during the construction process.

- ❑ Developers are required to submit progress reports as a means to keep the authority informed about tax credit projects throughout construction. Developers have either not submitted reports or have submitted inaccurate reports to the agency. For instance, a developer submitted a progress report stating that foundations were being laid on the project site. However, following the developer's failure to complete the project and nine months after the report was submitted, an authority official confirmed that no foundations had been laid on the property. We concluded that the authority has not terminated tax credit projects and rescinded credits when it appeared that projects could not be completed.

- ❑ After a tax credit project is completed, the Internal Revenue Service requires the authority to monitor compliance regarding tenant rents, tenant incomes, and housing standards. The authority has adequately monitored compliance with these requirements.

- ❑ The authority has not maximized the use of tax credits. Developers who have failed to meet carryover (expend 10% of estimated development costs within six months) or failed to complete projects must return tax credits to the authority. Between 1998 and 2000, approximately $2.3 million in credits were returned. Of this amount, $475,000 was lost to a national pool and is no longer available to developers in South Carolina. In addition, there has been a steady increase in returned credits in recent years, from no credits returned in 1997 to four returns amounting to $1.4 million in calendar year 2000. This increase may be due to the lack of penalties against developers who fail to meet program requirements yet continue to participate in the tax credit program.

- We found that 46 of the 48 tax credit projects that were allocated credits in 1997 and 1998 were completed. Credits amounting to $710,336 were returned to the authority for the two failed projects. We concluded that authority staff did not adequately monitor these projects.

- In calendar year 2000, authority staff attempted to enforce penalties that would disqualify developers from participating in the tax credit program for two years if they failed to meet carryover and for three years if they failed to complete a project. However, because staff did not include these penalties in the agency's 2000 qualified allocation plan, the penalties would have been difficult to enforce.

- Tax credit projects tend to be located in areas of the state with high median incomes. An agency official stated that the rents that can be achieved in poorer areas of the state are often below allowable rents, making tax credit developments infeasible in these areas. We recommend that the authority evaluate alternatives and seek funding to reduce rental rates for the program in poorer areas.

- Market studies assess the economic viability of a project. In 1999, the authority began requiring developers to submit independent market studies. However, the agency does not clearly define what constitutes an unacceptable relationship between a developer and a market analyst.

- Since the authority does not retain denied applications, we were unable to compare criteria used in the scoring of denied and successful applications. The practice of not retaining records makes the agency vulnerable if decisions are legally challenged and does not allow the audit of records to ensure compliance with tax credit selection criteria.

Introduction

Background and History

The South Carolina State Housing Finance and Development Authority was created in 1971. The authority's mission is to promote and provide safe, decent, and affordable housing for the citizens of South Carolina. In addition to the low-income tax credit program which we review in this report, the authority administers several rental and home ownership programs.

The agency is governed by a seven-member commission which is appointed by the Governor with the advice and consent of the Senate. The Governor and the Commissioner of the South Carolina Department of Health and Environmental Control (or their designees) serve as ex officio members of the commission, with full voting powers.

As of the end of calendar year 2000, the authority employed 107 full-time staff. In FY 00-01, eight employees worked with the low-income housing tax credit (LIHTC) program.

Low-Income Housing Tax Credit Program

Congress created the LIHTC program in 1986. This program directs private capital towards the creation of affordable rental housing. The credits provide incentives by offsetting costs for development acquisition, new construction, or substantial rehabilitation. Title 26, Section 42 of the Internal Revenue Code requires each state to designate a "state housing credit agency" to administer the program. In 1987, then Governor Carroll Campbell designated the State Housing Finance and Development Authority as the agency to administer this program.

The authority does not receive direct appropriations to administer the program. Rather, program administrative costs are offset by developer application and monitoring fees collected by the authority. In FY 00-01 the program's estimated cost was about $358,000. The authority had collected approximately $624,000 in fees as of May 2001.

Rather than a direct federally-appropriated subsidy, the LIHTC program provides a tax credit to offset an investor's federal income tax liability. The credits are deducted on a dollar-for-dollar basis from the developer's federal tax liability. For example, a developer receiving $200,000 in low income tax credits may deduct $200,000 from his overall federal tax liability. The developer may deduct this amount each year for up to ten years.

The amount of tax credits a developer receives for a project is based on several factors, including the cost of the development, the type of development, and the number of qualified units. A state's allocation for the low-income housing tax credit program is based primarily on the state's population. For example in 1999, 99% of the allocation ($4,794,953 of $4,842,120) was based on population.

Until the end of calendar year 2000, the credit was based on $1.25 per state resident. In 2001, the credit increased to $1.50 per resident. (Beginning in 2002, the credit will again increase to the maximum of $1.75.) In 2001, South Carolina's available tax credit totaled approximately $7 million.

Federal law requires the authority to develop policies and procedures to administer the tax credit program in an annual qualified allocation plan. A qualified allocation plan becomes effective after public review and comment and upon the Governor's signature.

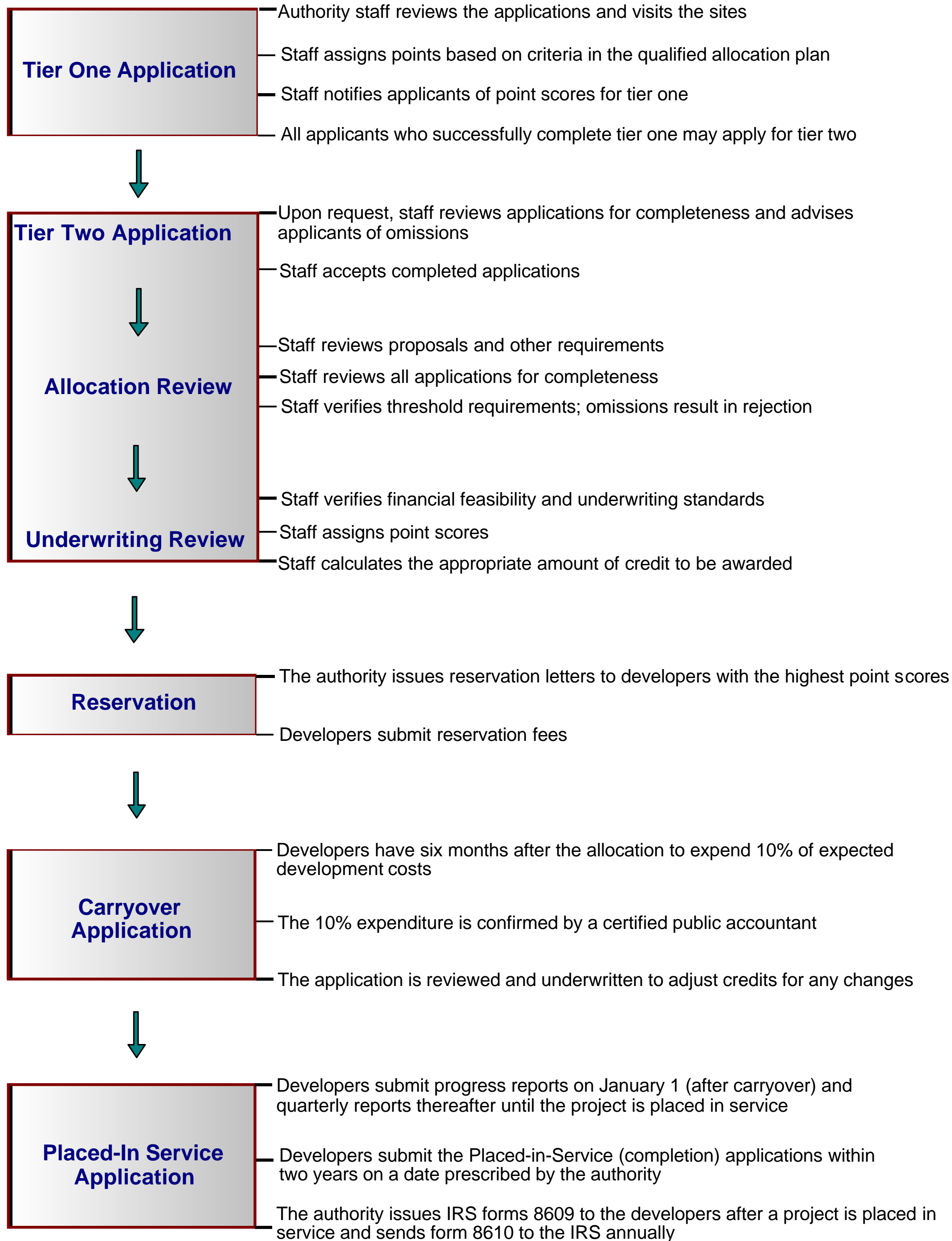
Program Administration

The authority informs developers about the availability of tax credits through public notices. Developers apply to the agency for proposed developments. Authority staff review and evaluate these proposals and assign a point score based on the qualified allocation plan. The agency then reserves credits for those developers that have achieved the highest point scores and publishes a list of developers. Although the agency has not established an appeals process, upon request developers and other interested parties are allowed to review the tax credit applications submitted. In about three months, agency staff send denied applications back to the developers that submitted them.

Developers who are reserved credits must submit a carryover application and receive an allocation of credits prior to year end. Developers must then expend 10% of estimated development costs within six months of receiving the allocation. Then, after receiving the allocation, the developers have two years to place the projects in service.

An outline of the LIHTC process in South Carolina follows.

Low-Income Housing Tax Credit Application Process



Between 1997 and 2000, approximately $19 million in low-income housing tax credits were reserved for 84 developments.

Table 1.1: Tax Credit Reservations and Applications from 1997 to 2000

Tax Year	Approved Applications	Tax Credit Reservations	Denied Applications
1997	27	$4,671,563	11
1998	20	4,299,736	20
1999	18	4,856,487	38
2000	19	5,485,431	41
Total	**84**	**$19,313,217**	**110**

Source: State Housing Finance and Development Authority.

Audit Objectives

Members of the General Assembly requested that we conduct an audit of the low-income housing tax credit program which is administered by the State Housing Finance and Development Authority. They were concerned about the authority's efforts to monitor compliance with program requirements, its role in reviewing and scoring applications, and whether the authority maximizes the use of tax credits. Our specific audit objectives follow.

- Determine how the authority ensures developer compliance with the tax credit program.
- Determine the adequacy of criteria used to review and score developer applications.
- Determine if the authority has administered the return of tax credits as required.
- Determine if developers who have been awarded tax credits have submitted independent market studies and audits.
- Determine the authority's ability to disallow developers from participation in the program when irregularities have been found.
- Determine how many projects approved for participation in the program were completed.
- Determine if tax credit projects have been targeted to the most needy areas of the state.

Scope and Methodology

This review was limited to operations of the low-income housing tax credit program. This program is administered on a tax year basis which coincides with the calendar year. The general period of our review was from calendar years 1997 through 2000.

We reviewed several types of records:

- Tax credit files.
- Agency qualified allocation plans.
- Compliance manuals.
- National standards for tax credits.
- Tax credit studies.

The agency's qualified allocation plans and regulations of the United States Internal Revenue Service were used to evaluate the authority's performance. Various samples were conducted during our review. For example, we sampled tax credit applications that were reserved credits to determine if the authority had monitored progress on tax credit projects. We interviewed authority staff, housing officials in other states, and officials of the National Council of State Housing Agencies.

This audit was conducted in accordance with generally accepted government auditing standards.

Oversight Issues

We reviewed the authority's oversight of the low-income housing tax credit program. In evaluating proposals, the authority awards points based on the developer's plan to use certain materials and amenities. However, authority staff does not directly verify developer compliance with these requirements. Also, authority staff has not monitored the status of tax credit projects when developers have not submitted required reports or have submitted reports which show little to no progress on projects. We found that the agency has complied with IRS monitoring requirements after a project has been placed in service.

Oversight of Project Plans and Specifications

The State Housing Finance and Development Authority has not adequately monitored developer adherence to project plans and specifications included in the agency's qualified allocation plan. In calendar year 2001, 651 points were available to developers in many categories including project location, county median income, the proposed number of apartment units, and construction amenities and materials. 120 (18%) of the 651 points were based on construction materials that *would be used* or amenities that *would be installed*. (Examples of materials and amenities are shown in Table 2.1.) Although authority staff scores applications and consequently reserves and awards tax credits based on this information, staff does not directly verify developer compliance. Housing officials in other states conduct on-site inspections to verify that developers have complied with the plans they submit in their tax credit applications.

Table 2.1: Examples of Tax Credit Point Allocations for Construction Materials and Amenities

Materials	Points	Amenities	Points
Interior doors that are six-paneled colonist, or solid core birch, or solid core lauan.	4	All grass areas must be sodded.	4
All interior cabinets to be solid wood or wood/plastic veneer products with dual slide tracks on drawers.	4	Garbage disposal in all units.	4
Architectural, dimensional anti-fungal shingles or equivalent.	10	Dishwasher in all units.	4

Source: 2001 Qualified Allocation Plan.

The authority requires developers to use the services of an architect or an engineer to certify the use of certain materials and the installation of particular amenities. The architect or engineer submits the first certification with the developer's application. In this certification, he or she attests that the project *will be constructed* according to the specifications contained in the application. Before the project is placed in service, the architect or engineer submits a second certification attesting that the project *has been constructed* according to the application.

Direct agency oversight of developer compliance with plans and specifications is needed since these points may determine which developers receive tax credits. Like South Carolina, Alabama and Mississippi require certification of compliance by persons including architects and engineers. However, agency staff in these states also conduct on-site inspections of ongoing tax credit projects. Officials in Alabama and Mississippi told us that agency inspections are important to confirm that developers have met their commitments. In addition, the official in Mississippi stated that agency oversight is needed since the architect may not review details to confirm that the developer has completed all requirements noted in the application. According to housing administrators in Georgia, Kentucky and North Carolina, agency personnel conduct on-site inspections at various phases of project construction to ensure compliance with plans and specifications.

. . . authority staff does not verify that developers are constructing projects according to their tax credit applications . . .

When authority staff does not verify that developers are constructing projects according to their tax credit applications, there is less assurance of developer compliance. Furthermore, because these proposals are used to score applications and to ultimately award tax credits, the fairness and integrity of the tax credit program may be compromised.

Recommendation

1. The State Housing Finance and Development Authority should conduct on-site inspections to verify developer compliance with tax credit applications.

Progress Reports

The qualified allocation plan provides that developers who are reserved tax credits are to submit progress reports beginning January 1 and quarterly thereafter for two years until a tax credit project is completed. The progress reports provide the date that construction begins, the percentage of the work that has been completed at a given time, and a proposed date of occupancy. A developer's representative signs the reports, certifying that the information submitted is accurate.

Developers have either not submitted progress reports or have submitted inaccurate reports to the authority.

We found that developers have either not submitted progress reports or have submitted inaccurate reports to the authority. In addition, the agency has not adequately followed up with developers on the reports when there appeared to be a question about the developer's ability to complete a project based on the progress made and the time remaining.

We reviewed reports for developers who were reserved tax credits in 1999 and for a developer who failed to complete two projects in 2000. Our findings are discussed in detail below.

Reserved Credits

In calendar year 1999, the authority reserved approximately $4.9 million in tax credits for 18 projects. We reviewed the six quarterly progress reports (January 2000 through April 2001) that were due for these projects and found the following:

- Eleven (65%) of the 17 developers did not submit all 6 of the required reports.

- On the fifth progress report, two developers wrote that only 15% and 20% of construction had been completed. Neither of these developers submitted a report for the sixth quarter.

- At the end of the first of the two years allowed for project completion, four developers reported that their construction loans had not closed. Although three of these developers indicated that no work had been performed, only one of the developers submitted a report for the next quarter. This report indicated that no additional work had been completed.

Failed Projects

Two projects which were not completed were both awarded tax credits in 1998 and involved the same developer. This developer did not make progress reports as required and submitted reports on one of the projects which did not reflect the development's actual status. Our review indicated the following:

- In calendar year 1999, the developer did not submit any of the four progress reports for either project.

- In the July 2000 progress report for one of the projects, the developer stated, *"All site work has been completed and foundations are being laid as we speak."* However, in March 2001 (three months after the project was to be completed and nine months after the July 2000 report), a housing official confirmed that no foundations had been laid on the property.

The authority has not taken the initiative to follow up with developers when minimum progress is indicated on progress reports.

- For the same project and in the same report, the developer stated that the loan had not closed. This meant that the construction loan had to close and a 72-unit project had to be constructed in three months. The project was not completed as required and tax credits were returned to the authority. In 2001, the developer reapplied for credits for this project (see p. 15).

- In the July 2000 report, the developer indicated that none of the work had been completed and the loan had not closed on a second project that was to be completed in October 2000.

Agency Follow-Up

The authority has not taken the initiative to follow up with developers when minimum progress is indicated on progress reports. Agency staff told us that tax credit projects are permitted to proceed for the entire two years allowed for completion regardless of the progress cited on the reports. However, we identified one case in which the authority terminated a project before it was scheduled for completion.

Additionally, an authority official stated that the agency contacts developers when reports are not submitted. In our review of these reports, we found no evidence that the authority contacted these developers.

According to an employee of the Alabama Housing Authority, if minimum progress has been made on a development, staff either contacts the developer or conducts an on-site inspection of the property. A housing official in Virginia stated that when completion of a project is questionable by spring of

the second (last) year allowed for construction, the agency requests documentation from the developer regarding completion. This official stated that this procedure has been used on two occasions. In one case, the developer provided the information and the project was completed on time. The second case was ongoing during our review. However, the official told us that if information is not provided, the tax credits must be returned to the agency. Finally, a housing official in Mississippi stated that if construction for a tax credit project is not proceeding as scheduled in 15 months, the developer is either penalized or tax credits are rescinded.

Conclusion

Progress reports are a means to keep the authority informed about tax credit projects throughout construction. When the agency does not follow up with developers on reports, projects may not be placed in service as scheduled. This can result in delays in the construction of affordable housing in the state. In addition, the state may lose tax credits when projects are not completed (see p. 14).

Recommendations

2. The State Housing Finance and Development Authority should follow up with developers when progress reports are not submitted in a timely manner and/or when reports show minimum progress on tax credit projects.

3. The authority should implement a policy that identifies situations and establishes time periods which warrant terminating a tax credit project before it is scheduled to be completed.

IRS Monitoring Requirements

We found that the authority has adequately monitored compliance with requirements established by the United States Internal Revenue Service (IRS) after a tax credit project is placed in service. The Internal Revenue code requires the agency to ensure that tax credit developments comply with program requirements for at least 15 years. During calendar years 1996 and 1997, the authority reviewed at least 20% of all developments awarded tax credits in any given year to ensure that tenant rents and income do not exceed maximum amounts established by the U.S. Department of Housing and Urban Development (HUD). The authority must also ensure compliance with HUD housing quality standards. The agency’s compliance staff conduct on-site visits to verify these requirements.

Authority staff must notify a developer of any noncompliance found and allow the developer 90 days to correct the deficiencies. The developer is to provide a notarized statement that noncompliance has been corrected within this period. According to an IRS official, the housing credit agency has discretion regarding which noncompliance cases will be reported to the IRS. An authority official stated that record-keeping deficiencies that are not corrected and repairs which pose a safety or health threat to residents are reported to the IRS.

We reviewed the authority's oversight of IRS requirements for 26 (55%) of 47 of the projects awarded tax credits in calendar years 1996 and 1997. We found adequate documentation regarding HUD income and rent limits and physical inspections in each of the files reviewed. Our review also indicated that the authority notified each developer of the results of the review and that the developer provided a statement that deficiencies had been corrected when noncompliance was found. The authority notified the IRS of noncompliance in only one of the cases we reviewed. In this instance, there was inadequate documentation regarding a tenant's income eligibility.

Administrative Issues

We reviewed issues regarding the authority's administration of the tax credit program. The authority has not implemented penalties against developers who do not meet program requirements. These and other findings relating to program administration follow.

Returned Tax Credits

The authority has not maximized the use of tax credits. Returned credits are generally reallocated to other developers. However, in 2000, the authority lost almost $500,000 in credits to a national pool, and these credits are no longer available to developers in the state. In addition, we found that the amount of returned credits has steadily increased in South Carolina in recent years.

A developer must return tax credits to the authority when he or she fails to make carryover or to complete a project. From calendar years 1998 to 2000, developers returned approximately $2.3 million in tax credits to the authority (see Table 3.1).

Table 3.1: Tax Credits Returned to the Authority — 1998 to 2000

Year Credits Returned	Reason for Return	Amount of Returned Credit by Project
1998	Project Not Completed	$265,400
1999	Did Not Meet Carryover	500,000
1999	Voluntary Return*	140,989
2000	Project Not Completed	261,633
2000	Project Not Completed	448,703
2000	Did Not Meet Carryover	451,135
2000	Did Not Meet Carryover	219,251
Total		**$2,287,111**

* These credits were returned after the developer determined that other tax credit developments served the area.

Source: Authority tax credit records.

. . . the authority lost almost $500,000 in credits to a national pool, and these credits are no longer available to developers in the state.

Credits to the National Pool

The Internal Revenue Service requires state housing agencies to return unused tax credits from carryovers to a national pool. Until 2001, the IRS allowed a state to carry forward unused credits to the next year to be allocated within that year. Any credits that were carried forward but not allocated within the year would be lost to the pool. (As of 2001, IRS allows states two years to allocate credits before losing them to the national pool.) Tax credits that a state loses to the national pool are not available to that state, but rather go to other qualifying states. A state is qualified for more tax credits if that state has used all of its tax credit allocations.

In calendar year 2000, the authority was required to return $475,000 in tax credits to the national pool as the result of failed carryovers in 1999 and 2000. Even though all of the 1999 tax credits that were carried forward were awarded during 2000, another developer did not meet carryover on two projects at the end of 2000. As a result, South Carolina lost the $475,000 in tax credits, and these credits are no longer available to developers in the state. Instead, they will be redistributed to other qualifying states.

We contacted officials in housing agencies in eight southeastern states — Alabama, Georgia, Florida, Kentucky, Mississippi, North Carolina, Tennessee, and Virginia — to determine if they have lost credits to the national pool due to failed carryovers. Five of these states (Alabama, Georgia, Kentucky, North Carolina, and Tennessee) assess penalties against developers who return credits for failure to meet carryover. Officials in seven of the states told us that they have lost no credits to the national pool. An administrator of the Kentucky Housing Corporation stated that no credits have been lost since at least 1994.

Increase in Returned Credits

From 1997 to 2000, the amount of returned credits increased from $0 to $1.4 million while the number of projects with returned credits increased from zero to four (see Table 3.2). These increases may be due in part to the lack of penalties against developers who have returned credits.

Table 3.2: Returned Tax Credits — 1997 to 2000

YEAR RETURNED	AMOUNT RETURNED	NUMBER OF PROJECTS
1997	$0	0
1998	$265,400	1
1999	$640,989	2
2000	$1,380,723	4

Source: Authority tax credit records.

Developers have been allowed to reapply for both previous and new tax credit projects immediately after they have failed to make carryover or to complete a project. For example:

- In 2001, a developer who failed to meet carryover on two projects in 2000 reapplied for tax credits for one of the failed projects and six other projects. As of May 2001, authority staff had eliminated two of the six new applications. The application for the failed project was still being considered.

- A different developer who returned tax credits for failure to complete two projects in 2000 reapplied for credits for one of the failed projects and two other projects in 2001. As of our review, the authority had rejected the project that previously failed along with one of the new projects. The remaining development was still being considered for credits.

In 2000, agency staff attempted to implement penalties against developers who did not meet carryover or complete a project. However, staff did not follow required procedures and the penalties would have been difficult to enforce (see p. 16).

The Georgia Housing and Finance Authority does not allow developers who have returned credits to participate in the tax credit program for one year. In Alabama, Kentucky, and Tennessee, developers are allowed to apply the following year, but negative points are assessed up to two years. North Carolina imposes negative points against future applications for ten years.

Developers have little incentive to meet state tax credit requirements when they can immediately re-apply for the credits and are not otherwise penalized for failed or incomplete projects. The authority's lack of controls in this area can result in the loss of tax credits or in delays in housing construction due to the need to reallocate credits.

Recommendation

4. The State Housing Finance and Development Authority should implement penalties against developers who fail to make carryover or fail to complete tax credit projects.

Completed Projects

We reviewed 48 (100%) of the projects that were allocated tax credits in calendar years 1997 and 1998 to determine how many of these projects were completed within the required two years. Our review indicated that 46 of the 48 projects were completed.

Reserved tax credits of $710,336 for the two unfinished projects were returned to the authority in 2000 to be reallocated in 2001(see Table 3.3). In both cases, with three months remaining to complete the projects, the developer had not closed either construction loan. We concluded that the two projects were not adequately monitored by authority staff (see p. 10).

Table 3.3: Incomplete Tax Credit Projects

Project	Credits Returned to the Authority in 2000
#1	$448,703
#2	261,633
Total	**$710,336**

These projects had the same developer.

Source: Authority tax credit records.

Program Disqualification

One of our audit objectives was to determine if the authority has disallowed developers from participating in the tax credit program due to irregularities. The agency has attempted to disqualify two developers from participation. However, because staff did not follow proper procedures, these developers continue to participate in the program.

In June 2000, after tax credit applications were reviewed and scored, authority staff informed developers who had successfully competed for tax credits that credits had been reserved for their project(s). In a letter, the authority also informed developers of conditions which would disqualify them from future participation in the tax credit program. Specifically, developers who did not meet carryover would not be able to participate in the tax credit program for two years, and developers who did not complete projects by 2002 would not be able to participate in the program for three years. The developers were required to sign and return a statement agreeing to these conditions. However, this process did not comply with procedures for notifying developers of such changes.

The agency has attempted to disqualify two developers from participation. However, staff did not follow proper procedures.

IRS regulations require state housing credit agencies such as the authority to include provisions for the housing credit program in a qualified allocation plan. The qualified allocation plan is subject to public review and a comment period and requires approval by the Governor before it becomes effective. Since the penalties for developers were not included in the authority's qualified allocation plan, they would have been difficult to enforce. The situations in which the authority attempted to disallow participation are described below.

Failure to Meet Carryover

On June 22, 2000, the authority reserved $670,386 in tax credits for two developers who were general partners on two tax credit projects. In July 2000, by signing and returning a reservation certificate and providing a reservation fee to the authority, the principal developer agreed to penalties for failure to meet carryover or to complete a tax credit project. Then, at the end of the calendar year, the developers failed to meet carryover on both of the projects. As a result, in January 2001, the authority notified the developers that they would not be able to participate in the tax credit program for two years.

One of the developers immediately challenged the authority's decision. A letter written on behalf of this developer stated that the authority had:

> Implemented banning provisions without going through the proper procedures and implemented such procedures in mid-stream after the Plan [the qualified allocation plan] had been published without the banning provisions.

Consequently, in March 2001, the authority's executive director rescinded the decision to disqualify the developers from program participation. The director in a letter stated:

> . . . it has been determined that . . . notice of the imposition of debarment penalty for failure to achieve carryover . . . had to be given at the beginning of the 2000 Tax Credit Program. Since timely notice was not properly given, I have concluded that the debarment penalty cannot be properly imposed.

The developer who challenged disqualification then applied for seven tax credits including one of the failed projects (see p. 15). The second developer was still a general partner on this project.

A February 2001 memo from an authority official stated that the agency's 2001 qualified allocation plan was to be amended to allow participation of developers who did not meet carryover in 2000. However, as of July 2001 (at the end of another tax credit cycle), agency staff had not revised the qualified allocation plan to allow these developers to participate in the program or to disallow developers who do not meet carryover in 2001 from participating in 2002.

Other states (Alabama, Georgia, Kentucky, North Carolina and Tennessee) assess negative points against future tax credit applications or disallow participation in the program due to developer failure to meet carryover or complete a tax credit project (see p. 15). In this review, we found that the return of tax credits due to these situations have steadily increased. This has resulted in the loss of almost half a million dollars in tax credits.

Recommendation

5. The State Housing Finance and Development Authority should establish penalties for developers which include the assessment of negative points or program disqualification for failure to meet carryover.

Project Locations

Tax credit projects tend to be located in areas of the state with higher median incomes. We found that 28 (33%) of the 84 tax credit projects awarded between 1997 and 2000 are located in four counties of the state — Charleston, Greenville, Horry, and Spartanburg. Three of these counties have relatively high median incomes (see Table 3.4). In addition, authority officials stated that factors such as achievable rents impact the construction of tax credit projects in these counties as opposed to other counties in the state. An official stated that the rents that can be achieved in poorer areas of

. . . 28 (33%) of the 84 tax credit projects awarded . . . are located in four counties of the state.

the state are often below allowable rents, making tax credit developments infeasible in these areas.

The authority has awarded points or prioritized locations for tax credit programs based on factors including counties with lower median incomes and counties where tax credit projects have not been recently awarded. However, regardless of the county, the maximum allowable rent for tax credit projects are based on 30% of the annual income limits. Using this method, in 2000, the maximum allowable rent on a two-bedroom unit for a family of three with an annual income of $21,780 in Lee County (the county with the lowest median income in the state) was $545 a month.

Table 3.4: Number of Tax Credit Projects By County 1997 – 2000

County	2000 Median Income	Projects		County	2000 Median Income	Projects
York	$57,100	1		Chester	$42,200	2
Beaufort	$53,400	5		**Horry**	**$42,100**	**6**
Lexington	$51,100	1		Newberry	$42,000	2
Richland	$51,100	2		Saluda	$41,300	0
Anderson	$48,700	2		Darlington	$40,000	1
Cherokee	$48,700	2		Union	$39,800	1
Greenville	**$48,700**	**6**		Calhoun	$38,200	0
Pickens	$48,700	2		Chesterfield	$37,800	0
Spartanburg	**$48,700**	**6**		Sumter	$37,800	4
Barnwell	$48,400	3		Orangeburg	$37,700	1
Aiken	$46,600	1		Colleton	$37,500	2
Edgefield	$46,600	3		Marlboro	$37,500	1
Lancaster	$45,400	3		Georgetown	$36,500	1
Greenwood	$45,000	1		Hampton	$34,700	0
Oconee	$44,900	0		Jasper	$34,500	0
Berkeley	$44,600	0		McCormick	$34,100	0
Charleston	**$44,600**	**10**		Marion	$33,300	1
Dorchester	$44,600	1		Williamsburg	$32,500	2
Kershaw	$44,000	1		Dillon	$31,200	1
Fairfield	$43,300	0		Bamberg	$31,000	0
Florence	$43,100	3		Clarendon	$30,800	2
Laurens	$43,000	1		Allendale	$29,800	1
Abbeville	$43,000	1		Lee	$29,100	1

Sources: United States Department of Housing and Urban Development (HUD) and authority data.

Authority staff told us that Housing Trust Funds (a state-funded program to develop affordable housing) were used to provide services to under-served areas and to lower rents on tax credit projects prior to 1998. These officials did not know why these funds are no longer used. Finally, in May 2000, an authority employee proposed that additional funds be budgeted for use in conjunction with the tax credit program to reduce rents. In a memo, the employee stated that these funds could create opportunities for the development of tax credit projects in under-served rural areas. This proposal was presented to the finance committee of the agency's commission but not to the full commission, and no action was taken.

According to authority officials, $4 million in HOME Funds (a federal program which assists households at 80% or below the county median income) will be allocated to help lower rents on tax credit units in 2001. However, agency officials stated that additional funds are needed to provide tax credit housing to other parts of the state.

To reduce rents on tax credit projects, the North Carolina Housing Finance Agency uses funds from programs including HOME and the Housing Trust Fund. A manager with that office told us that these funds have allowed the construction of tax credit projects in poorer areas of the state.

An authority official told us that a Request for Proposal (RFP) to determine the state's housing needs will be issued by the Budget and Control Board's Office of General Services. The tentative publication of this assessment is November 2001. An assessment of housing needs, in conjunction with the identification and use of additional funds to supplement rental fees for the tax credit program, would help to ensure that affordable housing is available to all citizens in South Carolina.

Recommendation

6. The State Housing Finance and Development Authority should evaluate alternatives and seek funding to reduce rental rates for the tax credit program in poorer areas of the state.

Audits and Market Studies

One of our audit objectives was to determine whether developers who have been awarded tax credits have submitted independent audits and market studies. Developers must submit cost certifications that are prepared by an independent certified public accountant (CPA) at different stages throughout the tax credit process. We investigated an allegation regarding the independence of a particular CPA and a developer. An examination of public records and other data showed no evidence to suggest that there was a problem with the independence of the CPA.

In addition, the authority currently requires a developer to submit an independent market study which addresses the needs of the market area and the ability of the community to support a proposed tax credit project. We concluded that the authority has not clearly defined standards for independent market studies.

Prior to 1999, the authority did not prohibit developers from using market analysts that they were associated with. A developer was only required to disclose an "identity of interest" with an analyst. An identity of interest generally involves financial interests between the developer and another party.

In 1998, we found that a developer used a market analysis firm which listed him as its "registered agent," the person designated to receive any lawsuit or other official communication on behalf of the firm. The developer did not disclose this relationship to the authority. Then, after the authority began requiring independent market studies in 1999 (which were also subsequently required by Congress at the end of 2000), this developer hired a different firm to conduct two market studies. An authority official told us that it was unclear whether the developer's relationship with the first company constituted an identity of interest.

Market analysts assess the economic viability of a proposed tax credit project. When independent studies are not conducted, there is increased risk of project failure.

Recommendation

7. The South Carolina Finance and Development Authority should clearly define standards of independence for market studies, including acceptable relationships between developers and market analysts.

Retention of Tax Credit Records

One of our audit objectives required us to examine criteria that the authority uses to review and score tax credit applications. In the review we attempted to compare developer applications that were denied tax credits to those in which tax credits were reserved. Since the authority does not retain denied applications, we were unable to conduct this portion of our review. The practice of not retaining denied tax credit applications makes the agency vulnerable to liability issues if cases are legally challenged. Also, this practice does not allow the audit of these records to ensure agency compliance with tax credit selection criteria.

. . . not retaining denied tax credit applications makes the agency vulnerable if cases are legally challenged.

Prior to 2001, the general time lines for selection of developers for the tax credit program included the following:

- mid-April — The authority accepted tax credit applications from developers.
- April–June — The authority reviewed and scored applications to determine which developers would be reserved tax credits and which applications would be denied.
- June — The authority published information on developers receiving tax credit reservations.
- July–September — Developers and other interested parties were allowed to review tax credit applications.
- **September —** ***The agency sent each denied application back to the developer that submitted it.***

All of the eight states that we contacted retain unsuccessful tax credit applications beyond the three months that these records are retained in South Carolina. Record retention in these states ranged from two years to permanently.

According to a housing authority official, denied applications are not retained due to storage problems. One of the primary missions of the South Carolina Department of Archives and History is to assist state agencies in records management, including storage. Department analysts work with agencies to develop record retention schedules. These services are provided to an agency at no charge. We reviewed an index of housing authority records stored at the Department of Archives and History which indicated that no tax credit records are presently stored.

The authority should retain tax credit records for legal and auditing purposes. Because the agency has not retained denied applications, the authority may be vulnerable if developers seek resolution through the legal system. Additionally, because records have not been retained, we were unable to compare applications that were awarded tax credits to those that were denied credits. As a result, there is less assurance that policies and procedures to determine awards have been followed.

Recommendation

8. The State Housing Finance and Development Authority should work with South Carolina Department of Archives and History officials to arrange for storage of tax credit records and to develop a retention schedule for records, including denied applications.

Agency Comments

South Carolina State Housing Finance and Development Authority

919 Bluff Road, Columbia, South Carolina 29201

Telephone: (803) 734-2000 TTY: (803) 734-2369

www.sha.state.sc.us

Dan J. Rawls
Chairman

David M. Leopard
Executive Director

September 5, 2001

Mr. George L. Schroeder, Director
Legislative Audit Council
1331 Elmwood Avenue, Suite 315
Columbia, South Carolina 29201

Dear Mr. Schroeder:

Enclosed are our final comments in response to your final draft report, "A Review of the State Housing Finance and Development Authority's Low Income Housing Tax Credit Program." Our comments have been forwarded via e-mail also, as you requested.

Thank you for the professional and courteous manner in which the audit was conducted.

Sincerely,

David M. Leopard

Enclosure

Recommendations

1. The State Housing Finance and Development Authority shall conduct on-site inspections to verify developer's compliance with Tax Credit applications.

   Response: Agree. As part of the 2001 Qualified Allocation Plan, the Authority has added Section II (A) (1) Development Progress Requirements to establish timelines by which the development will progress to completion. The Authority will track developments via progress reports and by physical inspection of the developments during the construction period. The Authority will utilize staff to inspect the development or contract out the inspections as necessary.

2. The State Housing Finance and Development Authority should follow up with developers when progress reports are not submitted in a timely manner and/or when reports show minimum progress on Tax Credit projects.

   Response: Agree. The Authority has implemented the above recommendation. As part of the 2001 Qualified Allocation Plan, the Authority has added Section II (A) (1) Development Progress Requirements to establish timelines by which the development will progress to completion, as well as Progress Report requirements.

   The Tax Credit Program itself is self-regulating and the Authority has relied on this fact in its implementation of the program. Once the credits are reserved, carryover and the 10% expenditure test are met, developers have up to two years to complete the construction and place the project in service in order to be entitled to the credits, as defined in Section 42 of the Internal Revenue Code. In the past, the Authority has relied more heavily on the governing statutory provision than on progress reports. The Authority has remained informed on the progress of developments whether documented by progress reports or not. The lack of or inaccuracy of a progress report has not been the cause of the Authority losing tax credits. It has been the practice of the Authority to allow Tax Credit projects to proceed for the entire two years allowed for completion regardless of the progress cited on the report. The one exception that the LAC cites, as discussed in the Agency Follow-Up section on page 10 of the report, was not the result of questioning a progress report. Rather, the process that led to the credits being returned was initiated by the developer when the actions of the local governmental unit made it impossible to complete the project within the 24-month period allowed by Section 42.

3. The Authority should implement a policy that identifies situations and establishes time periods that warrant terminating a Tax Credit project before it is scheduled to be completed.

Response: Agree. As part of the 2001 Qualified Allocation Plan, the Authority has added in Section II (A) (1) Development Progress Requirements to establish guidelines for the development to progress to completion, as well as Progress Report requirements. These guidelines clearly establish when and under what circumstances a Low Income Housing Tax Credit allocation will be cancelled.

4. The State Housing Finance and Development Authority should implement penalties against developers who fail to make carryover or fail to complete Tax Credit projects.

Response: Agree. The Authority has implemented the above recommendation. As part of the 2001 Qualified Allocation Plan, the Authority has added in Section I *LIHTC Program Disqualification* language that specifically provides debarment language for not meeting carryover and the 10% expenditure test and for not placing in service a Tax Credit development.

5. The State Housing Finance and Development Authority should establish penalties for developers, which include the assessment of negative points or program disqualification for failure to meet carryover.

Response: Same as No. 4 above.

6. The State Housing Finance and Development Authority should evaluate alternatives and seek funding to reduce rental rates for the Tax Credit Program in poorer areas of the State.

Response: Agree. Much is being done to address this complex issue. It is important to recognize that, when given a choice, developers are drawn to the areas with greater populations and higher incomes. This should be expected as these areas present less risk to a rental property. In fact, the greater incentive to pursue developments in the four counties cited (Greenville, Spartanburg, Charleston, and Horry) may have more to do with populations than with median incomes. These four counties ranked 7th, 9th, 17th, and 25th, respectively, in the table of descending median incomes (Table 3.4) in the LAC report. These are four of the most populous counties in the State. Urban areas have a much larger, more concentrated tenant population that reduces vacancy risk and may in itself drive up demand for units and result in higher achievable rents. Because development costs are relatively the same across the State (with the exception of land costs), there is little incentive for a developer to build in rural areas.

Response Continued:
The Authority has taken steps to prioritize other locations in an effort to more widely distribute the credits across the State. Point incentives have been established to encourage development in other areas and, each year, we place limits on the number of developments to be awarded in any one county. In the 2001 Tax Credit competition, we awarded additional points to developments in counties that had received no award in the previous two years.

Because a limited amount of soft money (grants, very low interest loans) is available for use with Tax Credits, we must be careful not to drive developments into areas where there is not an adequate tenant or income base to support a Tax Credit property. There are many areas of the State where Tax Credit developments would be difficult, if not impossible, to maintain.

We have contracted for a statewide housing needs assessment study and expect the data gathered to provide a clearer picture of the housing needs and feasibility of development in all areas of the State. This study should provide information on the need (demand) for additional units or upgrade of existing units, the tenant population to serve, and the achievable rents for all areas of the State. We expect that information collected on achievable rents will allow us to determine which areas need additional subsidy (grants, very low interest loans) and the extent of the needed subsidy. The needs assessment is expected to provide guidance to the Authority on the best use of such additional subsidies as may become available to be combined with Tax Credits.

The challenge of delivering Tax Credit developments to rural areas of the State is not limited to South Carolina. The National Council of State Housing Agencies is sponsoring national legislation to allow the usage of the state median income in rural areas as opposed to the lower county medians. Additionally, although not included in the last tax bill, consideration has been given to the establishment of a national housing trust fund to be utilized with Tax Credit development.

It is important to note the efforts the Authority has made to promote further development of Tax Credit developments in rural areas. For the past several years, a set-aside has been created for the exclusive use of Rural Housing Service (formerly Farmers' Home Administration) developments. This past year we increased the Rural Housing Service set-aside to $500,000. This partnership with Rural Housing Service ensures the funding of Tax Credit developments in rural areas.

Response Continued:
The Governor's Affordable Housing Task Force has recognized the difficulty of affordable housing development in rural areas as a top issue and is proposing the adoption of a State Tax Credit designed to work with the Federal Credit to lower rents in the rural areas.

7. The South Carolina State Housing Finance and Development Authority should clearly define standards of independence for market studies, including acceptable relationships between developers and market analysts.

Response: Agree. In 1999, the Authority imposed the requirement that independent third parties conduct market studies. Furthermore, as part of the tax bill passed in December of 2000, it is now a statutory requirement that market studies be conducted at the expense of the developer by a "disinterested" party as defined in Section 42 of the Internal Revenue Code at 42(m)(1)(A)(iii).

8. The State Housing Finance and Development Authority should work with South Carolina Department of Archives and History officials to arrange for storage of Tax Credit records and to develop a retention schedule for records, including denied applications.

Response: Agree. The Authority has a retention schedule in place for Tax Credit records but has not historically included denied applications because of the volume of the documents. Also, because these applications are expensive to produce, developers have preferred to have them returned. Effective immediately, the Authority will retain all applications. We have contacted the Department of Archives and History and are establishing a retention schedule for denied applications, as well.

General Comments

Loss of Credits to the National Pool

The loss of Tax Credits to the national pool was a result of two developments that did not meet the requirements to receive a carryover allocation. Neither of the properties met the carryover requirements due to the developers' failure to take control of the property. According to the 2000 Tax Credit Manual, in order to qualify for a Tax Credit allocation, the transfer of the property must have occurred by December 31, 2000.

General Comments (Continued)

The key to preventing the loss of credits in this case would have been for the Authority to receive the unused credits back in time to award them to other developments. The Authority did not believe that it had the right to demand the credit back before the December 31 deadline contained in Section 42. The developer was not able to secure the property before the December 31, 2000, deadline.

It should be noted that Congress changed the Housing Credit Stacking Rule with the Tax Credit bill that passed in late 2000. Under the new Housing Credit Stacking Rule, these credits would not have been lost; unfortunately, the changes became effective starting in 2001, one year too late to prevent the loss of credits in this instance.

The Housing Credit Stacking Rule determines the order in which the credit components that make up a state's available credit are distributed. Each state's annual housing credit ceiling is made up of four components. These components are:

1) **Population** component (for 2000 = $1.25 x the state population)
2) **Returned Credit** component (credit returned or reduced for years prior to the current year)
3) **Unused Carry-forward** component (credit turned in before receiving an allocation)
4) **National Pool** component (unused credit turned in for distribution among eligible states)

Before the change, the Housing Credit Stacking Rule provided that a state allocate its per capita and returned credits *before* allocating its carry-forward and national pool credits. Any unused carry-forward credits were lost to the national pool and any unused pool credits were lost to the Treasury.

According to the National Council of State Housing Agencies, "The bill modifies the stacking rule so that each state is treated as having allocated its carry-forward credit before any amounts from the current year allocation (including per capita, returned, and national pool credits). The revised rule assures that states have a full two years to allocate credits before losing them to the national pool, as Congress intended when it wrote the carry-forward provision in 1990."

The credits that were lost to the national pool were carry-forward credits that would not have been lost under the new stacking rule. We do not anticipate that any credits will be lost to the national pool in the future.

Conclusion

The Authority will incorporate the recommendations as we continue to strive to operate the most efficient and effective program possible. The Low Income Housing Tax Credit Program is a complex affordable rental production program. Its success is tied to the private sector. The Tax Credit Program attracts capital from private investors. Private sector oversight ensures that program requirements are adhered to. It is not uncommon for each $100,000 of Tax Credits to generate $750,000 of private investment. With this kind of investment, "due diligence" from the investor community itself is substantial.

The Authority is challenged to administer an overall effective program that operates in the private market place with the fewest possible restrictions. The process is highly competitive and receives close scrutiny.

While the implementation of these recommendations may drive up program costs and will intensify oversight, we agree that these changes will improve the program.

August 28, 2001

Mr. George L. Schroeder, Director
Legislative Audit Council
1331 Elmwood Avenue, Suite 315
Columbia, SC 29201

Dear Mr. Schroeder:

Thank you for sharing a copy of the finding "Retention of Tax Credit Records" that is part of the report *A Review of the State Housing Finance and Development Authority's Low-Income Housing Tax Credit Program.*

We have reviewed the finding and have no recommendations for changes or additions to it. We would be pleased to work with the State Housing and Development Authority in developing records retention schedules and assisting in the storage of their records.

If you have any questions, please feel free to contact me at 896-6120 or tryon@scdah.sc.sc.us.

Sincerely,

Roy H. Tryon
State Archivist