

CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE
Minutes of the January 23, 2013 Meeting

1. Roll Call.

Bettina Redway for State Treasurer Bill Lockyer chaired the meeting of the Tax Credit Allocation Committee (TCAC). Ms. Redway called the meeting to order at 10:00 a.m. Also present: Alan Gordon for State Controller John Chiang; Pedro Reyes for the Department of Finance Director Ana Matosantos; California Housing Finance Agency Executive Director Claudia Cappio; and Department of Housing and Community Development Representative Laura Whittall-Scherfee.

County Representative Lois Starr was absent.

2. Approval of the minutes of the December 12, 2012 Committee meeting.

MOTION: Mr. Reyes moved to adopt the minutes of the December 12, 2012 meeting. Mr. Gordon seconded and the motion passed unanimously.

3. Executive Director's Report.

Mr. Pavão reported that TCAC awarded approximately \$4 million more to 9% projects in 2012 than it did in 2011 even though fewer projects were funded in 2012. He explained that TCAC awarded 105 9% projects in 2011 and 102 in 2012; however the 2012 projects accounted for a greater number of units. Mr. Pavão also reported that TCAC awarded 13 4% plus state credit projects in 2012 and 16 in 2011. He stated that TCAC awarded more federal and state credits to the 2012 4% plus state credit applicants, again due to a higher number of units in the projects.

Mr. Pavão reported that TCAC awarded 96 4% tax credit projects in 2012 and 109 in 2011. He commented that the decline in awarded projects was fairly significant. He explained that 2011 was somewhat unique with respect to the availability of tax-exempt bond financing at favorable terms. Mr. Pavão stated that approximately 8,200 units were funded in 2012 whereas approximately 10,000 units were funded in 2011.

Mr. Gordon asked Mr. Pavão if he could explain why the number of 4% units declined so significantly.

Mr. Pavão stated that TCAC staff would explore possible reasons with stakeholders and CDLAC staff. He reiterated that tax-exempt bond financing resources available in 2011 may have affected applicants in a manner that was not present in 2012.

Mr. Gordon asked Mr. Pavão to describe the funding trend 5 years ago. He asked if the trend showed a steady rise in the number of funded units followed by a sudden drop.

Mr. Pavão stated that staff had even longer time lines, which they graphed for their annual report. He explained that the graph showed a gradual increase in funded units over the years followed by a drastic decrease, mostly in 4% units, as the recession started. Mr. Pavão stated that TCAC funded just 40 4% projects in 2010. He

explained that the 4% credit market truly recovered in 2011. Mr. Pavão commented that even though the number funded units declined in 2012, the tax credit market was performing much better than it did during the recession years.

Ms. Redway noted that CalHFA took advantage of a federal program, which helped boost the volume in 2011.

Ms. Cappio referred to the program as the New Issue Bond Program.

4. Report on Amendment to the Interagency Agreement with the California State Controller's Office to extend audit review services by an additional 6 months for an additional amount up to \$50,000.

Mr. Pavão reminded the Committee that they granted him authority to enter into contracts and commit state resources. He explained that he used his authority to amend the interagency agreement TCAC had with the State Controller's Office (SCO), for which SCO had helped TCAC review its systems and conduct intensive audits of projects originally sponsored by ADI. Mr. Pavão stated that the existing interagency agreement was for \$50,000. The amendment would add another \$50,000 to the agreement and extend the term ending date from June 30, 2013 to December 31, 2013. Mr. Pavão predicted that SCO would be able to complete the remaining work by the end of 2013.

Mr. Gordon stated that SCO staff uncovered an issue during the prior ADI audits. He explained that there was potential for self-dealing with private accounting firms that reviewed projects for legitimacy of the cost basis. Mr. Gordon asked if TCAC has proceeded with the suggested policy that TCAC form a list of certified accountants and select from that list an accounting firm to perform the cost audit.

Mr. Pavão stated that TCAC staff was working to develop a policy. He stated that staff proposed a fairly significant change to stakeholders and received a lot of helpful public comment in return. As a result of comments received, staff intended to hire a certified public accountant (CPA) who may not be involved in auditing tax credit applications, but could help TCAC facilitate a working group to develop procedures regarding final cost certifications.

Mr. Pavão commented that TCAC would be thoughtful about changing its current procedures. He announced that staff proposed a regulation change for 2013, which would modestly strengthen current procedures.

Mr. Gordon asked Mr. Pavão if his staff abandoned the concept of TCAC being charged with hiring the CPA for the final audit instead of the project developers. He explained that in reviewing the banking crisis that occurred 5 years ago, which crashed the economy, he found that the relationship between the rating bureaus on Wall Street and the people who they rated was much too close. He stated that SCO was concerned the same situation may be happening among TCAC applicants. Mr. Gordon stated that if a firm hired to perform project cost audit was also doing business with the project, then the auditing firm would have a huge incentive to inflate costs. He stated that he was not sure what regulations could put in place to sever that relationship unless TCAC assumed the role of hiring the auditor.

Ms. Redway suggested the Committee revisit Mr. Gordon's concerns when they discussed Agenda Item 7.

5. Discussion and Consideration of setting a minimum point requirement for the competitive 2013 applications.

MOTION: Mr. Reyes moved to adopt staff recommendations. Mr. Gordon seconded and the motion passed unanimously.

6. Discussion and Consideration of the 2012 Applications for Reservation of Federal Low Income Housing Tax Credits (LIHTCs) for Tax-Exempt Bond Financed Projects.

MOTION: Mr. Reyes moved to adopt staff recommendations. Mr. Gordon seconded and the motion passed unanimously.

7. Discussion and Consideration of a Resolution to Adopt Proposed Regulations, Title 4 of the California Code of Regulations, Sections 10302 (nn) through 10337(a), Revising Allocation and Other Procedures.

Mr. Pavão reported that staff posted their proposed regulations for public review on October 24, 2012. In addition, staff held 4 public hearings across the state during the second week of November. Mr. Pavão reported that staff received 51 public comments in writing. In response to public comments, staff published revised proposed regulation changes on January 3, 2013. Mr. Pavão reported that staff revised the proposed regulations again on January 10th when they realized that they had explained some of the proposed changes in the Statement of Reasons, but neglected to include the actual changes in the document. He reported that staff disclosed the error to the public through a mass email within a week following the initial posting.

Mr. Pavão explained that staff proposed a change to the geographic apportionments. The change would add an 11th region to the existing 10 regions. The new region would be the City of Los Angeles and would be effective in 2013. Mr. Pavão explained that the new Los Angeles County region would include the current territory minus the City of Los Angeles.

Mr. Pavão announced that staff included language into the proposed regulations regarding CPA's who provided final cost certifications. He explained that the language required CPA's to be independent. In addition, CPA's must submit the documentation associated with their most recent peer review along with the cost certification. Mr. Pavão noted that CPA's undergo peer reviews at least once every 3 years. He stated that and if the peer review showed negative findings, staff could require a different CPA to do the final cost certification.

Mr. Pavão reported that staff was making changes to the manner in which they counted assumed public debt for competitive purposes. He explained that assumed public debt could be a loan made on a project some years ago when it was first developed. In a scenario where the project applied for credits for a second time after 20 years and the new sponsor assumed the old debt, staff would determine how much of the old public debt to count for competitive purposes. Mr. Pavão proposed

that staff count only the principal amount and remove any competitive advantage that would be gained by counting interest accumulated over time. He commented that the proposed change was not particularly controversial among public commenters; however it marked a significant change in staff's current operations.

Mr. Pavão reported that staff added language regarding negative points to the proposed regulation changes. The language specifically addressed serious uncorrected compliance problems. Mr. Pavão summarized that if sponsors had serious compliance problems, they would be subject to consequences that could impact their ability to compete in future award competitions.

Ms. Redway asked Mr. Pavão if the SCO auditing staff was aware of TCAC's proposal related to the CPA provisions.

Mr. Pavão stated that SCO staff was aware of the proposed regulation changes. He explained the initial draft of proposed changes stated that the CPA who performed the final cost certification could not have had any prior role in the project. Mr. Pavão stated that TCAC received public comments indicating that the proposed policy would have dysfunctional consequences. In addition, CPA's had different degrees of involvement with the project up until the final cost certification. Mr. Pavão stated TCAC required CPA's to submit their opinions at certain times during the initial application review. He stated staff may ask a CPA to provide their independent opinion on whether an applicant's other projects were positively cash flowing. Staff may also ask a CPA to give their opinion on the proposed project costs stated in the application and whether or not the costs were being appropriately carried over into basis.

Mr. Pavão explained that most commenters were concerned that they would not be allowed to use the same CPA who submitted opinions during initial application for the final cost certification. He commented that CPA's were no longer truly independent when they reached a certain degree of involvement in the project. He stated that more collective research and exploration of the issue was needed to determine exactly when CPA's were too involved. Mr. Pavão noted that the California Board of Accountancy and the American Institute of Certified Public Accountants had their own standards regarding independence. He explained that even though inappropriate actions were reported in spite of established professional standards, he still felt that those standards had meaning.

Mr. Pavão commented that the long term fix to the CPA issue was for TCAC and program users to develop an agreed upon set of rules for CPA's to follow as they performed audits.

Mr. Gordon suggested that staff allow one accounting firm to do the project auditing up until the end of the initial application process and use an independent firm with no relationship to project to determine the final basis. He commented that there was more opportunity for self-dealing among CPA's who have had close relationships with the projects they were auditing.

Mr. Reyes agreed with staff's original draft proposal and stated that he would like staff to include the language they previously removed from the proposed regulations.

Ms. Redway asked Mr. Pavão to describe based on public comment how difficult it would be for applications to hire additional staff for their cost audits.

Mr. Pavão stated that staff received comments during the public hearings and in writing from the CPA community. He stated that staff received a letter signed by a dozen CPA's expressing their disapproval of the proposed changes concerning cost auditing. Mr. Pavão reported that the CPA's letter also provided alternative provisions, most of which mirrored language already established by the California Board of Accountancy and the American Institute of Certified Public Accountants. He commented that he did not see the value in adding a subset of the existing CPA standards into the TCAC regulations.

Mr. Pavão stated that staff received complaints from developers regarding the cost involved in hiring additional staff for auditing. In addition, developers were concerned that changing CPA's for the final cost audit would be very disruptive due to the complexity of their projects. Mr. Pavão explained that developers felt TCAC goals could be better accomplished in other ways; such as establishing an agreed upon set of procedures that explicitly states the minimum functions CPA's could perform.

Mr. Gordon asked legal counsel, Robert Hedrick, how the Committee should proceed with re-inserting the language that staff removed from the proposed regulations changes.

Mr. Hedrick stated that the Committee could vote to re-insert the language into the proposed regulations changes.

Jim Kroger, a partner with Novogradac & Company, commented that he has worked with his firm for over 20 years consulting and advising TCAC applicants and auditing cost certifications. He asked what the definition of consulting would become if TCAC imposed the suggested limitations on consulting firms. He asked if consultants would still be able to discuss tax issues with the developer. He stated that consultants needed to be very involved with their clients, but not in a manner that impaired independence. Performing the final cost audit was one of the most important steps in the entire 15-year life of the project. He explained that the cost certification was a unique document involving 3 elements and federal income tax accounting, which was very complicated on a marginal basis. He stated that marginal tax accounting issues related to loans fees, common areas, and location of cell phone towers, etc. must be reviewed as they could affect basis. Mr. Kroger stated that the CPA's must review cost certifications to ensure they were technically correct in accordance with Section 42 of the Treasury regulations. Then they must audit the cost certifications to ensure the reported costs were real. Mr. Kroger stated that the first step in performing the audit was to ensure that the CPA was independent. He stated that the last element of the cost certification was to ensure that the certification was in the format required by TCAC.

Mr. Kroger stated that the reason the cost certification must be done was because the Internal Revenue Service (IRS) had a Treasury regulation 42-17, which states that the CPA for project must audit the costs. He explained that the CPA audited the costs and eligible basis, which determined the tax credits. He stated that TCAC's form included costs, sources and uses. Mr. Kroger commented that CPA's were unable to audit the sources because the permanent financing had not closed and the equity had

not been funded. He explained that CPA's approve cost certifications even though they cannot audit sources because investors and lenders were waiting to get the Form 8609.

Mr. Reyes asked if figures reported to a given CPA seemed unusually high or unusual for a TCAC project, would the CPA question those figures.

Mr. Kroger explained that his firm did not audit equity except to the extent described in the partnership agreement; however it could not test that amount in the sense of an audit. He commented that auditors were very sensitive to making sure they were independent and completed all the steps of an audit.

Mr. Kroger reported that his firm along with 12 other accounting firms submitted a list of suggestions to improve cost certifications. He commented that it would be somewhat difficult to establish the agreed upon procedures Mr. Pavão described. He stated that requiring CPA's to review every invoice from every contractor would be very time consuming. He stated that the procedures would have to specify the percentage of subcontractor contracts that must be reviewed. Mr. Kroger commented that the issue with the southern California developer was that its contract costs were overstated and there was not enough audit work done at the subcontractor level. He stated that HUD faced the same issue for many years. As a result HUD developed procedures for auditing at the subcontractor level. Mr. Kroger commented that some of the HUD procedures were helpful and some were nonproductive. He predicted that auditing costs would increase significantly if TCAC followed HUD procedures.

Ms. Redway asked if Mr. Kroger thought the situation with the southern California developer would have still occurred even if the regulations included the proposed language regarding CPA's.

Mr. Kroger speculated that the developer would have hired another CPA who was a sole proprietor, never had a peer review, and was not knowledgeable in the tax credit industry.

Mr. Gordon stated that the developer could possibly be sued for malpractice if they hired another CPA who found insufficient auditing was performed at the subcontractor level. He commented that the consulting staff would be more likely to perform adequate work at the subcontractor level if TCAC was given authority to select the CPA for the final cost audit. He explained that the consulting firm's reputation would be jeopardized if an independent CPA found that the subcontractor audit work was insufficient. Mr. Gordon asked Mr. Kroger to explain why the regulations should not be changed to allow TCAC to select the final cost auditor from an independent list of accountants.

Mr. Kroger stated that allowing the CPA who provided consulting services to do the final cost audit actually improved the cost certification. He explained that due to the complexity of the tax credit program cost certifications should be performed by CPA's who were knowledgeable about the TCAC system.

Mr. Gordon suggested TCAC impose a set of standards that accounting firms must meet in order to get on TCAC's list of independent CPA's. He stated that TCAC would ensure only experienced qualified CPA's were placed on the list.

Ms. Redway asked if Novogradac was placed on TCAC's list of CPA's, would the firm be able to provide advice and consultation to a project and perform the independent audit for that same project.

Mr. Gordon stated that if Novogradac provided advice and consultation on a given project, Novogradac would be excluded from performing the independent audit for that project.

Mr. Kroger commented that not allowing CPA's to advise developers and perform their cost certifications did not improve their independence. He stated that CPA's needed to do more work at the subcontractor level and auditing standards for CPA's needed to be raised.

Ms. Redway stated that she was intrigued by the proposed list of approved CPA's; however the Committee was not prepared to act on the proposal that day.

Mr. Reyes commented that the proposed CPA list would likely create a hurdle for program users. He asked Mr. Kroger if the accounting firm Arthur Anderson would have passed a review by other firms and been deemed reputable.

Mr. Kroger thought the firm was independent and he explained that the peer review was taken very seriously by. CPA's spend a lot of time on the reviews and Mr. Kroger stated that public accounting firms had a high degree of public visibility.

Mr. Gordon asked Mr. Kroger if his firm was simply auditing their own work at the final cost audit stage.

Mr. Kroger stated that his firm could not do loan staff work for a given client and then audit their cost certification. He explained that his firm helped clients prepare projections based on the client's assumptions. He stated that if his staff would be auditing their own work if they made management decisions. He stated that there were many rules in place to ensure CPA's never audit their own work.

Darren Bobrowski, from USA Properties, commented that he represented a developer. He explained that his firm was involved in ongoing discussions as it prepared applications and projections to show their projects were feasible. In addition, the firm was trying to determine how projects would be treated if a third party CPA intervened at the final cost stage. He commented that the third party CPA's findings could result in disastrous financial consequences to projects. Mr. Bobrowski commented that the affordable housing business had a good checks and balances system in place. He supported TCAC staff's proposal to establish agreed upon procedures.

Mr. Bobrowski brought the Committee's attention to Section 10325(c)(i)(C) of the regulations. He explained that the amount of public funds and tiebreaker was reduced by any amount in excess of curb, gutter, sidewalks, and utility connection costs, which created a disadvantage to developers during a challenging economic time. Mr. Bobrowski stated that the commitments local governments made to projects often require specific conditions of approval in order to get the projects built. He stated that Section 10325(c)(i)(c) reduced competitiveness because there were often

conditions of approval beyond curbs, gutters, and sidewalks. He suggested TCAC change regulation language include all costs required under conditions of approval. He explained that whether a given project was market rate or affordable, the developer must build all the items required by the local governments in order for the project to be built.

Mr. Bobrowski brought the Committee's attention to Section 10325(c)(5)(a)(4) of the regulations. He suggested that a proportional square footage of the common areas of grocery stores, such as checkout counters, back office, customer service, and restrooms should be included in the total square footage calculation.

Mr. Bobrowski brought the Committee's attention to Section 10325(d)(2) of the regulations, which described a change in the funding order of projects. He explained that if TCAC skipped over a project because it did not meet the 125% test, the tiebreaker had to be within 75% of the project that was skipped. Mr. Bobrowski stated that Section 10325(d)(2) put cost effective projects that may not need public funding at a disadvantage. He stated that public funding was a crucial part of the tiebreaker calculation. He explained that a project that did not need public funding to make it feasible may still be a viable project.

Mr. Bobrowski brought the Committee's attention to Section 10325(f)(1)(b) of the regulations. He stated that Mr. Pavão suggested waiving the condition related to the value of ratio square footage in the case of existing federal and state rental assistance. He reported that CDLAC policy already allowed its executive director to waive that condition on all acquisition rehabilitation projects. Mr. Bobrowski explained that projects were at risk of being disqualified from rehabilitation because they were built during a time when unit sizes were smaller.

Maurice Ramirez, Executive Vice President for AMCAL Multi-Housing, commented on the practicality of having two auditors for the cost certification. He commented that the cost certification was a sensitive document that must address concerns of TCAC and also the partnerships' investors. He explained that the cost certification was the starting point for every tax return that would be delivered to the partnership. Mr. Ramirez, pointed out that dueling cost certifications could potentially delay the process of tax filing.

William Leach commented that, if TCAC were to select the final cost certifying CPA, developers would need to know who the selected CPA is early (by the 180 day readiness deadline. Obtaining the tax forms in a timely fashion is facilitated by a CPA who is familiar with the project. Also, a set of agreed upon procedures would address any concerns about CPA performance of the final cost certification. Mr. Leach also endorsed staff's recommendations regarding application skipping protocols and the 75% of the skipped project's tiebreaker rule.

Mr. Reyes asked Mr. Hedrick if the Committee could adopt the regulations that day, but make them effective at a later date.

Mr. Hedrick confirmed that the Committee had authority to set an effective date for the regulations.

MOTION: Mr. Reyes moved to adopt the regulations with the original language regarding provisions for final cost auditing. In order to give stakeholders time to prepare and to give TCAC time to determine if the regulations required further revision, the different CPA at final cost certification requirement would become effective on July 1, 2013. Mr. Gordon seconded and the motion passed unanimously.

8. Closed Session – Litigation (Government Code Section 11126(e)(2)(c))
Discussion with Legal Counsel Regarding Pending Litigation – UHC 00402 Reseda, L.P. v. CTCAC, Sacramento Superior Court Case No. 34-2012-80001337, Filed 12/17/12.

The closed session took place after the final public comments (Agenda Item 9).

9. Public Comment

Alex Gevorgian made a comment regarding TCAC's decision to deny funding a Second Round project in Arvin.

Toni Pichardo, City of Arvin council member, commented that Arvin was a farmworker community. In addition, the city had a large number of low-income residents. She explained that the housing structures were full and encouraged the Committee to assist in the city's efforts to build additional housing.

Laticia Perez, Kern County Supervisor, commented that she grew up with her father, a farmer in the city of Arvin. She discussed her successes as an adult and how she took pride in her heritage. Ms. Perez stated she wished to bring more balance to her community and expressed her support for more affordable housing development in Arvin.

10. Adjournment

The meeting adjourned at 11:35 a.m.