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CRS Report for Congress

An Introduction to the Design of the Low-Income Housing Tax Credit

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Summary

The Low-Income Housing Tax Credit (LIHTC) is a federal provision that reduces the income tax liability of taxpayers claiming the credit. These taxpayers are typically investors in real estate development projects that have traded cash for the tax credits to support the production of affordable housing. The credit is intended to lower the financing costs of housing developments so that the rental prices of units can be lower than market rates, and thus, presumably, affordable.

In the 109th Congress, the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) expanded the amount of LIHTC allocation authority for Alabama, Louisiana, and Mississippi. In addition to the 2006 allocation of $1.90 per capita for each state, the LIHTC allocation was increased for 2006, 2007, and 2008. The act also made an additional $3.5 million in LIHTC authority available to both Texas and Florida in 2006.

In the 110th Congress, legislative attention has focused on extending the completion deadline for LIHTC projects funded from the GO Zone LIHTC allocation. Current law required those projects to be placed in service (ready for occupancy) by December 31, 2008, but a proposal included in the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (P.L. 110-28) extends that date through December 31, 2010. Other legislation, H.R. 1043, proposes more comprehensive changes to the tax credit rules.

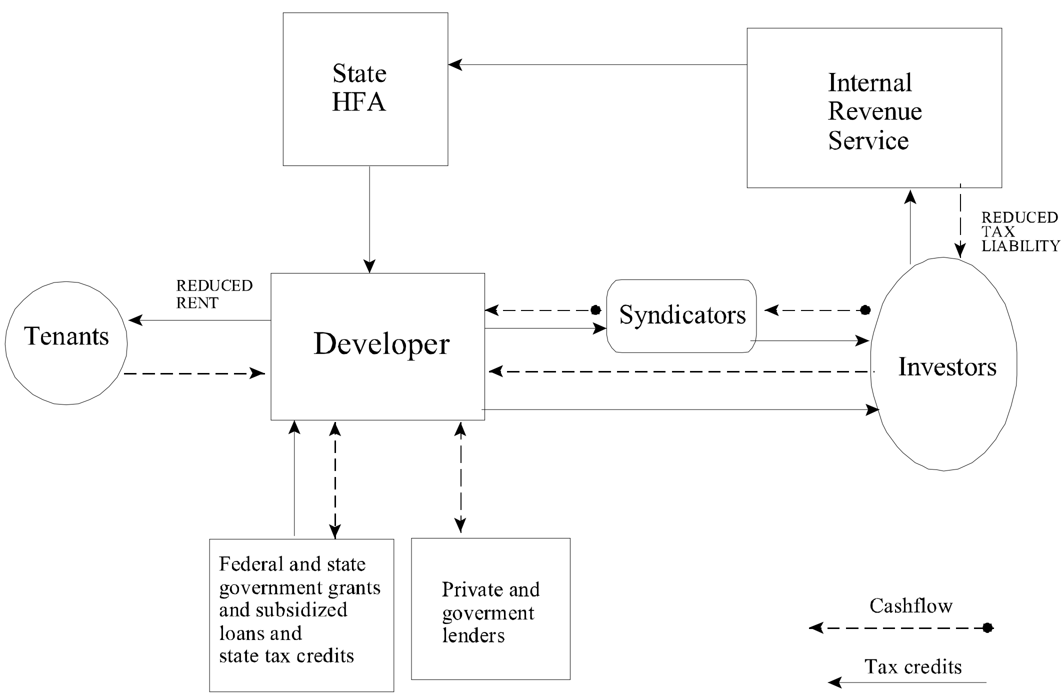
This report will be updated as warranted by legislative changes.

For more detailed information and analysis of the LIHTC, see CRS Report RL33904, *The Low-Income Housing Tax Credit: A Framework for Evaluation*, by Pamela J. Jackson.

The LIHTC was created by the Tax Reform Act of 1986 (P.L. 99-514) to provide an incentive for the acquisition (excluding land) and development or the rehabilitation of affordable rental housing. These federal housing tax credits are awarded to developers of qualified projects. Sponsors, or developers, of real estate projects apply to the corresponding state housing finance authority for LIHTC allocations for their projects. Developers either use the credits or sell them to investors to raise capital (or equity) for real estate projects. The tax benefit reduces the debt and/or equity that the developer would otherwise have to incur. With lower financing costs, tax credit properties can potentially offer lower, more affordable rents.

The process of allocating, awarding, and then claiming the LIHTC is complex and lengthy. The LIHTC is allocated annually to states according to federal law. State housing agencies are required to allocate credits to developers of rental housing according to federally required, but state created, allocation plans. Many states have two allocation periods per year. Developers apply for the credits by proposing plans to state agencies. On average, one project out of five may receive an allocation of tax credits. Upon receipt of a LIHTC allocation, developers typically must exchange the tax credits for equity. Taxpayers claiming the tax credits are usually real estate investors, not developers. The tax credits cannot be claimed until the real estate development is complete and operable. If, for example, a project were completed in June of 2005, the tax credits may not begin to be claimed until the tax return filing period of April 2006. More than a year or two could pass between the time of tax credit allocation and the time the credit is claimed. **Figure 1**, below, outlines the flow of the tax credits.

Figure 1. Flow of Tax Credits



Allocation Process

LIHTCs are allocated to each state according to its population and are typically administered by the state's Housing Finance Agency (HFA). HFAs receive annual tax credits equal to $1.95 per person in 2007.[1] The minimum tax credit ceiling for states with small populations rises from $2,125,000 in 2005 to $2,195,000 in 2007.[2] However, these limits do not apply in the case of development projects that are financed with tax-exempt bond proceeds.[3] Tax credits that are not allocated by states are added to a national pool and then distributed to those states that apply for the excess credits. However, to be eligible for those credits, a state must have allocated all of its previously allotted tax credits.

HFAs award tax credits to developers according to a Qualified Allocation Plan (QAP) that outlines the states' affordable housing priorities and how to apply for tax credits. Federal law requires that the QAP give priority to projects that serve the lowest income households and that remain affordable for the longest period of time.

Project Eligibility. In order to be eligible for the LIHTC, properties are required to meet certain tests that restrict both the amount of rent that is assessed to tenants and the income of eligible tenants. The "income test" for a qualified low-income housing project requires that the project owner irrevocably elect one of two income level tests, either a 20-50 test or a 40-60 test. In order to satisfy the first test, at least 20% of the units must be occupied by individuals with income of 50% or less of the area's median gross income, adjusted for family size. To satisfy the second test, at least 40% of the units must be occupied by individuals with income of 60% or less of the area's median gross income, adjusted for family size.[4] A qualified low-income housing project must meet the "gross rents test" by ensuring rents do not exceed 30% of the elected 50% or 60% of area median gross income, depending on which income test the project elected.[5]

The types of projects eligible for the LIHTC are apartment buildings, single family dwellings, duplexes, or townhouses. Projects may include more than one building. Tax credit project types also vary by the type of tenants served. Housing can be for families and/or special needs populations including the elderly.

Enhanced LIHTCs are available for difficult development areas (DDAs) and qualified census tracts (QCTs) as an incentive to developers to invest in more distressed areas: areas where the need is greatest for affordable housing, but which can be the most

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[1] From 1986 through 2000, the initial credit allocation amount was $1.25 per capita. The allocation was increased to $1.50 in 2001, to $1.75 in 2002 and 2003, and indexed for inflation annually thereafter. The 2004 allocation was $1.80, and the 2005 allocation was $1.85.

[2] The initial minimum tax credit ceiling for small states was $2,000,000, and was indexed for inflation annually after 2003.

[3] Tax-exempt bonds are issued subject to a private activity bond volume limit per state. For more information, see CRS Report RL31457, *Private Activity Bonds: An Introduction*, by Steven Maguire.

[4] U.S. Department of Treasury, Internal Revenue Service, Internal Revenue Code, Section 42(g)(1).

[5] U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Updating the Low-Income Housing Tax Credit (LIHTC) Database Projects Placed in Service Through 2003* (Washington: January 2006), p. 1.

difficult to develop.[6] In these distressed areas, the LIHTC can be claimed for 130% (instead of the normal 100%) of the project's total cost excluding land costs. This also means that available credits can be increased by up to 30%.

Developers and Investors. Developers of housing projects compete for tax credits as part of the financing for the real estate development by submitting proposals to the HFA. Types of developers include nonprofit organizations, for-profit organizations, joint ventures, partnerships, limited partnerships, trusts, corporations, and limited liability corporations. For-profit developers can either retain tax credits as financing for projects or sell them; nonprofit developers sell tax credits.

Trading tax credits, or selling them, refers to the process of exchanging tax credits for equity investment in real estate projects. Developers recruit investors to provide equity to fund development projects and offer the tax credits to those investors in exchange for their commitment. When credits are sold, the sale is usually structured with a limited partnership between the developer and the investor, and sometimes administered by syndicators who must adhere to the complex provisions of the tax code.[7] As the general partner, the developer has a very small ownership percentage but maintains the authority to build and run the project on a day-to-day basis. The investor, as a limited partner, has a large ownership percentage with an otherwise passive role. Typically, the investor does not expect the project to produce income. Instead, investors look to the credits, which will be used to offset their income tax liabilities, as their return on investment. The investor can also receive tax benefits related to any tax losses generated through the project's operating costs, interest on its debt, and deductions such as depreciation and amortization.

For the taxpayers who provide equity to real estate projects in exchange for the credits, there is a primary investment in real estate and a secondary tax benefit (the tax credits and any depreciation and/or interest expense).

Investors can be either individuals or corporations, although most investors are corporations. Neither individuals nor corporations can claim the LIHTC against the alternative minimum tax.

The type of tax credit investor has changed over the life of the LIHTC. Upon the introduction of the LIHTC in 1986, public partnerships were the primary source of equity investment in tax credit projects, but diminished profit margins have driven some syndicators out of the retail investment market. In recent years, the vast majority of investors have come from corporations, either investing directly or through private partnerships.[8] Different types of investors have different motivations for investing in tax

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[6] Internal Revenue Code Section 42(d)(5)(C).

[7] Syndicators are intermediaries who exist almost exclusively to administer tax credit deals. In the early years of the LIHTC, syndicators were more prevalent. In later years, as the number of corporate investors in the LIHTC grew and interacted directly with developers, the role of syndicators diminished.

[8] HousingFinance.com, "Corporate Investment and the Future of Tax Credits: What Should You Expect," at [http://www.housingfinance.com/housingreferencecenter/

(continued...)

credits. An estimated 43% of investors are subject to the Community Reinvestment Act (CRA), and investment in LIHTCs is favorably considered under the investment test component of the CRA.[9] Other investors include real estate, insurance, utility, and manufacturing firms, many of which list the rate of return on investment as their primary purpose for investing in tax credits. Tax sheltering is the second-most highly ranked purpose for investing.[10]

Implementation Process

The LIHTC finances part of the total cost of many projects rather than the full cost and, as a result, must be combined with other resources. The financial resources that may be used in conjunction with the LIHTC include conventional mortgage loans provided by private lenders and alternative financing and grants from public or private sources. Individual states provide financing as well, some of which may be in the form of tax credits modeled after the federal provision. Additionally, some LIHTC projects may have tenants who receive other government subsidies such as housing vouchers.

The value of the credit is approximately 9% of qualified basis per year for new construction, or 4% of qualified basis per year for rehabilitation or federally subsidized buildings.[11] The actual tax credit rates employed are not exactly 9% and 4%, and vary on a monthly basis. The rates, which are indexed to 10-year U.S. Treasury bond yields, are calculated and released monthly by the U.S. Treasury Department. Over the years, the actual 9% rate has ranged from 7.90% to 8.65%. The 4% credit has ranged from 3.33% to 3.68%.[12]

Legislative Developments

In December 2005, the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) was enacted to provide tax relief to communities adversely affected by Hurricanes Katrina, Wilma, and Rita.[13] The new law temporarily added to existing LIHTC allocation authority for Alabama, Louisiana, and Mississippi. There are now two authorized

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[8] (...continued)
Corporate_Investment.html], visited November 21, 2005.

[9] "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," Ernst & Young report commissioned by the National Council of State Housing Agencies, February 2003, p. 4.

[10] Jean L. Cummings and Denise DiPasquale, "Building Affordable Housing: An Analysis of the Low-Income Housing Tax Credit," City Research, 1998, p. 33.

[11] Qualified basis is determined by calculating the total development costs of the project and then subtracting non-depreciable costs, such as land, permanent financing costs, rent reserves, and marketing costs.

[12] U.S. Department of the Treasury, Internal Revenue Service, *Revenue Ruling 2006-7, Table 4, Appropriate Percentages Under Section 42(b)(2) for February 2006*, Internal Revenue Bulletin 2006-6, February 6, 2006.

[13] The Gulf Opportunity Zone (GO ZONE) is defined as those areas in Alabama, Mississippi, and Louisiana that have been designated by the federal government as warranting assistance due to Hurricane Katrina.

allocations of tax credits for these states. The first allocation, which existed prior to the Gulf Opportunity (GO) Zone enactment, is the nationwide statutory allocation of $1.90 per capita per state. According to this formula, for calendar year 2006, LIHTC authority was approximately $5,515,635 for Mississippi, $8,579,963 for Louisiana, and $8,607,346 for Alabama. As mentioned earlier, the per capita rate is indexed for inflation and is adjusted annually.

The second allocation of tax credit authority, which is temporary, is in addition to the amounts listed above. The second allocation is an amount equal to the lesser of either $18.00 multiplied by the portion of the state's population in the GO Zone as determined prior to August 28, 2005, or the amount of tax credits that had been allocated by each state to buildings in the GO Zone as determined prior to August 28, 2005.[14] These provisions apply for projects placed in service during 2006, 2007, and 2008.[15] The second allocation could yield an annual amount of approximately $35,429,094 for Mississippi, $56,759,274 for Louisiana, and $15,651,792 for Alabama for each of the three years.[16]

The tax law also made an additional $3.5 million in LIHTC authority available to both Texas and Florida in 2006 and also increased the size of the credit from 100% of qualifying project costs to 130% of such costs by assigning the designation of difficult development area (DDA) to the GO Zone (and also the Rita and Wilma Zones) for 2006, 2007, and 2008.

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The Preservation Approval Process Improvement Act of 2007 (P.L. 110-35), which became law in June 2007, modified the rules regarding the processing of participation certificates for LIHTC investors filing claims for the credits.

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[14] The amount of tax credits allocated by each state to buildings in the GO Zone prior to the hurricane reflects not only the value of credits allocated to current construction projects that may have been in progress, but also the value of credits allocated to buildings already placed in service, yet still in the 10-year tax credit claim period.

[15] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4440, the "Gulf Opportunity Zone Act of 2005," as passed by the House of Representatives and the Senate on December 16, 2005*, JCX-89-05R, December 20, 2005, and *Technical Explanation of the Revenue Provisions of H.R. 4440, the "Gulf Opportunity Zone Act of 2005," as passed by the House of Representatives and the Senate*, JCX-88-05, December 16, 2005.

[16] U.S. Department of the Treasury, Internal Revenue Service, *IRS Notice 2006-21 Providing Alabama, Louisiana, Mississippi Population Portions for Computing Housing Amount, Face Amounts of Gulf Opportunity Zone Bonds* (Washington, March 2006).