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CRS Report for Congress

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

Mark Patrick Keightley
Analyst in Public Finance
Government and Finance Division

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.

The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) significantly expanded the amount of LIHTC allocation authority for Alabama, Louisiana, and Mississippi and in the 110th Congress, legislative attention had been focused on extending the completion deadline for projects funded from that increased LIHTC allocation. The original law required 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.

The Affordable Housing Investment Act of 2008 (S. 2666), introduced on February 25, 2008, would change the method used to determine the tax credit rate. Most recently, the Housing Assistance Tax Act of 2008 (H.R. 5720) and the Dodd-Shelby proposed amendment to the American Housing Rescue and Foreclosure Prevention Act of 2008 (H.R. 3221) include proposals to enhance and modify the LIHTC program to aid with current housing market concerns. Other legislation, the Community Restoration and Revitalization Act of 2007 (H.R. 1043 and S. 584), proposes more comprehensive changes to the tax credit rules.

For more detailed information and analysis of the LIHTC program, see CRS Report RL33904, *The Low-Income Housing Tax Credit: A Framework for Evaluation*, by Pamela J. Jackson. This report will be updated as warranted by legislative changes.

Overview

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.

LIHTC developers receive a fixed tax credit amount each year over a 10-year period. The value of the annual credit is approximately 9% of the qualified basis for new construction, or 4% of the qualified basis per year for rehabilitation or federally subsidized buildings.[1] The present value of the 10-year stream of tax credits is required to equal 70% or 30% of the cost of the project, depending on the nature of the project (new construction or rehabilitation). As a result, the actual tax credit rates vary month to month, in line with movements of the 10-year U.S. Treasury bond yields used to calculate the present value of the total 10-year stream of tax credits. Over the years, the actual 9% rate has ranged from 7.90% to 8.65%. The 4% credit rate has ranged from 3.33% to 3.68%.[2] **Table 1** summarizes the relationship between the project cost, the credit rate, and the annual and 10-year total tax credits.

Table 1. Calculation of the Tax Credit Amount

Newly Constructed Apartment Building (assumes 100% of the units are LIHTC)	**Amount**
Cost	$500,000
Credit Rate	8.07%
Tax Credits per Year (8.07% x $500,000)	$40,356
Total Tax Credits ($40,350 x 10 years)	$403,560

Source: Author's calculations.

The Allocation Process

The process of allocating, awarding, and then claiming the LIHTC is complex and lengthy. The process begins at the federal level with each state receiving an annual LIHTC allocation in accordance with federal law. State housing agencies than allocate

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[1] 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.

[2] 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; *Revenue Ruling 2008-28, Table 4, Appropriate Percentages Under Section 42(b)(2) for June 2008*, Internal Revenue Bulletin 2008-22, June 2, 2008.

credits to developers of rental housing according to federally required, but state created, allocation plans. The process typically ends with developers exchanging allocated credits for equity with outside investors. A more detailed discussion of each level of the allocation process is presented below.

Federal Allocation to States. LIHTCs are first allocated to each state according to its population and are typically administered by each state's Housing Finance Agency (HFA). HFAs receive annual tax credits equal to $2 per person in 2008.[3] The minimum tax credit ceiling for states with small populations is $2,325,000 in 2008.[4] However, these limits do not apply in the case of development projects that are financed with tax-exempt bond proceeds.[5] Tax credits that are not allocated by states are added to a national pool and then redistributed to those states that apply for the excess credits. To be eligible for an excess credit allocation, a state must have allocated its entire previous allotment of tax credits.

State Allocation to Developers. State Housing Finance Agencies (HFAs) allocate credits to developers of rental housing according to federally required, but state created, Qualified Allocation Plans (QAPs). 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. 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.

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.

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.[6] A qualified low-income housing project must also meet the "gross rents

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[3] 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.

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

[5] 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.

[6] U.S. Department of Treasury, Internal Revenue Service, Internal Revenue Code, Section

(continued...)

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.[7]

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 difficult to develop.[8] 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. Upon receipt of an LIHTC allocation, developers typically exchange the tax credits for equity. For-profit developers can either retain tax credits as financing for projects or sell them; nonprofit developers sell tax credits. 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. This means that more than a year or two could pass between the time of the tax credit allocation and the time the credit is claimed. If, for example, a project were completed in June of 2008, depending on the filing period of the investor, the tax credits may not begin to be claimed until some time in 2009.

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.[9] 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

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[6] (...continued)
42(g)(1).

[7] 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.

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

[9] 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.

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.

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. Although there are individual tax credit investors, in recent years, the vast majority of investors have come from corporations, either investing directly or through private partnerships.[10] Neither individuals nor corporations can claim the LIHTC against the alternative minimum tax.

Different types of investors have different motivations for investing in tax 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.[11] 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.[12]

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 state tax credits modeled after the federal provision. Additionally, some LIHTC projects may have tenants who receive other government subsidies such as housing vouchers.

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 allocations of tax credits for these states. The first allocation, which existed prior to the Gulf Opportunity (GO) Zone enactment, was approximately $5,515,635 for Mississippi,

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[10] HousingFinance.com, "Corporate Investment and the Future of Tax Credits: What Should You Expect," at [http://www.housingfinance.com/housingreferencecenter/Corporate_Investment.html], visited June 19, 2008.

[11] U.S. Department of the Treasury. Office of the Comptroller of the Currency, *Low Income Housing Tax Credits:FactSheet* Aug. 2005, pp. 1-2, at [http://www.occ.treas.gov/Cdd/fact%20sheet%20LIHTC.pdf], visited June 19, 2008.

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

[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.

$8,579,963 for Louisiana, and $8,607,346 for Alabama. The second allocation of tax credit authority, which is temporary, is in addition to the amounts listed above and could yield an annual amount of approximately $35,429,094 for Mississippi, $56,759,274 for Louisiana, and $15,651,792 for Alabama each year for three years.[14] 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.

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, the Community Restoration and Revitalization Act of 2007 (H.R. 1043 and S. 584), proposes more comprehensive changes to the tax credit rules.

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.

The Affordable Housing Investment Act of 2008 (S. 2666), introduced on February 25, 2008, would, among other things, change the method used to determine the applicable tax credit rate. LIHTC recipients would receive the greater of a tax credit calculated under the current method, or a 4% or 9% tax credit, depending on whether the credit was used for rehabilitation or new construction.

The Housing Assistance Tax Act of 2008 (H.R. 5720)and the Dodd-Shelby proposed amendment to the American Housing Rescue and Foreclosure Prevention Act of 2008 (H.R. 3221) include proposals to enhance and modify the LIHTC program. H.R. 5720, which was passed by the House Ways and Means Committee on April 9, 2008, and the proposals in the amendment to H.R. 3221, would temporarily increase the $2 per capita rate of LIHTC allocation to states to $2.20 per capita for 2008 and 2009. The legislation proposes to simplify LIHTC program rules and would, among other things, eliminate the distinction between new and existing buildings, establish a minimum credit rate for non-federally subsidized buildings, clarify the circumstances under which a building is considered to be federally subsidized, and reform rules pertaining to sales of low-income housing buildings. These proposed changes are estimated to cost $250 million over 10 years.[15]

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[14] 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).

[15] U.S. Congress, House of Representatives, Committee on Ways and Means, *Ways and Means Passes Bipartisan Housing Tax Relief: Summary of H.R. 5720, the Housing Assistance Tax Act of 2008*, website, [http://waysandmeans.house.gov/media/pdf/110/eresummary.pdf], visited Apr. 11, 2008.