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 111th Congress, the American Recovery and Reinvestment Act of 2009 (ARRA), P.L. 111-5, directs the Secretary of the Treasury to make grants to states in lieu of a portion of their 2009 LIHTC credit volume limit. The change allows a state to elect to receive as grants up to 85% of 10 times the sum of the state's unused and returned credit allocation from 2008, 40% of their 2009 LIHTC credit allocation, and 40% of any allocation in 2009 made to the state from the national LIHTC pool. The Tax Extenders Act of 2009, H.R. 4213, includes a one-year extension of the program.

ARRA also provides $2.25 billion in grant funding to the LIHTC program through the Tax Credit Assistance Program (TCAP) via the HOME Investment Partnerships (HOME) Program. The TCAP is intended to ensure the development of LIHTC projects that received an LIHTC award between October 1, 2006, and September 30, 2009. The funds are allocated to states according to a predetermined formula. States, in turn, award grants to developers in a competitive process to assist with the completion of their developments. All TCAP grant funding must be expended by February 2012.

In the 110th Congress, the Housing and Economic Recovery Act of 2008 (HERA), P.L. 110-289, included a number of provisions that made temporary or permanent changes to the LIHTC program. For example, HERA increased the effective LIHTC rate applied to new construction completed prior to 2014 and increased the LIHTC allocation to states from $2.00 per capita to $2.20 per capita through 2009. The act also gave state housing credit agencies the authority to designate certain buildings as qualified for the enhanced LIHTC, clarified the circumstances under which a building is to be considered federally subsidized, and expanded the size of the community common areas that may be included in the eligible basis.

Also passed in the 110th Congress was the Emergency Economic Stabilization Act of 2008 (EESA), P.L. 110-343, which included a temporary change to the LIHTC with the intent of assisting victims of Hurricane Ike and the severe weather and flooding in the Midwest. Specifically, EESA allowed certain states to allocate additional credits to affected areas for the years 2008, 2009, and 2010. For states located in the Midwestern disaster area the additional allocation is equal to $8.00 multiplied by the state's disaster area population. For the two states most directly affected by Hurricane Ike, Texas and Louisiana, the additional allocation is equal to $16.00 multiplied by the state's population residing in affected counties/parishes.

This report will be updated as warranted by legislative changes.

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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.

The LIHTC was originally designed to deliver a 10-year subsidy equal to 30% or 70% of a project's cost, dependent on the nature of a project. Rehabilitation and federally subsidized construction is intended to receive the 30% subsidy, whereas new construction is supposed to receive the 70% subsidy. Over time, the annual credit rate that has delivered the 30% rehabilitation construction subsidy has approximately equaled 4% of the project's qualified basis, although the rate has fallen as low as 3.33%.[1] At the same time, the annual credit rate implied by the 70% new construction subsidy has approximately equaled 9%, with a range of 7.89% to 9.27%.[2] The method used to determine the actual credit rate a project receives depends in part on the prevailing market interest rate at the time the project is completed. Because the market interest rate changes monthly, so do the LIHTC rates.[3]

The Housing and Economic Recovery Act of 2008 (HERA), P.L. 110-289, changed the method used to determine the credit rate for new construction projects completed before 2014. Under the new law, the credit rate assigned to new construction will not be less than 9%. If the interest rate that prevails at the time a project is completed is such that the credit rate as determined under the previous method is greater than 9%, then the project will receive the higher rate. On the other hand, if the market interest rate is such that the LIHTC rate is less than 9%, then the project will be assigned a credit rate of exactly 9%. HERA made no changes to the credit rate that rehabilitation and federally subsidized construction projects receive.

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 then allocate 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.

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[1] U.S. Department of the Treasury, Internal Revenue Service, *Revenue Ruling 2003-71, Table 4, Appropriate Percentages Under Section 42(b)(2) for July 2003*, Internal Revenue Bulletin 2003-27, July 7, 2003.

[2] U.S. Department of the Treasury, Internal Revenue Service, *Revenue Ruling 89-65, Table 4, Appropriate Percentages Under Section 42(b)(2) for May 1989*, Internal Revenue Bulletin 1989-19, April 20, 1989; *Revenue Ruling 2008-28, Table 4, Appropriate Percentages Under Section 42(b)(2) for June 2008*, Internal Revenue Bulletin 2008-22, June 2, 2008.

[3] See CRS Report RS22917, *The Low-Income Housing Tax Credit Program: The Fixed Subsidy and Variable Rate*, by Mark P. Keightley.

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). For example, HFAs originally received annual tax credits equal to $2 per person in 2008, with a minimum small population state allocation of $2,325,000.[4] The Housing and Economic Recovery Act of 2008 temporarily increased the per capita state allocation by $0.20 for the years 2008 and 2009, and the minimum small population state allocation by 10% in addition to the annual inflation adjustment. For 2009, the per capita state allocation is $2.30, and the minimum small state allocation is $2,665,000. The state allocation 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 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]

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[4] 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 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 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.

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%. P.L. 110-289 allows an HFA to classify any building it sees fit as difficult to develop and hence, eligible for the enhanced credit.

Developers and Investors

Upon receipt of a 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 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

[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.

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 the 111th Congress, the American Recovery and Reinvestment Act of 2009 (ARRA), P.L. 111-5, as agreed to in conference and signed into law by the President, directs the Secretary of the Treasury to make grants to states in lieu of a portion of their 2009 LIHTC credit volume limit. Specifically, under the act a state may elect to receive as grants up to 85% of 10 times the sum of the state's unused and returned credit allocation from 2008, 40% of their 2009 LIHTC credit allocation, and 40% of any allocation in 2009 made to the state from the national LIHTC pool. The grants are not taxable income to the recipients. States may allocate the grant money to qualified housing projects regardless of whether a project has received a LIHTC allocation. The Joint Committee on Taxation (JCT) estimates that the modifications made by the act will cost $419 million for FY2009 through FY2018.[13] The Tax Extenders Act of 2009, H.R. 4213, includes a one-year extension of the program.

ARRA also provides $2.25 billion in grant funding to the LIHTC program through the Tax Credit Assistance Program (TCAP) via the HOME Investment Partnerships (HOME) Program.[14] The TCAP is intended to ensure the development of LIHTC projects that received an LIHTC award between October 1, 2006, and September 30, 2009. The funds are allocated to states according to a predetermined formula. HFAs, in turn, award grants to developers in a competitive process, in-

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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: Fact Sheet* August 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] U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects Of The Revenue Provisions Contained Division B, Titles I And III, of H.R. 1 [1] As Passed By The House Of Representatives On January 28. 2009*, committee print, 111th Cong., 1st sess., January 30, 2009, JCX-14-09.

[14] HUD has established a website for the TCAP. It may be found at http://www.hud.gov/recovery/tax-credit.cfm

line with their QAPs. States must commit 75% of all TCAP grants by February, 2011. By February 2012 all funds must have been expended.

In the 110th Congress, the Housing and Economic Recovery Act of 2008 (HERA), P.L. 110-289, included a number of provisions that made temporary or permanent changes to the LIHTC program.[15] As discussed earlier in this report, HERA guaranteed that the LIHTC rate applied to non-federally subsidized new buildings completed prior to 2014 will not be less than 9%. The act also increased the LIHTC allocation to states from $2.00 per capita to $2.20 per capita for 2008 and 2009. P.L. 110-289 changed the LIHTC program to allow state housing credit agencies to designate certain buildings as qualified for the enhanced LIHTC. Lastly, the act clarified the circumstances under which a building is considered to be federally subsidized and expanded the size of the community common areas that may be included in the eligible basis.

Also passed in the 110th Congress was the Emergency Economic Stabilization Act of 2008 (EESA), P.L. 110-343, which included a temporary change to the LIHTC with the intent of assisting victims of Hurricane Ike and the severe weather and flooding in the Midwest. Specifically, EESA allowed certain states to allocate additional credits to affected areas for the years 2008, 2009, and 2010. For states located in the Midwestern disaster area the additional allocation is equal to $8.00 multiplied by the state's disaster area population. For the two states most directly affected by Hurricane Ike, Texas and Louisiana, the additional allocation is equal to $16.00 multiplied by the state's population residing in affected counties and parishes: the counties of Brazoria, Chambers, Galveston, Jefferson, and Orange in Texas, and the parishes of Calcasieu and Cameron in Louisiana.

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[15] The Housing and Economic Recovery Act of 2008 (H.R. 3221) was passed in the Senate on July 11, 2008, and in the House on July 23, 2008.