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Key Issues in Tax Reform: The Low-Income Housing Tax Credit

The low-income housing tax credit (LIHTC) program is one of the federal government's primary policy tools for encouraging the development and rehabilitation of affordable rental housing. The program is estimated to cost approximately $9.0 billion annually in forgone federal tax revenue. Because of its importance as a housing policy tool and its cost, Congress has continually expressed interest in modifying the program over the years, including as part of recent tax reform discussions.

This In Focus provides a brief overview of the LIHTC program and associated economic considerations. For more information on the LIHTC program, see CRS Report RS22389, *An Introduction to the Low-Income Housing Tax Credit*, by Mark P. Keightley.

Overview of LIHTC

Origin

LIHTC was created by the Tax Reform Act of 1986 (P.L. 99-514) to replace various existing affordable housing tax incentives that were viewed as inefficient and uncoordinated. The tax credits are given to developers over a 10-year period in exchange for constructing affordable rental housing. The LIHTC program was originally scheduled to expire in 1989, but was extended several times before being made permanent in the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

The Mechanics of the Program

The mechanics of the LIHTC program are complex and lengthy. The process begins at the federal level with each state receiving an annual LIHTC allocation based on population. In 2017, states received an LIHTC allocation equal to the greater of $2.35 per person, or $2,710,000. State or local housing agencies then award credits to developers. The process typically ends with developers selling the credits to investors.

Developers are awarded tax credits via a competitive application process administered by their state or local housing finance authority (HFA). HFAs review developer applications to ensure that proposed projects satisfy certain federally required criteria, as well as criteria established by each state. For example, some states may choose to give priority to buildings that offer specific amenities such as computer centers or that are located close to public transportation, while others may give priority to projects serving a particular demographic, such as the elderly. Delegating authority to states to award credits gives each state the flexibility to address its individual housing needs, which is important given the local nature of housing markets.

Upon receipt of an LIHTC award, developers typically sell the tax credits to investors in exchange for an equity investment in the project. The return investors receive is determined in part by the market price of the tax credits, which fluctuates but typically ranges from the mid-$0.80s to mid-$0.90s per $1.00 tax credit. The larger is the difference between the price of the credits and their face value ($1.00), the larger the return to investors. The investor can also receive tax benefits related to any tax losses generated by the project's operating costs, interest on its debt, and deductions such as depreciation.

Rent and Income Limits

LIHTC properties must satisfy two tests applied to the income of tenants and the amount of rent that may be charged. 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 (AMI). To satisfy the second test, at least 40% of the units must be occupied by individuals with income of 60% or less of AMI. 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% AMI threshold determined by the income test. The maximum rent a tenant can be charged is based on 30% of the elected AMI threshold, and not the income of the tenant.

Types of Tax Credits

One of two tax credits is available depending on the type of rental housing construction. The so-called 9% credit is generally reserved for new construction. A developer who is awarded these credits will receive a tax credit equal to at least 9% of a project's qualified construction costs each year for 10 years. For example, if a new affordable housing complex costs $1 million (excluding land costs, which do not qualify), the developer would receive credits equal to $90,000 per year for 10 years, or $900,000 in total.

The so-called 4% credit is typically claimed for rehabilitated housing and new construction that is financed with tax-exempt bonds. Like the 9% credit, the 4% credit is claimed annually over a 10-year credit period. If, in the example above, the $1 million in qualifying costs were associated with rehabilitating a building or constructing a new building using tax-exempt bonds, the developer would receive credits equal to $40,000 per year for 10 years, or $400,000.

The use of the terms "4% credit" and "9% credit" has created confusion. Historically, the credits have not been exactly 4% and 9%. Instead, the actual credit rates are set to ensure that the *present value* of the 10-year stream of credits equals 30% of construction costs for rehabilitation and bond-financed projects, and 70% of construction costs for new construction. Because present value calculations depend on interest rates, and because interest rates fluctuate over time, so do the tax credit rates. Typically, the actual credit rates have been below the 4% and 9% nominal thresholds. Beginning in 2008, a temporary "floor" was placed under the credit for new construction so that the rate could not fall below 9%. It was later made permanent. No such floor exists for the 4% credit. Regardless, it is the subsidy levels (30% or 70%) that are explicitly specified in the Internal Revenue Code (IRC), not the credit rates.

Economic Considerations

The LIHTC program has supported the development of 45,905 projects and 2.97 million housing units between 1987 and 2015. Industry experts often cite figures such as these as evidence of the credit's success. But for the LIHTC program to increase the stock of affordable housing, it must result in a *net increase* in the housing supply. The question is then: how much of the affordable housing financed with LIHTCs would have been provided by the market, either via new construction or from the depreciation of existing housing, had the LIHTC not existed?

The economic literature suggests that LIHTC-financed additions to the affordable rental housing stock are at least somewhat, and in the extreme case fully, substituting for market-provided affordable housing. The degree of substitution is important as it indicates how effective the LIHTC program is at achieving its prime policy objective of increasing the supply of affordable housing. The results in the literature are limited due to the wide variability of estimates, which is driven in part by the local nature of housing itself and data availability.

Other policy justifications may exist for the LIHTC program (or construction subsidies generally) other than its effect on the overall housing supply that policymakers may want to consider. For example, new LIHTC construction may result in higher-quality affordable housing than provided by the market. One could argue that a minimum standard of housing is a fundamental feature of a prosperous society, and if the LIHTC program promotes such a standard, then society should subsidize affordable housing construction.

The LIHTC program could also be a useful strategy to reduce poverty and social isolation among lower-income individuals, since it allows mixed-income housing. Therefore, policymakers could justify the LIHTC to the extent that mixed-income housing is effective at addressing these two concerns. The most recent LIHTC data available, however, show that LIHTC developments almost exclusively house eligible low-income tenants as opposed to a mixture of tenants across income levels.

Lastly, the LIHTC program may promote more ideally located affordable housing. Oftentimes there is a tradeoff between affordability and convenience or desirability of location. There is a concern in the affordable housing community that the transportation burden for low-income workers is too high and that affordable housing is not located in safe neighborhoods with access to quality schools. The LIHTC program is one way to encourage affordable housing more closely situated to tenants' jobs, and in better neighborhoods and school districts. Alternative policy approaches, however, could be more effective or cost efficient, such as encouraging construction in less densely populated markets and providing a transit subsidy, or supplementing renters' incomes with vouchers so they may choose where they live.

Reform Proposal

The Unified Framework for Fixing Our Broken Tax Code, issued by the Office of the Speaker on September 27, 2017, states that it would preserve the LIHTC program. In the 113th Congress, the Tax Reform Act of 2014 (H.R. 1) proposed eliminating the 4% credit and extended the credit period from 10 years to 15 years. Additionally, the reform would have changed the method for allocating tax credit financing to states.

A number of other recent proposals could be included as part of reform. For example, some have proposed using an income "averaging" approach to determine tenant eligibility so the program targets households further down the income distribution. Specifically, individuals with incomes up to 80% of AMI could qualify for LIHTC housing, as long as the average income of all tenants did not exceed 60% of AMI. Thus, renting to someone with an income equal to 80% of AMI would also require renting to someone with an income equal to 40% of AMI. The belief is this would promote greater income mixing and help those further down the income distribution obtain affordable housing.

Recent proposals have also included increasing the amount of credits states receive by up to 50% and installing a 4% "floor" below which the credit for rehabilitation could not fall. It has also been proposed that states be allowed to convert private activity bond volume cap into LIHTCs to assist in meeting the demand for the credits. There have also been calls for more information reporting by tax credit syndicators and participants more generally in order to better understand the role these intermediaries play in arranging LIHTC deals.

It is important to consider the indirect effects of tax reform. Most reforms propose lowering tax rates. Lower tax liabilities will naturally lower the demand for tax credits, which means less private capital financing for credit-financed housing. Tax credit prices have fallen in recent months, suggesting that markets already appear to be pricing in lower demand for the credit and uncertain future taxes.

This In Focus is part of a series of short CRS products on tax reform. For more information, visit the "Taxes, the Budget, & the Economy" Issue Area page at www.crs.gov.

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