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An Introduction to the Low-Income Housing Tax Credit

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Summary

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. These non-refundable federal housing tax credits are awarded to developers of qualified rental projects via a competitive application process administered by state housing finance authorities. Developers typically sell their tax credits to outside investors in exchange for equity. Selling the tax credits reduces the debt developers would otherwise have to incur and the equity they would otherwise have to contribute. With lower financing costs, tax credit properties can potentially offer lower, more affordable rents. The LIHTC is estimated to cost the government an average of approximately $9.0 billion annually.

The LIHTC program was originally designed to provide a 30% subsidy for rehabilitated rental housing via the so-called 4% credit, and a 70% subsidy for newly constructed rental housing via the so-called 9% credit. To ensure that the 30% or 70% subsidies were achieved, the U.S. Department of the Treasury designed a formula for determining the effective 4% and 9% LIHTC rates. The formula depended in part on current market interest rates that fluctuate over time. These fluctuations caused the LIHTC rates to change over time, and typically have resulted in effective LIHTCs below the 4% and 9% thresholds.

The Housing and Economic Recovery Act of 2008 (P.L. 110-289) temporarily changed the credit rate formula used for new construction. The act effectively placed a floor equal to 9% on the new construction tax credit rate. The 9% credit rate floor originally only applied to new construction placed in service before December 31, 2013. The 4% tax credit rate that is applied to rehabilitation construction or new construction jointly financed with tax-exempt bonds remained unaltered by the act. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the 9% credit floor for one year. Most recently, Division Q of P.L. 114-113—the Protecting Americans from Tax Hikes Act (or "PATH" Act) permanently extended the 9% floor. Thus, new construction receives a credit rate equal to the greater of the rate determined under the original Treasury formula, or 9%. The 4% credit was left unaltered.

This report will be updated as warranted by legislative changes.

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Overview

The low-income housing tax credit (LIHTC) was created by the Tax Reform Act of 1986 (P.L. 99-514) to provide an incentive for the development and rehabilitation of affordable rental housing. These federal housing tax credits are awarded to developers of qualified projects via a competitive application process administered by state housing finance authorities (HFAs). Developers either use the credits or sell them to investors to raise capital for real estate projects, which, in turn, reduces the debt or equity contribution that would otherwise be required of developers. With lower financing costs, tax credit properties can potentially expand the supply of affordable rental housing. The LIHTC is estimated to cost the government an average of $9.0 billion annually.[1]

Two types of LIHTCs are available depending on the nature of the rental housing construction. The so-called 9% credit is generally reserved for new construction. Each year, for 10 years, a tax credit equal to roughly 9% of a project's qualified basis (cost of construction) may be claimed. The applicable credit rate has historically not actually been 9%; instead, the specific rate that a project would receive was set so that the present value of the 10-year stream of credits equaled 70% of a project's qualified basis.[2] The formula that was developed by the Department of the Treasury to ensure the 70% subsidy was achieved depended in part on current market interest rates that fluctuated over time. These interest rate fluctuations caused the LIHTC rate to change over time as well. When interest rates were relatively low, the 70% subsidy could be achieved with a lower credit rate than when interest rates were relatively high. Since 1986, the 9% credit has ranged between 7.35% and 9.27%.[3]

Beginning in 2008, a temporary "floor" was placed under the credit for new construction so that the rate could not fall below 9%. In 2015, the 9% floor was permanently extended. Thus, new construction receives a credit rate equal to the greater of the rate determined under the original Treasury formula, or 9%. See the "Recent Legislative Developments" section for more information on the 9% floor.

The so-called 4% credit is typically claimed for rehabilitated housing and new construction that is financed with tax-exempt bonds.[4] Like the 9% credit, the 4% credit is claimed annually over a 10-year credit period. The actual credit rate fluctuates around 4%, but is set by the Treasury to deliver a subsidy equal to 30% of a project's qualified basis in present value terms. At one point, the 4% credit rate had fallen to as low as 3.15%.[5] For both the 4% and 9% credit it is the subsidy

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[1] Computed as the average estimated tax expenditure associated with the program between 2016 and 2020. U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020*, committee print, 115th Cong., 1st sess., January 30, 2017, JCX-3-17.

[2] The concept of present value is used when it is necessary to value a stream of money that is expected to be received over time. Because of the ability to earn a return on money received sooner rather than later, money received in the future is less valuable than money received today. The present value concept accounts for this "time value of money" by discounting money expected to be received at different points in time. Usually, discounting is carried out using an interest rate because interest rates measure the time value of money.

[3] The lower bound of this range is the rate that would have prevailed in absence of the 9% credit floor. U.S. Department of the Treasury, Internal Revenue Service, *Revenue Ruling 2012-24, Table 4, Appropriate Percentages Under Section 42(b)(2) for September 2012*, Internal Revenue Bulletin 2012-36, September 4, 2012, and Novogradac & Company LLP, "Appendix H: List of Monthly Credit Percentages," in *Low-Income Housing Tax Credit Handbook*, 2006 ed. (2006), p. 845.

[4] A developer using federal tax-exempt bonds can qualify for the 9% credit if they reduce the project's eligible basis by the amount of the tax-exempt bond subsidy.

[5] U.S. Department of the Treasury, Internal Revenue Service, *Revenue Ruling 2012-24, Table 4, Appropriate*
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levels (30% or 70%) that are explicitly specified in the Internal Revenue Code (IRC), not the credit rates.

To understand the mechanics of the LIHTC, consider a new affordable housing apartment complex with a qualified basis of $1 million. Since the project involves new construction it will qualify for the 9% credit and generate a stream of tax credits equal to $90,000 (9% × $1 million) per year for 10 years, or $900,000 in total. Under the appropriate interest rate the present value of the $900,000 stream of tax credits should be equal to $700,000, resulting in a 70% subsidy. The situation would be similar if the project involved rehabilitated construction except the developer would be entitled to a stream of tax credits equal to $40,000 (4% × $1 million) per year for 10 years, or $400,000 in total. The present value of the $400,000 stream of tax credits should be equal to $300,000, resulting in a 30% subsidy.

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 selling allocated credits to outside investors in exchange for equity. 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. In 2017, states received a LIHTC allocation of $2.35 per person, with a minimum small population state allocation of $2,710,000.[6] The state allocation limits do not apply to the 4% credits which are automatically packaged with tax-exempt bond financed projects.[7] The administration of the tax credit program is typically carried out by each state's Housing Finance Agency (HFA).

State Allocation to Developers

State 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. Types of developers include nonprofit organizations, for-profit organizations, joint ventures, partnerships, limited partnerships, trusts, corporations, and limited liability corporations.

An allocation to a developer does not imply that all allocated tax credits will be claimed. An allocation simply means tax credits are set aside for a developer. Once a developer receives an

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Percentages Under Section 42(b)(2) for September 2012, Internal Revenue Bulletin 2012-36, September 4, 2012.

[6] 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.

[7] 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.

allocation it has several years to complete its project. Credits may not be claimed until a project is completed and occupied, also known as "placed in service." Tax credits that are not allocated by states are added to a national pool and then redistributed to 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. This use or lose feature gives states an incentive to allocate all of their tax credits to developers.

In order to be eligible for a LIHTC allocation, 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.[8] 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.[9]

The types of projects eligible for the LIHTC are apartment buildings, single family dwellings, duplexes, and 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 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.[10] 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%. HERA (P.L. 110-289) enacted changes that allow 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 to investors; nonprofit developers sell tax credits. Taxpayers claiming the tax credits are usually 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 July of 2016, depending on the filing period of the investor, the tax credits may not begin to be claimed until sometime in 2017.

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

[8] Internal Revenue Code (IRC) §42(g)(1).

[9] IRC §42(g)(2).

[10] IRC §42(d)(5).

adhere to the complex provisions of the tax code.[11] 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. Syndicators charge a fee for overseeing the investment transactions.

Typically, investors do 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 return investors receive is determined in part by the market price of the tax credits. The market price of tax credits fluctuates, but in normal economic conditions the price typically ranges from the mid-$0.80s to low-$0.90s per $1.00 tax credit. The larger the difference between the market 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 through the project's operating costs, interest on its debt, and deductions such as depreciation.

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.[12]

Different types of investors have different motivations for investing in tax credits. Some investors are motivated by the Community Reinvestment Act (CRA), which considers LIHTC investments favorably.[13] 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.[14]

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.

Recent Legislative Developments

The Housing and Economic Recovery Act of 2008 (P.L. 110-289) temporarily changed the credit rate formula used for new construction. The act effectively placed a floor equal to 9% on the new construction tax credit rate. The 9% credit rate floor originally only applied to new construction placed in service before December 31, 2013. The 4% tax credit rate that is applied to

[11] 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.

[12] HousingFinance.com, "Corporate Investment and the Future of Tax Credits: What Should You Expect," at http://www.housingfinance.com/news/corporate-investment-and-the-future-of-tax-credits-what-should-you-expect_o, January 1, 2011.

[13] For more information on the LIHTC program and the CRA, see Office of the Comptroller of the Currency, *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks*, Washington, DC, April 2014, http://www.occ.gov/topics/community-affairs/publications/insights/insights-low-income-housing-tax-credits.pdf.

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

rehabilitation construction or new construction jointly financed with tax-exempt bonds remained unaltered by the act. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the 9% credit floor for one year. Most recently, Division Q of P.L. 114-113—the Protecting Americans from Tax Hikes Act (or "PATH" Act) permanently extended a previously temporary 9% floor. The Joint Committee on Taxation (JCT) estimated the permanent extension included in the PATH Act would result in a 10-year revenue loss of $19 million.[15]

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[15] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Budget Effects Of Division Q Of Amendment #2 To The Senate Amendment To H.R. 2029 (Rules Committee Print 114-40), The "Protecting Americans From Tax Hikes Act of 2015,"* 114th Cong., 1st sess., December 16, 2015, JCX-143-15.