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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 nonrefundable 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.

In late 2017, there was a revision to the Internal Revenue Code (P.L. 115-97) that substantially changed the federal tax system. The revision did not directly alter the LIHTC program; however, there have been early reports of downward pressure on tax credit demand stemming from the 2017 tax revision. It is not yet clear what, if any, impact there may be on the affordable housing supply in the long run as the result of the recent changes to the federal tax code.

Most recently, the 2018 Consolidated Appropriations Act (P.L. 115-141) made two changes to the LIHTC program. First, the act modified the so-called "income test," which determines the maximum income a LIHTC tenant may have. Previously, each individual tenant was required to have an income below one of two threshold options (either 50% or 60% of area median gross income, depending on an election made by the property owner). With the modification, property owners may use a third income test option that allows them to average the income of tenants when determining whether the income restriction is satisfied. Second, the act also increased the amount of credits available to states each year by 12.5% for years 2018 through 2021.

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]

Types of Credits

Two types of LIHTCs are available depending on the nature of the construction project. The so-called 9% credit is generally reserved for new construction, while the so-called 4% credit is typically used for rehabilitation projects and new construction that is financed with tax-exempt bonds.[2] Each year, for 10 years, a tax credit equal to roughly 4% or 9% of a project's qualified basis (cost of construction) is claimed. The applicable credit rates have historically not actually been 4% and 9%. Instead, the credit rates have fluctuated in response to market interest movements so that the program has delivered a subsidy equal to 30% of the present value of a project's qualified basis in the case of the 4% credit, and 70% in the case of the 9% credit.[3] For both the 4% and 9% credit it is the subsidy levels (30% or 70%) that are explicitly specified in the Internal Revenue Code (IRC), not the credit rates. Since 1986, the 4% rate has ranged between 3.15% and 3.97%, and the 9% credit between 7.35% and 9.27%.[4] Since 2008, however, there has been a floor under the 9% credit below which the new construction credit rate cannot fall.

An Example

A simplified example may help in understanding how the LIHTC program is intended to encourage affordable housing development. 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 subsidy is intended to incentivize the development of affordable housing that otherwise may not be financially feasible or attractive relative to alternative investments.

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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] 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.

[3] For both the 4% and 9% credit it is the subsidy levels (30% and 70%) that are explicitly specified in the Internal Revenue Code (IRC), not the credit rates.

[4] 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 2016-18, Table 4, Appropriate Percentages Under Section 42(b)(2) for August 2016,* and Novogradac & Company LLP, "Appendix H: List of Monthly Credit Percentages," in *Low-Income Housing Tax Credit Handbook*, 2006 ed. (2006), p. 845. The 4% and 9% credits also hit these lower bounds in September, 2012.

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 2018, states were originally scheduled to receive a LIHTC allocation of $2.40 per person, with a minimum small population state allocation of $2,765,000.[5] The 2018 Consolidated Appropriations Act (P.L. 115-141) increased the amount of credits states will receive by 12.5% through 2021. The state allocation limits do not apply to the 4% credits which are automatically packaged with tax-exempt bond financed projects.[6] 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 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.

[5] 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.

[6] 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 and Jeffrey M. Stupak.

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. Historically, the "income test" for a qualified low-income housing project has required project owners to 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.[7]

The 2018 Consolidated Appropriations Act (P.L. 115-141) added a third income test option that allows owners to average the income of tenants. Specifically, under the income averaging option, the income test is satisfied if at least 40% of the units are occupied by tenants with an average income of no greater than 60% of AMI, and no individual tenant has an income exceeding 80% of AMI. Thus, for example, renting to someone with an income equal to 80% of AMI would also require renting to someone with an income no greater than 40% of AMI, so the tenants would have an average income equal to 60% of AMI.

In addition to the income test, 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 option the project elected.[8]

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.[9] 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 non-tax exempt bond financed LIHTC project 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 2017, depending on the filing period of the investor, the tax credits may not begin to be claimed until sometime in 2018.

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

[8] IRC §42(g)(2).

[9] IRC §42(d)(5).

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.[10] 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.[11]

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.[12] 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.[13]

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.

[10] 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.

[11] 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.

[12] 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.

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

Recent Legislative Developments

In late 2017, there was a revision to the Internal Revenue Code (P.L. 115-97) that substantially changed the federal tax system. The revision did not directly alter the LIHTC program, however, the reduction in corporate taxes, along with the limits on deducting net operating losses that were part of the act, has led affordable housing advocates to voice concern about a reduction in the demand for LIHTCs.

Most recently, the 2018 Consolidated Appropriations Act (P.L. 115-141) made two changes to the LIHTC program. As was discussed in the "The Allocation Process" section, the act modified the so-called "income test" to allow for income averaging across tenants, and also increased the amount of credits available to states each year by 12.5% for years 2018 through 2021. These changes may help alleviate some concerns stemming from the 2017 tax revision's potential effect on LIHTC development. Still, it is not yet clear what, if any, impact there may be on the affordable housing supply in the long run as the result of these recent changes to the federal tax code. Reduced demand for LIHTCs could require developers to secure alternative sources of financing. If such financing is prohibitively costly, there could be a reduction of capital from the private sector flowing into affordable housing construction.

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