Low Income Housing Tax Credits

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Administering Agency: Internal Revenue Service (IRS) of the Department of the Treasury

Year program started: 1986

Number of households served: 51,000 new households served in 2013, the latest data available

Population targeted: Households with incomes either below 60% of area median income (AMI) or 50% AMI

FY15 funding: Joint Committee on Taxation estimates $7.8 billion for 2016

Also see: *Qualified Allocation Plan*

The Low Income Housing Tax Credit program (LIHTC) finances the construction, rehabilitation, and preservation of housing affordable to lower income households. The LIHTC program encourages private investment by providing a tax credit: a dollar-for-dollar reduction in federal taxes owed on other income. Although housing tax credits are federal, each state has an independent agency that decides how to allocate the state's share of federal housing tax credits within a framework formed by the Internal Revenue Code.

HISTORY

LIHTC was created by the Tax Reform Act of 1986 and is codified at Section 42 of the Internal Revenue Code, 26 U.S.C. 42, so tax credit projects are sometimes referred to as Section 42 projects. The IRS provides additional guidance through revenue rulings, technical advice memorandums, notices, private letter rulings, and other means.

PROGRAM SUMMARY

The LIHTC program finances the construction, rehabilitation, and preservation of housing affordable to lower income households. LIHTC can be used to support a variety of projects: multifamily or single-family housing; new construction or rehabilitation; special needs housing for elderly people or people with disabilities; and permanent supportive housing for homeless families and individuals. The latest data from HUD indicates that LIHTC provided nearly 2.6 million housing units between 1987 and 2013.

LIHTC is designed to encourage corporations and private individuals to invest cash in housing affordable to lower income people by providing a tax credit over the course of a 10-year period: a dollar-for-dollar reduction in federal taxes owed on other income. The cash that investors put up, called equity, is used along with other resources to build new affordable housing or to make substantial repairs to existing affordable housing. Tax credits are not meant to provide 100% financing. The infusion of equity reduces the amount of money a developer has to borrow and pay interest on, thereby reducing the rent level that needs to be charged.

The Furman Center for Real Estate and Urban Policy at New York University released a report in October 2012 using tenant-level data from 15 states representing 30% of all LIHTC units. The report found that LIHTC recipients tend to have higher incomes than households assisted by other federal rental assistance programs. Although 43% of the households had income below 30% AMI—were "extremely low income" (ELI)—approximately 70% of those ELI households also had other forms of rental assistance, such as vouchers. For the 30% of ELI LIHTC households who did not have rental assistance, 86% paid more than 30% of their income for rent and utilities; they had "cost burden." Only 8% of ELI households in LIHTC homes were neither cost-burdened, nor in receipt of additional housing assistance.

Although housing tax credits are federal, each state has an independent agency, generally called a housing finance agency (HFA), which decides how to allocate the state's share of federal housing tax credits. Tax credits are allocated to states based on population. In 2015, each state received $2.30 per capita, with small states receiving a minimum of $2.68 million.

Each HFA must have a qualified allocation plan (QAP), which sets out the state's priorities and eligibility criteria for awarding federal tax credits, as well as tax-exempt bonds and any state-level tax credits. Developers apply to an HFA and compete for tax credit allocations. The law requires that a minimum of 10% of an HFA's total tax credits be set aside for nonprofits.

Once awarded tax credits, a developer then sells them to investors, usually to a group of investors pulled together by someone called a syndicator. Syndicators sometimes pool several tax credit projects together and sell investors shares in the pool. The equity that the investors provide, along with other resources such as conventional mortgages, state loans, and funds from the HOME program, is used by the developer to construct or substantially rehabilitate affordable housing.

When applying to an HFA for tax credits, a developer has two lower income unit set-aside options, and must stick with the chosen option during a required lower income occupancy period. The two lower income unit set-aside choices are:

- Ensuring that at least 20% of the units are rent-restricted and occupied by households with income below 50% of AMI.
- Ensuring that at least 40% of the units are rent-restricted and occupied by households with income below 60% of AMI.

Rent-restricted units have fixed maximum gross rents, including allowance for utilities, that are less than or equal to the rent charged to a hypothetical tenant paying 30% of either 50% of AMI or 60% of AMI, whichever option the developer has chosen. Tenants may have to pay rent up to that fixed maximum tax credit rent even if it is greater than 30% of their income. In other words, the maximum rent a tenant pays is not based on 30% of the tenant's income; rather it is based on 30% of the fixed AMI level (50% or 60%).

Consequently, lower income residents of tax credit projects might be rent-burdened, meaning they pay more than 30% of their income for rent and utilities. Or, tax credit projects might simply not be financially available to very low and ELI people because rents charged are not affordable to them. HUD's tenant-based or project-based vouchers or U.S. Department of Agriculture Rural Development Section 521 Rental Assistance are often needed to fill the gap between 30% of a resident's actual income and the tax credit rent.

Tax credits are available only for rental units that meet one of the above rent-restricted minimums (20/50 or 40/60). With these minimums it is possible for LIHTC projects to have a mix of units occupied by lower income, moderate and middle income people. These are minimums; projects can have higher percentages of rent-restricted units occupied by lower income people. In fact, the more rent-restricted lower income units in a project the greater the amount of tax credits provided. New developments should balance considerations of the need for more units with concerns about undue concentrations of poverty in certain neighborhoods.

The law requires units to be rent-restricted and occupied by income-eligible households for at least 15 years, called the 'compliance period,' with an 'extended use period' of at least another 15 years, for a total of 30 years. Some states require low income housing commitments greater than 30 years or provide incentives for projects that voluntarily agree to longer commitments. Where states do not mandate longer restricted-use periods, an owner may submit a request to the HFA to sell a project or convert it to market rate during year 14 of the 15-year compliance period. The HFA then has one year to find a buyer willing to maintain the rent restrictions for the balance of the 30-year period. If the property cannot be sold to such a 'preservation purchaser,' then the owner's obligation to maintain rent-restricted units is removed and lower income tenants receive enhanced vouchers enabling them to remain in their units for three years.

HFAs must monitor projects for compliance with the income and rent restriction requirements. The IRS can recapture tax credits if a project fails to comply, or if there are housing code or fair housing violations.

There are two levels of tax credit, 9% and 4%, formally known as the 'applicable percentages.' Projects can combine 9% and 4% tax credits. For example, buildings can be bought with 4% tax credits and then substantially rehabilitated with 9% tax credits. Instead of 9% and 4%, tax credits are sometimes referred to by the net present value they are intended to yield, either 70% or 30%. This is just another way of saying, in the case of a 9% credit, that the stream of tax credits over the 10-year credit period has a value today equal to 70% of the eligible development costs.

The 9% tax credit is available for new construction and substantial rehabilitation projects that do not have other federal funds. Federal funds include loans and bonds with below market-rate interest. Rehabilitation is substantial if the greater of an average of $3,000 is spent on each rent-restricted lower income unit or 10% is spent on the “eligible basis” (described below) during a 24-month period.

The 4% tax credit is available for three types of activities:

- Acquisition of existing buildings for substantial rehabilitation.
- New construction or substantial rehabilitation subsidized with other federal funds.
- Projects financed with tax-exempt bonds. (Every year, states are allowed to issue a set amount, known as the volume cap, of tax-exempt bonds for a variety of economic development purposes.)

In recent years, the figures 9% and 4% were only approximate rates. IRS computed actual rates monthly based on Treasury Department interest rates, the ‘appropriate percentage.’ For any given project, the real tax credit rate was set the month a binding commitment was made between an HFA and developer, or the month a finished project was first occupied, ‘placed in service.’ This applicable percentage is applied to the ‘qualified basis’ (described below) to determine the investors’ tax credit each year for 10 years (the ‘credit period’).

For 9% projects, the Housing and Economic Recovery Act of 2008 (HERA) established a fixed 9% value for projects placed in service between July 30, 2008, and January 1, 2014. The American Taxpayer Relief Act of 2012 allowed any project receiving a LIHTC allocation before January 1, 2014 to qualify for the fixed 9% credit. There was no Congressional action in FY13 and FY14 renewing a fixed the 9% value. Although the FY15 Appropriations Act provided a fixed 9% minimum, it only extended the rate through December 31, 2014, providing virtually no benefit because most HFAs had already made their 2014 allocations and the vast majority of projects had closed using the floating rate. Therefore, the applicable percentage continued to float. For example, the applicable percentage was 7.51% in January 2015, 7.47% in June, and 7.49% in December. The 4% credit continued to float, with an applicable percentage rate of 3.22% in January 2015, 3.2% in June, and 3.21% in December.

Finally, on December 18, 2015, the president signed into law a broad tax extenders bill, the “Protecting Americans from Tax Hikes Act of 2015,” which, among many other tax provisions, made the fixed 9% applicable percentage permanent and retroactive to January 1, 2015. However, the statute did not establish a fixed 4% applicable percentage rate. The Joint Committee on Taxation estimates that permanently setting the 9% rate will cost $19 million over a 10-year period.

The amount of tax credit a project can receive, and therefore how much equity it can attract, depends on several factors. First, the ‘eligible basis’ must be determined by considering costs such as building acquisition, construction, soil tests, engineering costs, and utility hookups. Land acquisition and permanent financing costs are not counted toward the eligible basis. The eligible basis is usually reduced by the amount of any federal funds.

The eligible basis of a project can get a 30% increase, or ‘basis boost,’ if the project is located in a census tract designated by HUD as a low income tract (a Qualified Census Tract, or QCT) or a high-cost area (a Difficult to Develop Area, or DDA). QCTs are census tracts with a poverty rate of 25% or in which 50% of the households have incomes below 60% of the AMI. LIHTC projects in QCTs must contribute to a concerted community revitalization plan. The aggregate population in census tracts designated as QCTs cannot exceed 20% of the metropolitan area’s population. DDAs are areas in which construction, land, and utility costs are high relative to incomes. HERA expanded the use of this basis boost to areas designated by a state as requiring an increase in the credit amount in order to be financially feasible.

Next, the ‘applicable fraction’ must be determined. This is a measure of rent-restricted lower income units in a project. There are two possible percentages: the ratio of lower income units to all units (the ‘unit fraction’), or the ratio of square feet in the lower income units to the project’s total square feet (the ‘floor space fraction’). The lowest percentage is the applicable fraction. The applicable fraction agreed to by the developer and IRS at the time a building is first occupied is the minimum that must be maintained during the entire affordability period.

The ‘qualified basis’ is the eligible basis multiplied by the applicable fraction. The amount of annual tax credits a project can get is the qualified basis multiplied by the tax credit rate (9% or 4%).

FUNDING

The LIHTC is a tax expenditure, which does not require an appropriation. The Joint Committee on Taxation estimated that the program would cost $7.3 billion in tax expenditures in 2015, rising to $7.8 billion in FY16 and $8.3 billion in FY17.

FORECAST

Chief issues of concern for the LIHTC program in recent years—tax reform and deficit reduction—have diminished for the time being. Several advisory commissions in previous years recommended either the elimination of or a substantial reduction in tax expenditures. Because the LIHTC is one of the largest corporate tax expenditures, it remains vulnerable to future elimination or substantial reduction to help pay for the lowered rates.

On March 26, 2015, Representative Keith Ellison (D-MN) introduced H.R. 1662, "the Common Sense Housing Investment Act." The bill would reform the mortgage interest deduction by changing it to a 15% non-refundable mortgage interest tax credit, and cap the amount of a home mortgage eligible for a tax break at $500,000—down from $1 million. Such reform is estimated to make the tax break available to 15 million more households, most of whom have annual incomes less than $100,000. The reform is estimated to save the federal government $213 billion over 10 years. Mr. Ellison proposes to dedicate 60% of the savings to the National Housing Trust Fund (NHTF). In addition, Mr. Ellison's bill proposes significant LIHTC provisions. Before determining the 60% in federal savings for the NHTF, the LIHTC per capita allocation would be raised to $2.70 and increased annually by a cost-of-living index. The $2 million minimum allocation for small states would also be increased by an annual cost-of-living adjustment. Most importantly, the LIHTC program would create an incentive to develop units affordable to ELI people by providing a 150% basis boost.

The president's budget request for FY17 contains proposed changes to the LIHTC program:

1. Allowing LIHTC projects to elect an "average income" criterion where at least 40% of the units in a LIHTC project would have to be occupied by tenants with annual incomes that average no more than 60% of AMI. Under the proposal, no rent-restricted unit could be occupied by a tenant with an income over 80% AMI. Tenants making less than 20% of AMI would be treated as earning that much for income averaging purposes. NLIHC's policy agenda includes a similar proposal, but would require projects that use the income averaging criterion to provide at least 30% of a project's units to households with incomes below 30% AMI.
2. Allowing states to convert some of their private activity bond (PAB) volume cap received for a particular calendar year into tax credits applicable to the same year. The conversion ratio would change each calendar year to respond to shifting interest rates, and there would be a maximum amount of the PAB volume cap that could be converted.
3. Adding a fourth required allocation preference to clarify states' obligations to allocate tax credits in a way that affirmatively furthers fair housing. The proposal would also add preservation of federally assisted affordable housing to the IRS' selection criteria that each state must include in its Qualified Allocation Plan.
4. Removing the QCT population cap. HUD could designate as a QCT any census tract that meets the current statutory criterion of having a poverty rate of at least 25% or having at least 50% of its households earning incomes less than 60% AMI.
5. Implementing changes to comply with the Violence Against Women Reauthorization Act (VAWA) of 2013, which extended protections for survivors of domestic violence to the LIHTC program. The legislation that was signed into law failed to include changes to the Internal Revenue Code or enforcement provisions that Treasury believes are necessary to impose VAWA protections in LIHTC buildings. To remedy this problem, the FY17 proposal would require all long term use agreements to include housing protections that would apply to both low income and market rate units in the LIHTC development.

NLIHC's proposed income averaging option would require at least 40% of the units in a project to be occupied by residents with incomes that average no more than 60% of AMI, with at least 30% of the units rent-restricted and occupied by households with income at or below 30% of AMI. No rent-restricted units would include households with income above 80% of AMI. For purposes of computing the average, any unit with an income limit that is less than 20% of AMI would be treated as having a 20% limit. Rents would be based on 30% of the income limit for that unit; for example, the rent at a 20% AMI unit would be 30% of 20% of AMI. NLIHC also recommends adding a 30% basis boost for properties that use NLIHC's proposed third option for income averaging. NLIHC's proposal will likely be most effective in markets where there is a significant need for affordable housing for households with income at 80% of AMI.

TIPS FOR LOCAL SUCCESS

LIHTCs are distributed based on a state's QAP. See the QAP entry in this *Advocates' Guide* for advocacy ideas for influencing how LIHTC is used in your state.

WHAT TO SAY TO LEGISLATORS

LIHTC is an important source of funding for affordable housing. Congress should act to protect the program and provide a means to target more units that are affordable to ELI residents paying no more than 30% of their income for rent and utilities.

FOR MORE INFORMATION

NLIHC, 202-662-1530, www.nlihc.org

Affordable Rental Housing A.C.T.I.O.N. Campaign, http://rentalhousingaction.org

HUD's database of LIHTC projects, updated through 2012, www.huduser.org/datasets/lihtc.html

List of QCTs and DDAs, www.huduser.org/datasets/qct.html

Novogradac, a consulting firm, lists the HFAs in all states, http://bit.ly/XoOL2b ■