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Tax Incentives for Affordable Housing: The Low Income Housing Tax Credit — Who Invests in the Low Income Housing Tax Credit and Why?

RESEARCH BRIEFS
FALL 2011

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Guaranteeing a supply of rental housing for low-income residents is critical to the United States' long-term economic recovery. Monica Singhal's recently published research on the U.S. Low Income Housing Tax Credit (LIHTC) examines the LIHTC program in the context of other federal affordable housing programs, and its relevance to recent legislative responses to the economic recession. Singhal's findings are timely and pertinent to ensuring the continued availability of low-income rental units during a period of economic uncertainty.

In the context of the recent United States economic recession, the political and public policy discussion about the volatile residential housing market has focused on residential home ownership and mortgage issues. While public discourse has to a limited degree addressed the effect of the U.S. housing and mortgage crisis on low-income residents, it has mostly focused on the plight of middle-class mortgage holders of residential homes. The crisis, however, has also strained the LIHTC program, the largest supply-side program for the provision of affordable housing, and legislation has resulted in a variety of reforms to the program.

Examining the LIHTC program is pertinent to understanding the range of federal options for ensuring the continued availability of low-income rental housing.

Since its inception in 1986, the LIHTC program has become the largest source of new affordable housing in the United States. The program introduced a new type of supply-side model for adding to the stock of affordable rental housing. Unlike previous supply-side programs, which have directly provided or subsidized low-income housing, the LIHTC program provides tax credits to housing developers who then sell the credits to investors in exchange for equity finance. Investors subsequently claim the credits on their tax returns, making the investor a beneficiary of the LIH credits, in addition to the housing developer or the targeted beneficiary of the subsidized service.

There is an ongoing debate about whether new construction is the most efficient and cost-effective method of providing housing assistance to low-income housing, or whether vouchers are a more effective way of subsidizing affordable housing.[1] A common critique of supply side programs is that they may simply crowd out other low-

1 Please see Desai, Dharmapala, and Singhal (2010) for a more detailed review of this literature as well as an expanded discussion of all the issues covered in this brief.

The REAI is an interfaculty, interdisciplinary program focused on real estate and urban development research and education at Harvard University. Periodic research briefs document the REAI-funded research work of Harvard faculty and students.

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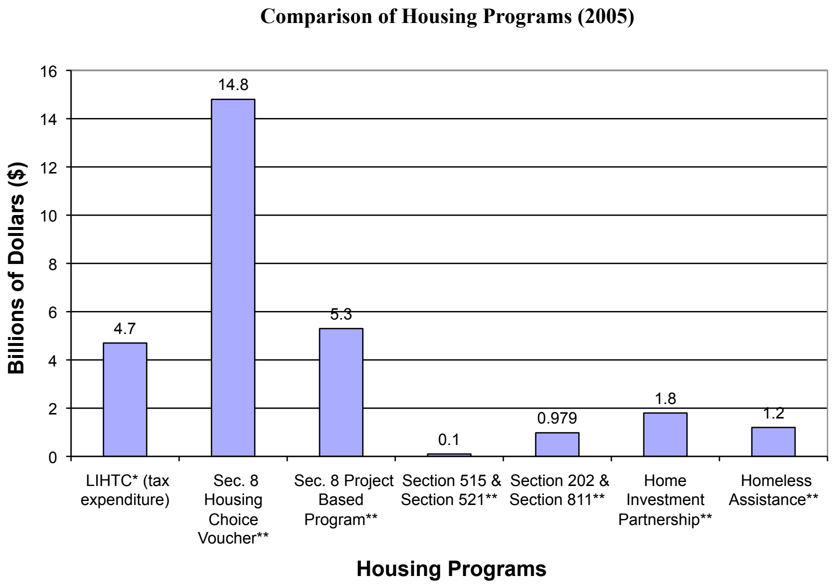
Figure 1



Notes: * Data for LIHTC tax expenditure are from JCT. ** Data on remaining programs come from Rice and Sard (2007). Budget Authority rather than outlays. Funding estimates for these programs are based on budget authority rather than expenditure. The Section 8 Housing Choice Voucher program provides vouchers to low-income tenants. The Section 8 Project Based program subsidizes affordable rental housing. Section 515 and Section 521 provides low-interest loans to encourage the production of affordable rental housing in rural areas. Section 202 and Section 811 provide subsidies to developers of affordable rental housing for the elderly and those with disabilities; Section 811 also includes tenant-based rental assistance for the disabled. The HOME Investment partnership provides a variety of subsidies (both project and tenant based) for rental and non-rental affordable housing. Homeless assistance refers to a number of programs that provide housing assistance to the homeless. See Rice and Sard (2007) for further details.

income housing rather than raising the net supply. The LIHTC program specifically has also generated some academic skepticism (see, for example, Weisbach 2006).

Nevertheless, the program is politically popular and has grown quickly. By using a market-based system to encourage affordable housing construction, the LIHTC program has been more widely politically popular than traditional programs. Proposed reforms to expand the program have generally passed with almost overwhelming bipartisan Congressional support. A comparison of LIH credits to other government expenditures is illustrated in Figure 1. In addition, the federal government has replicated the LIHTC structure in other programs. Under the New Market Tax Credits Program, for example, the federal government allocates tax credits to designated Community Development Entities (CDEs). The CDE then sells these credits to investors in exchange for equity finance, which is used by the CDE to provide investments in low income communities.

The ongoing financial uncertainty has illustrated some of the vulnerabilities of the LIHTC program. Prices for LIH credits fell dramatically in 2008 and 2009, straining the credit market precisely at a time when the need for affordable housing was likely the most acute. This has prompted the passage of new legislative initiatives and proposals for further policy reform. In particular, both the Housing and Recovery Act of 2008 (HERA) and the American Recovery and Reinvestment Act of 2009 (ARRA) have resulted in important changes to the LIHTC. Gaining a better understanding of who invests in LIH credits – and why – is a critical factor when thinking about the future of the program.

How LIHTC Works

The LIHTC program was devised as part of the Tax Reform Act of 1986, which included several provisions that reduced the profitability of investing in rental housing. To preserve incentives for developers to continue providing affordable rental housing, the Internal Revenue Service began allocating non-refundable tax credits to state housing agencies. These state agencies in turn award the credits to proposed housing projects whose developers must meet federal requirements to ensure that they are committed to providing low-income housing. To fund their housing projects, real estate developers then sell the credits to investors who may be individuals, corporations, or financial institutions. Syndicators often create the market for trading in these tax credits. Figure 2 illustrates the mechanics of the LIHTC program.

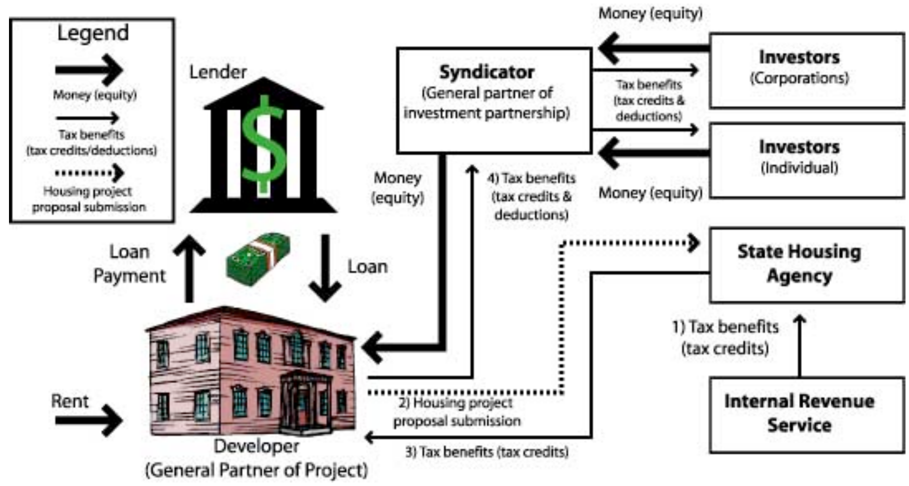
The LIHTC program allocates two types of housing credits, depending on how a project is financed. The first type of credit ("9% credit") is allocated to new construction projects that receive no other federal subsidies, with credits apportioned to states based on their population. Initial allocations for the program were $1.25 per capita, increased to $1.50 in 2002, $1.75 in 2003, and indexed for inflation thereafter. If a project is financed with private-activity tax exempt bonds, it is eligible for the second type of credit

("4% credit"). Unlike the 9% credit, the 4% credits are capped indirectly through state private activity bond caps, rather than per capita. Each dollar of allocated credit entitles the investor to a dollar tax credit each year for ten years.

Housing development projects must meet several federal government criteria in order to qualify for LIHTC funding. Most importantly, a certain share of units must be rent restricted and be occupied by low income households, and in most cases these conditions must be met for a minimum of 30 years. Beyond these federal guidelines, state housing agencies hold broad discretionary powers in setting criteria for the credit allocation process. States establish eligibility criteria in Qualified Action Plans (QAPs) that are, in many cases, stricter than the federal guidelines. Qualified housing projects are then awarded tax credits based on the project's development costs and the share of the project that is reserved for low-income residents. According to this formula, new construction projects that aren't receiving any other federal subsidies are awarded substantially more credit allocations.

Once state housing agencies award credits to housing projects, developers can either use the tax credits to reduce their tax bills or sell the credits to investors. Investors who buy the credits provide the developers with equity to fund the construction of low-income housing. These transactions are often structured as a limited partnership between investors and developers. For investors who are the limited partners in the transactions, the return is generally from the tax credits rather than income from the project. A significant aspect of this syndication process is that the program creates tax

Figure 2



Notes: Source: Adapted from U.S. General Accounting Office, Tax Credits.

benefits for investors and intermediaries who have no intrinsic interest in providing low-income housing. This model creates a much wider constituency supporting the program than is the case for direct subsidy programs for low-income housing: a seemingly unlikely political coalition of real estate developers, investors and housing advocates enthusiastically support the LIHTC program.

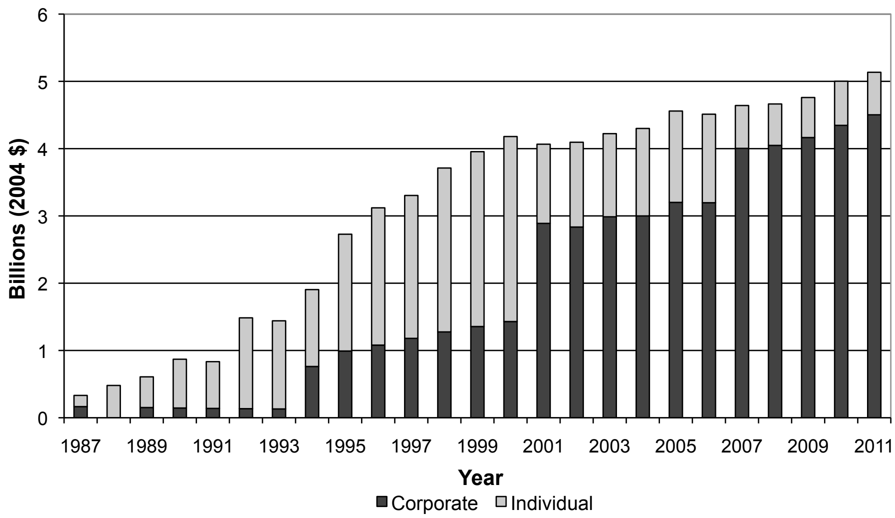
While the LIHTC does not offer direct payments or subsidies to housing developers, the tax credits claimed by investors translates to lost revenue for the federal government coffers. Joint Committee on Taxation (JCT) estimates of tax expenditure under this program are shown in Figure 2. Growth in the early period reflects the phase in of the program; growth in the later period results from the legislated increases in per-capita allocations. An interesting feature of the LIHTC is that there is a high degree of predictability on the level of tax expenditure, based on the number of credits allocated. There is, however, uncertainty over the actual provision of housing, since lower credit prices may dictate that fewer housing units are constructed.

How Investors Realize a Return on LIH Tax Credits

For investors in LIH tax credits, the return on investment is generally the difference between the purchase price and the value of the credit. In the early years of the program, credit prices were fairly low: one survey found prices around $0.50 per discounted dollar of tax credit benefit when the program was first established (Cummings and DiPasquale 1999). These low prices may have reflected uncertainty about the program on the part of investors. In addition, investors may have required an additional premium to compensate them for the risk that the project goes out of compliance, in which case the credits can in theory be reclaimed by the IRS. In practice, such occurrences are extremely rare, although it is not completely clear whether this is a result of strong compliance or poor program oversight.

Figure 3

JCT Estimates of LIHTC Tax Expenditure



Notes: Data Source: JCT, "Estimates of Tax Expenditures," various years. Figures for a given year are taken from the report immediately preceding that year. All figures are in 2004 dollars. Starting from 2008, estimates are based on a -0.3 annual CPI changes which reflects the average for 2005-2007. The apparent one-year shift from individual to corporate claimants from 2000 to 2001 reflects a change in the method of estimation rather than a true change in the distribution of claimants.

Prices increased fairly rapidly as the program became established. Prior to the financial crisis, credit prices were quite high, approaching or in some cases even exceeding one when the stream of tax credits is appropriately discounted. One possible explanation is that certain financial institutions may be using LIH credits to satisfy requirements imposed by the Community Reinvestment Act (CRA). The CRA requires depository institutions to provide credit to their local communities, and while CRA evaluations are somewhat subjective, it is widely acknowledged that the LIHTC can count toward CRA provisions. Investors may therefore be willing to pay above the actuarially fair price for LIH credits, since they benefit both from the tax advantage and from the CRA fulfillment.

Who Invests in Low Income Housing Tax Credits

One of the most interesting aspects of the LIHTC program is who's investing in the tax credits, and how the investment trend is shifting. As seen in Figure 2, the distribution of claimants has shifted increasingly away from individuals and toward corporations. We can examine the characteristics of individual and corporate claimants by using tax data on credits claimed. While the measure of credits claimed from publicly available tax records is not perfect, it is a good approximation; see Desai, Dharmapala, and Singhal (2010) for further details. Somewhat surprisingly, individual LIHTC investments appear to be small, and shrinking. While the number of claimants has been fairly constant over time, the average credit per claiming return has declined substantially, decreasing from $4,100 to $2,100 in real terms between 1995 and 2002 (Figure 3).

An examination of credits claimed by income category also reveals interesting patterns (Figure 4). The distribution is hump-shaped in each year, likely reflecting the fact that low income households do not have tax liability to offset while higher income individuals are more likely to be subject to the Alternative Minimum Tax (AMT). There has also been a shift down the income distribution in the distribution of credits claimed, perhaps as a result of the AMT binding.

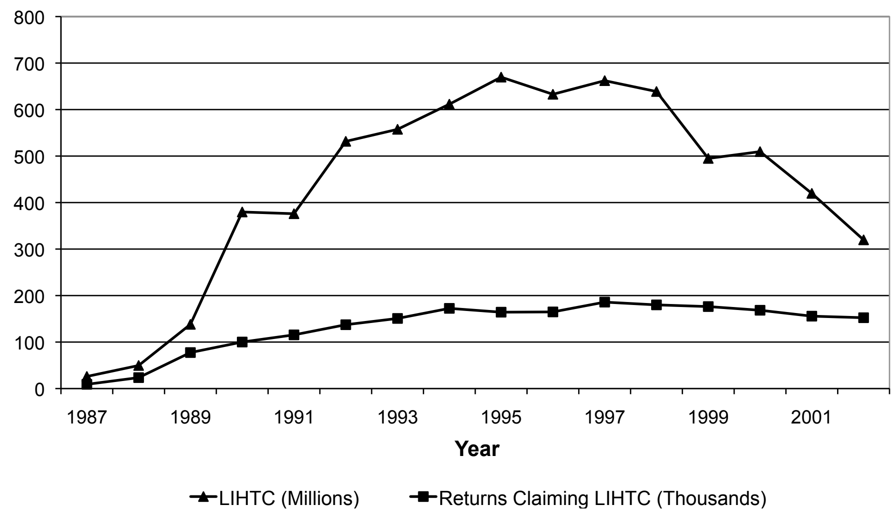
While tabulations by income category are not available in the published corporate tax reports, we can examine claims by sector. Table 1 illustrates the share of annual credit value claimed by the largest five sectors as well as the real estate and leasing sectors. For corporate investors, credits are claimed primarily in the finance and insurance sectors and in holding companies, comprising 65% of the total corporate credits claimed in 2000 and 89% in 2006. This high concentration strongly suggests that these sectors derive additional benefits from investment, such as the CRA benefits discussed above. Little investment has come from the real estate sector, indicating that the separation of the service provision and the tax beneficiary may have been an important factor in attracting corporate LIHTC investors.

The Credit Crisis and Legislative Responses

The U.S. housing bubble collapse in 2007 followed by the subsequent financial crisis had profound consequences for the LIHTC program. Before the economic crisis, $1 of tax

Figure 4

LIHTC Claimed by Individual Investors



Notes: Source: Public use sample of individual tax returns (1987–2002). LIHTC claimed is calculated from the LIHTC line item in the tentative general business tax credit calculation.

credits traded at nearly 90 cents; by early 2009, the corresponding price had fallen below 70 cents (Federal Reserve Bank of Dallas, 2009). The housing credit price declined primarily because of decreased investor demand for LIH credits. This was largely the result of losses incurred by banks and other financial institutions that have rendered tax credits significantly less valuable. The exit from the credit market of two major buyers of LIH credits, Fannie Mae and Freddie Mac, after entering government conservatorship in 2008, also reduced tax credit prices. The decreased market value of LIH credits during the recent crisis has severely curtailed developers' ability to obtain equity financing through the sale of credits, at a time when demand for low-income housing likely increased.

Congress responded by adopting various measures to encourage the supply of low-income housing as part of its economic stimulus efforts. The HERA included provisions designed both to make LIH credits more attractive to investors and to expand the scale of the LIHTC program. HERA established a floor for the annual credit rate and increased LIHTC allocations to the states by 10% for 2008 and 2009. HERA also allowed investors to use LIH credits to offset AMT liability to make credits more attractive to investors who are subject to the AMT or who are concerned about facing the AMT over the lifetime of the credits.

The ARRA significantly changed the LIHTC by introducing a credit exchange program whereby the U.S. Treasury could make cash grants to the states in lieu of part of their LIHTC. For example, a state was permitted to elect to receive as cash grants up to 40% of its 2009 LIH credit allocations and to receive grants in exchange for unused credits for 2008. The Federal government will pay 85 cents for each $1 of LIH credits given up by the state, with the intention that states will award these funds to developers to pursue projects that conform to LIHTC requirements. These projects need not have any other LIHTC funding, although developers are required to demonstrate that they

Table 1

Distribution of Corporate Claimants by Selected Sectors

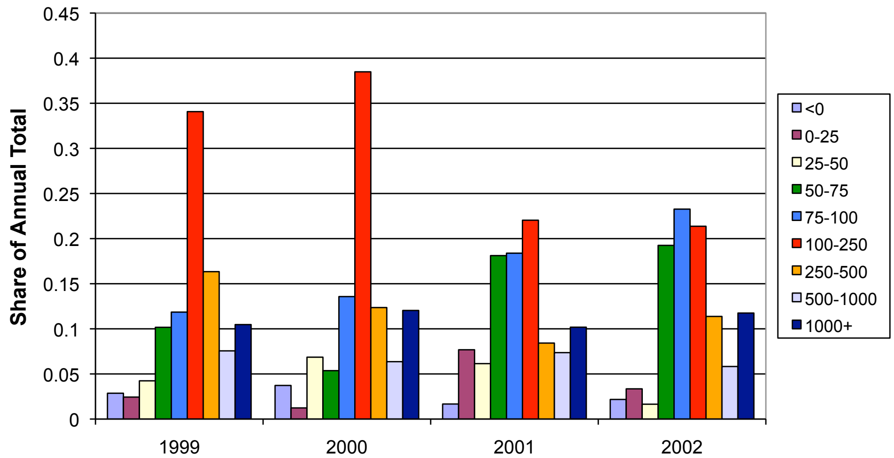
	Share of Annual Value of Corporate Credits Claimed	
	2000	**2006**
Finance and Insurance	33.4	42.9
Management of Companies (Holding Companies)	31.5	45.6
Utilitites	9.61	N/A
Manufacturing	14.7	4.11
Information	5.43	3.56
Real estate and rental and leasing	1.02	0.06

Notes: Source: Public Table 21 of the Corporation Complete Report. LIHTC claimed is calculated from the LIHTC line item in the tentative general business tax credit calculation. Table includes the five sectors that account for the largest shares of credits claimed as well as the real estate sector.

have made a good faith effort to obtain equity investment. The funds awarded in this way are not considered taxable income for the recipients, and do not reduce the project's eligibility for LIHTC. This LIHTC exchange program effectively bypasses the market for LIH credits, helping to ensure continued investment in affordable housing development even if the market is depressed.

Figure 5

Distribution of Claimants by Income



Notes: Source: Public use sample of individual tax returns (1987–2002). LIHTC claimed is calculated from the LIHTC line item in the tentative general business tax credit calculation. Income refers to an approximation of cash income (please see text for details).

Conclusion

The LIHTC program has become the primary federal program subsidizing low-income housing development and appears to have broad support among policymakers, low income housing advocates, developers and institutional investors. The program has been expanded and reformed and has served as a model for other related federal and state programs. The program's political popularity is largely a result of its departure from supply-side provisions or housing subsidies, with service providers and tax beneficiaries essentially "unbundled". This structure makes the program efficient and encourages competition, but it also means that its success depends on the incentives of a variety of market participants. Additionally, while tax expenditures under LIHTC are more predictable than demand-side programs, the supply of housing can vary. Corporations are now the primary investors in LIH credits, and their incentives may reflect not only features of the LIHTC program, but also of related programs.

The economic and housing crisis has illustrated the potential vulnerability of the LIHTC program to aggregate market conditions. Subsequent policy reforms have loosened the supply of credits or made the terms of their use more favorable, but have not altered the program's fundamental structure. The replacement of some LIHTC allocations by cash grants, however, represents a significant shift in the program's design from the "investable tax credit" model towards a direct subsidy approach. In view of these changes, continued analysis and debate about the relative advantages of the LIHTC program and traditional housing programs is more pertinent than ever.

The full research paper can be found at the National Bureau of Economic Research at this link: http://www.nber.org/papers/w14149. Tax Incentives for Affordable Housing: The Low Income Housing Tax Credit; Mihir Desai, Dhammika Dharmapala, and Monica Singhal, Tax Policy and the Economy 2010 24:1, 181-205

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