

1. INTRODUCTION

The Low-Income Housing Tax Credit (LIHTC) program has been a significant source of new multifamily housing for more than 20 years. As the LIHTC matures, however, thousands of properties financed using the program are becoming eligible to end the program's rent and income restrictions, prompting U.S. Department of Housing and Urban Development's (HUD's) Office of Policy Development and Research to commission this study. In the worst-case scenario, more than a million LIHTC units will have left the stock of affordable housing by 2020, a potentially serious setback to efforts to provide housing for low-income households.

The research conducted for this study—including interviews with syndicators, LIHTC property owners, and industry experts, as well as analysis of HUD's LIHTC database and market research—demonstrates that the worst-case scenario is unlikely to be realized. Our answer to the question of whether older LIHTC properties continue to provide affordable housing for low-income renters is a qualified 'yes.' Most LIHTC properties remain affordable despite having passed the 15-year period of compliance with Internal Revenue Service (IRS) use restrictions, with a limited number of exceptions.

Other research issues addressed by this study include why and how owners and investors make decisions about the future of their properties, whether properties still in the LIHTC program are performing well financially, and the extent to which properties at around Year 15 seek additional allocations of tax credits.

The remainder of this chapter provides an introduction to the LIHTC and its role in the multifamily market, comparing it with previous rental production subsidies. Chapter 2 provides more detail on who owns LIHTC properties and how they are financed. Chapters 3 and 4 describe the outcomes for properties at the end of the 15-year IRS compliance period, including the mechanisms through which properties change ownership and the extent to which LIHTC properties are no longer monitored by state agencies after Year 15. Chapter 5 reports our findings on properties' financial and physical condition at Year 15. Chapter 6 describes three outcome patterns for early year LIHTC properties: remaining affordable without major recapitalization with new tax credits, recapitalization with new tax credits, and leaving the affordable housing stock. Chapter 7 assesses whether the patterns observed for early year LIHTC properties are likely to continue for properties placed in service in 1995 and later. Chapter 8 is a conclusion with a discussion of policy implications and recommendations for future research.

THROUGHOUT THE REPORT, **AFFORDABLE HOUSING** REFERS TO HOUSING WITH RENTS AT OR BELOW THE LIHTC MAXIMUM FOR THE AREA.

1.1 WHAT IS THE LOW-INCOME HOUSING TAX CREDIT?

The LIHTC was created by the Tax Reform Act of 1986, in part to replace the generous tax benefits for affordable multifamily housing that were abolished by the same legislation. As suggested by its name, it provides a subsidy to private developers of affordable housing through the federal tax code. Congress allocates tax credits to states based on population, in the amount of \$2.15 per state resident (as of 2011). In turn, states allocate tax credits through a competitive process, often administered by the state's housing finance agency (HFA). Properties must meet one of two criteria to qualify for tax credits: either a minimum of 20 percent of the units must be occupied by tenants with incomes less than 50 percent of Area Median Income (AMI), or 40 percent of units must be occupied by tenants with incomes less than 60 percent of AMI. These affordability restrictions

remain in place for a minimum of 15 years. Points are awarded to qualifying development proposals based on priorities documented in a Qualified Allocation Plan (QAP), which is created individually by each state and which states revise annually.

The tax credits are provided to developers through federal tax credits received annually for 10 years. Tax credits are set at either 70 percent of the present value of the qualifying costs (initial development costs, excluding the cost of land and certain other expenses), which translate to a yearly tax credit of about 9 percent. Credits in the amount of 30 percent of qualifying costs, which amounts to a yearly tax credit of about 4 percent, are distributed outside the allocation system. These are discussed in Section 6.2. The amount of the 9-percent credits depends on whether the project is new construction, substantial rehabilitation, or acquisition and minor rehabilitation of an existing property, whether it is in a difficult development area (DDA) or qualified census tract (QCT),¹ the share of units set aside for low-income households,² and other factors. With boosts in the qualified basis of a project for meeting certain requirements, the ultimate government subsidy can cover up to 91 percent of construction costs (Eriksen and Rosenthal, 2007).³

LIHTC developers frequently sell the tax credits to equity investors through a syndicator; syndicators serve as matchmakers between developers and tax credit investors, who are generally corporations with substantial and predictable federal tax obligations. Syndication is necessary because the real estate project itself is unlikely to generate enough federal tax liability for the owner to be able to claim the full value of the tax credits for itself. Purchasers have sufficient tax liability to be able to use the tax credits and may also benefit in other ways such as sharing in cash flow and resale value.

THE LIHTC IS THE LARGEST RENTAL HOUSING PRODUCTION PROGRAM IN HISTORY

Perhaps surprisingly for a government program embedded in arcane IRS regulations (Section 42 of the Internal Revenue Code), the LIHTC program is an important source of new rental housing. Recently, it has produced roughly 100,000 units each year. Altogether, about 2.2 million units in some 35,000 separate properties⁴ were placed in service under the program between 1987 and 2009, the latest year for which we have data.⁵ As of 2011, the number may be close to 2.4 million units. The LIHTC program has outstripped both public housing (with 1.1 million units currently existing) and HUD-assisted, privately owned housing (with up to 1 million units). LIHTC is thus the largest program in U.S. history providing property-based subsidies to rental housing, and since the early 1990s, has been the only such program developing substantial numbers of additional units.⁶

1. As part of the Omnibus Reconciliation Act of 1989, Congress added provisions to the LIHTC program designed to increase production of LIHTC units in hard-to-serve areas. Specifically, the act permits projects located in DDAs or QCTs to claim a higher eligible basis (130 percent of the standard basis) for the purposes of calculating the amount of tax credit that can be received. Designated by HUD, DDAs are defined by statute to be metropolitan areas or nonmetropolitan areas in which construction, land, and utility costs are high relative to incomes, and QCTs are tracts in which at least 50 percent of the households have incomes less than 60 percent of the AMI. The Housing and Economic Recovery Act of 2008 broadened this authority to allow any building designated by the state housing credit agency as requiring the increase in credit in order to be financially feasible to be treated as located in a difficult development area.
2. In reality, nearly all units in tax credit projects qualify as low-income, including 95 percent of units placed in service from 1995 to 2007 (Climaco et al., 2010).
3. The highest subsidies are for properties that receive both 9-percent credits and a 30-percent basis boost for locating in a QCT or a DDA.
4. The term *property* is used interchangeably with *project* and *development*.
5. <http://www.huduser.org/portal/datasets/lihtc.html>.
6. The HOME program is also used to produce new rental units, although on a much smaller scale. In addition, HOME funding is often used in combination with tax credits and does not produce units on a stand-alone basis.

Beyond the fact that they now outnumber other government-funded rental units, LIHTC-funded units increasingly represent an important share of all rental housing units. From 1987 to 2006, LIHTC units accounted for roughly one-third of all multifamily rental housing constructed (Eriksen and Rosenthal, 2010) and as of 2009 made up about 6 percent of all renter occupied housing units.⁷

LIHTC DIFFERS FROM OTHER RENTAL HOUSING PRODUCTION PROGRAMS

The tax credit program differs from earlier subsidized rental housing production programs such as the public housing built from the 1930s to the 1980s and the Section 8 projects built in the 1970s and 1980s, in several important ways. Tax credit units' rents are not related to specific tenants' income. Researchers have pointed out that, in many of the housing markets and specific locations where LIHTC housing has been built, LIHTC units compete with market-rate units because rents are quite similar to market rents. LIHTC projects sometimes have layered subsidies, however, and tiers of rents that are lower than either the LIHTC maximum rents or market rents.

Another programmatic difference from traditional public housing or Section 8 projects is that the federal role in tax credit projects is small, and the projects are allowed to fail if their financial condition is poor. Regardless of the fact that tax credit projects are subject to market discipline because of their similarity to market-rate housing, some inefficiencies exist in the program. Each of these features of LIHTC is discussed in more detail in the following section.

LIHTC RENTS ARE NOT BASED ON THE INCOMES OF INDIVIDUAL TENANTS

Tax credit rents are not based on the income of the tenants. Although tax credit units must be affordable to households at either 50 percent or 60 percent of the AMI, rents do not vary with actual tenant incomes—nor is rent limited to 30 percent of the tenants' income, an amount considered affordable. As a result, the program reaches a somewhat higher income group than previous production programs, unless it is coupled with other subsidies such as tenant-based housing vouchers. Wallace (1995) estimated that only 28 percent of LIHTC residents had incomes less than 50 percent of AMI, compared with 81 percent of those who reside in traditional public housing. That analysis was done at a time when lower tiers of rents in LIHTC properties were less common than they became later, so the percentage may be higher now.⁸

7. Based on a calculation using data on the total number of renter occupied units from the American Housing Survey: <http://www.census.gov/housing/ahs/data/ahs2009.html>.

8. Until recently, no systematic data were collected about the income levels of LIHTC tenants across the program. In 2008, HUD began collecting data on the elected rent/income ceiling for the low-income units in LIHTC projects (either 50 or 60 percent of area median gross income) and whether any units were set-aside to have rents that are less than the elected rent/income ceiling. (The 2008 collection included properties placed in service through 2006.) In 2010, HUD implemented a new mandate to collect tenant-level data, including annual income, for tenants residing in LIHTC units. These tenant-level data are not yet available for analysis.

LIHTC RENTS ARE SIMILAR TO MARKET RENTS

In some markets, tax credit units are no more affordable than rental units generally. Burge (2011) conducted a study of LIHTC projects in service as of 2002 in Tallahassee, Florida, considered to be a typical medium-sized metropolitan statistical area (MSA). Tallahassee has had a weak housing market in recent years, but not during the period covered by the study. Using hedonic regression analysis, Burge found that maximum tax credit rents are initially less than implied market rents because of the properties' high quality—their newness—when placed in service. This market advantage eroded, however, as the properties aged and declined in quality during the 15-year period of affordability required for compliance with the tax code.

This dynamic does not hold in all markets. In strong housing market areas such as parts of the Northeast and California, tax credit rents tend to be lower than market-rate rents for comparable units and may remain so over time. Even in strong housing markets, however, this trend depends on the specific location of the LIHTC property, as the competition for rental housing is for nearby properties, not those in a different part of a metropolitan area or rural region.

Baum-Snow and Marion (2009) analyzed 330 MSAs and also found that, in many cases, LIHTC maximum rents in 2000 did not result in LIHTC rents that were below unsubsidized rents. The nonbinding effect of the LIHTC restrictions was the case regardless of the income level of the neighborhood, but especially in low-income neighborhoods. They found that, when LIHTC properties were in tracts where 50 percent or fewer households were LIHTC-eligible, two-thirds of occupied rental apartments had rents below the LIHTC maximums. When LIHTC properties were in tracts with more than 50 percent of households LIHTC-eligible—that is, in low-income neighborhoods—82 percent of apartments had rents below the maximum rents.

Both Burge and Baum-Snow and Marion used maximum tax credit rents because they were not able to observe actual rents paid for LIHTC units. This highlights two points. First, although these authors' conclusions may be strictly accurate, the LIHTC units may be providing more affordability than they suggest because rents may be set below the LIHTC rent ceiling. Second, the LIHTC database does not include information on tenant-specific rent payments. The lack of data on LIHTC rents actually paid is an important gap in the information available about these units.

LIHTC UNITS COMPETE WITH MARKET-RATE RENTS

Unlike public housing and project-based Section 8, for which residents pay a percentage of their actual income, however low, tax-credit units often are in competition with other middle-market rental housing because the HUD-defined LIHTC maximum rent is often similar to market rent. This competition for renters provides incentives for owners to manage the projects well (Khadduri and Wilkins, 2008). Because of this competition, and also because of the design standards required by some HFAs and chosen by some LIHTC developers, tax-credit properties can be difficult to identify as low-income housing. Under some circumstances, they can create positive amenity effects such as the revitalization of low-income neighborhoods (Burge, 2011 and Freedman and Owens, 2011). The need to compete with other housing may also provide an incentive to avoid locating tax-credit projects in the most undesirable locations, where renters with a range of options would not choose to live.

LIHTC PROJECTS CAN INCLUDE HOUSEHOLDS WITH MIXED INCOMES

Tax-credit projects can sometimes be considered mixed income, because households with incomes close to 60 percent of AMI reside in the same complex as those assisted with Housing Choice Vouchers (HCVs), who usually have incomes below 30 percent of AMI. This income mixing allows tax-credit projects to serve households with poverty-level incomes, but also reduces the stigma attached to government-subsidized housing and, therefore, acceptance of the projects in relatively high-income communities. However, a lack of information about the tax credit program makes it impossible to assess the extent of income mixing (Khadduri and Wilkins, 2008).

THE FEDERAL ROLE IN PROGRAM DECISIONS IS LIMITED

LIHTC also differs substantially from previous production programs in that the federal role in program decisions is quite limited. As described previously, LIHTCs are allocated and monitored at the state level. Applications for tax credits almost always exceed the total availability of tax credits, which gives HFAs latitude in making awards. The role of the federal government is limited to funding the program through the income tax system and setting some broad parameters that are spelled out in law: maximum rents and income limits, a minimum percentage of nonprofit owners, the percentage of development costs that may be taken as a credit, and some requirements for QAPs.⁹ Because LIHTC is a tax provision rather than an appropriation of funds, the regulations governing the program have focused on appropriate interpretations of tax policy rather than on using the program as an instrument of housing policy. The federal government has essentially no role in the management of tax credit properties.

OWNERS OF LIHTC DEVELOPMENTS BEAR RISKS OF FINANCIAL FAILURE

Correspondingly, the risk that a property will fail is not taken by the federal government, but by owners, investors and lenders. In some cases, the federal government provides financing such as Federal Housing Administration (FHA) insured loans for tax credit properties, but tax credit properties often rely solely on conventional financing in addition to the equity provided by the tax credits. In general, LIHTC projects are at low risk of failure—at least during the first 15 years—because of monitoring by the syndicator, investors, and the developer and perhaps also because of the stringent penalties under the federal tax code for investors and owners for foreclosure. The state also monitors LIHTC projects and has a particularly strong incentive to ensure the financial viability of projects in cases where the HFA has provided some of the financing. According to a recent study of a sample of LIHTC projects, the cumulative foreclosure rate through 2006 was only 0.85 percent, and the annualized foreclosure rate since inception was 0.08 percent (Ernst & Young, 2010).

THE LIHTC PROGRAM DESIGN CREATES BOTH EFFICIENCIES AND INEFFICIENCIES

There is much debate about using a tax credit as the subsidy mechanism for housing development. Unlike previous rental production programs in which developers received a lump sum grant, developers of tax credit units receive the subsidy in an illiquid form and over a relatively lengthy period of time. Because credits are paid out over 10 years, although the investor supplies equity at the beginning of the deal, the tax credit price is discounted. That

9. For example, federal law requires QAPs to give priority to projects that serve the lowest income households and that ensure affordability for the longest period of time.

is, \$1 of tax credits is worth less than \$1 in affordable housing. The program has grown more efficient over time, however, increasing from below 50 cents per dollar of tax credits in the early years of the program to more than 90 cents per dollar for properties placed in service in 2006 (Ernest & Young, 2010). Discounting the stream of tax credits over the appropriate 10-year period indicates higher implied prices for tax credits (Cummings and DiPasquale, 1999). Investors also realize tax benefits from depreciation, which affects the cost of the housing subsidy to the federal government.

Some research suggests that the value of the tax credit subsidy is eroded by the complexity of the subsidy mechanism, which includes the costs of syndication and of complying with IRS affordability requirements. Eriksen (2009) analyzed a sample of tax credit properties in California allocated credits from 1999 to 2005 and found that the sale of developers' tax credit equity alone—required to realize the full value of the tax credits—required transaction fees of 15 percent or more during that period. Similarly, the Government Accountability Office (GAO) found that syndication costs amount to 10 to 27 percent of total equity raised (GAO, 1997).

Eriksen argues that the calculation of the qualified basis on which the amount of tax credits is awarded provides an incentive for developers to construct more expensive housing units than they would otherwise. He compared LIHTC housing units in his sample with unsubsidized units built over the same period, and found that unsubsidized units cost about 20 percent less per square foot to construct. A number of other explanations for this cost differential may exist, however, including the prevailing wage laws that may be triggered by sources of funds commonly paired with LIHTC; carrying costs associated with the long periods of time needed to apply for and secure tax credit allocations and other financing; and costs associated with additional regulation, oversight, and reporting involved in developing and leasing LIHTC housing.

And on the flip side, other researchers argue that the subsidy mechanism used by the LIHTC creates efficiencies. An important example is the delegated compliance monitoring (done primarily by investors and syndicators) and the powerful enforcement mechanism built into the program, the threat of tax credit recapture if the project is not maintained as affordable. Investment in tax credits has been allowed as a way for banks to meet their Community Reinvestment Act (CRA) obligations, which in some markets may increase the price of tax credits to more than their actuarially fair value (Desai et al., 2008). In addition, competition for tax credits may introduce efficiencies as well as allow states to best meet their housing policy goals (Deng, 2005).

LIHTC UNITS ARE AT RISK OF LOSS FROM THE AFFORDABLE HOUSING STOCK

Like earlier housing production programs, units subsidized using the LIHTC may eventually convert to market-rate housing with higher rents and thereby be lost from the stock of affordable housing. Initial affordability restrictions for the LIHTC program were limited to 15 years, after which the units could convert to market rate. Previous multifamily production programs have addressed the risk that privately owned, subsidized units might eventually become unaffordable by using grants to cover rehabilitation costs, forgiveness of debt (when properties had FHA insurance), and increases in the rents paid under subsidy contracts with HUD. Nonetheless, some properties left the affordable housing stock by prepaying mortgages with use restrictions and by opting out of their rental subsidy contracts (Finkel et al., 2006; Hilton et al., 2004).

Similar policy concerns about tax credit units motivate this research, but the relatively limited active involvement of the federal government means that federal legislative or regulatory tools for preserving the units as affordable are limited. Beginning in 1990, federal law required tax credit projects to remain affordable for a

minimum of 30 years, for a 15-year initial compliance period and a subsequent 15-year extended use period. However, the Qualified Contract (QC) process provides an option for owners to leave the LIHTC program after 15 years by asking the HFA to find a buyer, at a formula-determined price, who will agree to maintain the property under affordability restrictions. If no such buyer is found, affordability restrictions phase out over 3 years. The QC process is described in detail in chapter 4.2.

STATE EFFORTS TO PREVENT TAX CREDIT UNITS FROM REPOSITIONING TO MARKET RATE

Beyond this federally mandated period of affordability, the task of preserving tax credit units as affordable primarily belongs to the states, and states have responded by taking a variety of measures. California made longer affordability periods mandatory almost from the beginning of the program, and, by 2001, 41 states either required or gave preference to projects with affordability periods of longer than 30 years. These periods extend from 40 to 60 years and even to perpetuity in the case of Massachusetts, Michigan, and Vermont (Gustafson and Walker, 2002).

The binding constraint on the period of affordability is sometimes not the federal requirement or state QAPs, but the conditions imposed by other funders. States, local governments, and nonprofits sometimes provide additional sources of funding for construction of tax credit properties and often require periods of affordability longer than 30 years.

Finally, a number of states require tax credit applicants to waive the use of the QC process, ensuring that the property cannot phase out of the tax credit program as early as Year 18. According to our interviews, some states also discourage the use of the QC process by making the process complicated and expensive.

OTHER FACTORS AFFECTING THE AFFORDABILITY OF TAX CREDIT UNITS

Other factors also affect whether LIHTC properties will be repositioned to market rate. Many developments have socially motivated sponsors, often nonprofits whose mission is to create and preserve affordable housing in their neighborhoods. Even if no additional affordability restrictions prevent these organizations from converting properties to market rate, they typically maintain the units' affordability to achieve their mission. Federal law requires that 10 percent of tax credits be allocated to projects with nonprofit sponsors. In the first 2 years of the LIHTC program, states were not meeting that target but, by 1993, 18 percent of properties had nonprofit sponsors, and the percentage continued to grow.

Perhaps most important, the dynamics of rental markets affect whether tax credit properties are repositioned. In many places, rents for tax credit properties—particularly by Year 15, when the properties have aged—may already be at market potential.

OTHER FEDERAL HOUSING PROGRAMS ARE MORE COST-EFFECTIVE THAN LIHTC IN SOME MARKETS

Given the cost of the LIHTC program to the federal government—roughly \$5 billion in annual tax expenditures—surprisingly little research examines its cost-effectiveness. A body of literature beginning with the Experimental Housing Allowance Program (starting in the 1970s) demonstrates that housing production

programs are generally more expensive than housing vouchers.¹⁰ However, few studies specifically compare the costs of LIHTC—with its built-in private-market efficiencies—to other housing subsidy mechanisms. We are aware of only two studies, both are described in the following section.

Most recently, Deng (2005) compared newly constructed units placed in service after 1994 with vouchers in six metropolitan areas. She compared the subsidies required to produce a LIHTC unit with the voucher subsidy required to house a family with the same target income¹¹ in the metropolitan area. This research required detailed review of individual project cost certification forms and project evaluation worksheets to compile the necessary data on project development costs, which points to an important gap in the data readily available to researchers on LIHTC projects. Both state and federal subsidies were included in the analysis.

Deng found that the LIHTC units, all subsidized with 9-percent credits, were more expensive than the cost of vouchers over a 20-year period, but that the size of the LIHTC premium depends on the voucher payment standard and characteristics of the local housing market as well as local program administration.

Assuming a housing voucher payment standard of 90 percent of Fair Market Rent (FMR), tax credit units are more expensive than vouchers in all six metropolitan areas. In Atlanta, tax credit units are, on average, six times more expensive than vouchers. In Miami, tax credit units are 66 percent more expensive than vouchers under this payment standard. With a higher payment standard (110 percent of FMR), the cost-effectiveness of tax credit units increases, but are still more expensive than vouchers in four of the six metropolitan areas (Atlanta, Boston, Cleveland, and New York). With a voucher payment standard of 100 percent of FMR, tax credit units are more expensive than vouchers in all metropolitan areas, but only by 2 percent in San Jose and 12 percent in Miami.

Housing market tightness did not necessarily drive the cost effectiveness of tax credit units. Tax credit units are most cost effective in Miami, a balanced market, and in San Jose, a tight market, although the reasons for this effectiveness are quite different in each market. They are least cost effective in Atlanta, a balanced market, and Boston, a tight market. Again, the reasons for this are quite different in Atlanta and Boston. For example, Deng attributes the high cost of tax credit units in Atlanta to two primary factors. First, Atlanta's FMRs are relatively low, making the comparative cost of vouchers low. Second, the income targets for LIHTC units in Atlanta are relatively high: 50 to 60 percent of the AMI, a target driven by both program administration and local market conditions. In this market, most households residing in tax credit units would not qualify for a housing voucher because they could easily afford market rents (demonstrated by the fact that their minimum rent contributions are often higher than FMR). The voucher subsidy to these households is thus \$0, while tax credit units to house these families are expensive to build.

On the other hand, LIHTC units were estimated to be roughly equivalent to the cost of vouchers in San Jose, a tight market. Again, local conditions and program administration are important factors. FMRs are high in San Jose (higher than in either New York or Boston) and the metropolitan area has a history of high growth rates in FMRs, both conditions that make vouchers relatively expensive. In addition, LIHTC production costs are relatively low in San Jose because projects are relatively large (thus achieving economies of scale) and tend to be developed in suburban areas.

10. These studies are reviewed by Olsen, 2000, and include HUD 1974; Mayo et al. 1980; Olsen and Barton 1983; and Wallace et al. 1981. More recent studies include McClure 1998; and Shroder and Reiger, 2000.

11. Where the units' targeted family income was not available, maximum allowable rent was used.

In New York and Boston, the other tight markets, even new construction LIHTC projects tend to be smaller and developed in infill areas, increasing the costs of construction and thus reducing the cost effectiveness of tax credit units. The location of LIHTC projects in these areas is influenced by these states' focus on community revitalization as a secondary goal of affordable housing development.

An earlier study by GAO (2002) compared the cost (both of development and operations over the useful life of the project¹²) of six federal housing programs and found that LIHTC units are less expensive *to the government* than housing vouchers, but only because tenants—who are relatively higher income households and also often pay more than 30 percent of their income for rent—pay a larger share of the bill. The *total* cost of LIHTC units, considering costs both to the government and to tenants, is higher than the cost of housing vouchers. This was true in both metropolitan and nonmetropolitan areas, although not in all housing markets. Further, of the four production programs compared, LIHTC units were the most expensive for both one- and two-bedroom units in metropolitan areas, although differences in unit quality could not be controlled for by the study.

The GAO study did not consider other sources of project subsidies such as grants and soft debt from state or local governments or other sources. The study assumed that capital reserves would be sufficient to cover the properties' needs for a 30-year period during which the properties would provide housing for low-income renters. The authors noted that shortfalls in capital reserves, which are historically underfunded by production programs, would result in costs that were higher than estimated, perhaps by nearly 15 percent.

The present study strongly suggests that reserves for LIHTC properties are indeed often underfunded, as evidenced both from the interviews conducted for the study and from the observation that some LIHTC properties are resyndicated with new allocations of tax credits at Year 15.

LIHTC UNITS SUBSTITUTE FOR SOME PRIVATE MULTIFAMILY PRODUCTION

Unlike earlier public housing and Section 8 developments that were very heavily concentrated in low-income areas, Eriksen and Rosenthal (2010) point out that LIHTC projects are relatively well-distributed geographically across the income spectrum. As of 2000, nearly one-half of LIHTC projects (44 percent) were in neighborhoods in either the upper or middle third of their MSA's income distribution. In comparison, 77 percent of public housing units were in low-income neighborhoods in 2000. This may indicate that the program is expanding the stock of affordable housing in higher income neighborhoods.

A point of contention about the LIHTC, however, is whether the properties expand the overall stock of housing. That is, to what extent do tax credit units built substitute for—or crowd out—other multifamily rental housing that would have been built without a subsidy. If tax credit units completely replace private units, then there is no net addition to the housing stock, although the quality of the housing stock may improve. The substitution of tax credit units for privately funded units stems from their similarity to market-rate units. This similarity plays the useful role of imposing market discipline on tax credit projects. It also suggests, however, that in places where tax credit units have rents similar to unsubsidized rental housing, conversion of LIHTC properties to market-rate properties may not seriously threaten the total number of units that are affordable to moderate-income households.

12. This period was assumed to be 30 years.

Subsidized housing generally has been found to substitute for private housing to some degree, so that one unit of subsidized housing results in less than one unit of additional housing on net (Murray, 1983 and 1999 and Sinai and Waldfoegel, 2002). Research conducted specifically on LIHTC developments finds some degree of substitution for private rental housing, but is mixed in its conclusions on whether tax credit units entirely crowd out unsubsidized housing. Malpezzi and Vandell's (2002) study produced point estimates that indicate that place-based housing subsidies fully crowd out private, unsubsidized construction. Their analysis was at the state level, however, and they were unable to draw firm conclusions about crowding out because of a small number of observations (51) and thus large standard errors. Eriksen and Rosenthal (2010) studied tax credit properties using tract-level data for 1990 and 2000 with more conclusive results. Their estimates indicate that, over a 10-mile radius area, nearly all LIHTC development is offset by reductions in private unsubsidized construction. They suggest that the program may affect the location of affordable housing units more than the overall number of new housing units developed.

Two recent studies concluded that the degree of crowding out depends on the type of neighborhood where the housing is built. Eriksen and Rosenthal (2007) examined high- and low-income communities (those in the top third and bottom third of the income distribution in the MSA) and found that the impact of LIHTC developments was quite different between the two. In low-income communities, the developments had a positive effect. Within a small area, LIHTC units may actually encourage private construction. The opposite was true in high-income communities. For those communities, within an area with a 0.5 mile radius, construction of LIHTC units substituted fully for private, unsubsidized construction. Here LIHTC did not increase the total stock of rental housing, but instead may have affected who gets to live in those communities.

Baum-Snow and Marion (2009) likewise found that the LIHTC program's impacts on housing development differ across neighborhood types. In areas where home prices had been declining, new tax credit units nearby increased property values. In gentrifying areas, nearby development of tax credit units had a negative impact on incomes. Consistent with these impacts, they concluded that tax credit units crowd out private multifamily rental construction much more in gentrifying areas than in declining areas. In declining areas, new tax credit units increased the overall rental stock by 0.8 units within one kilometer of the project site. In gentrifying areas, however, each new tax credit unit increases the overall rental housing stock by only 0.37 units.

THE FINANCIAL HEALTH OF LIHTC PROPERTIES

Although very few LIHTC developments fail to the point where they are foreclosed, this does not mean that tax credit properties are without financial problems. The physical condition of units is often closely intertwined with financial health, as the financial stability of the property is an important factor in the decisions property managers make about maintenance and capital improvements.

As Cummings and DiPasquale (1998) point out, investment in a tax credit property is investment in real estate, and real estate investment is risky. Beyond the typical risks involved in real estate investment, LIHTC projects face some unique risks, including the rent restrictions, the complexity of the program and its compliance requirements, the special needs of the population being served if projects are designed to serve people with special needs, such as the homeless or disabled, and other factors related to the design of the tax credit program.

RENT RESTRICTIONS

The program's maximum rents restrict the cash flows that can be used to replenish reserves, pay debt, and make capital improvements to the property. That is the theory behind compensating owners who agree to rent restrictions with a development subsidy—the equity raised through the tax credit—that reduces the need for debt.

On the other hand, LIHTC properties in markets where maximum tax credit rents are below market rents may perform better because other affordable housing is scarce and also because higher incomes in areas such as the Northeast and California mean that the maximum tax credit rents in these markets may be high relative to the costs of operating the housing. Ernst & Young (2010) analyzed the operating performance of a sample of tax credit properties that were placed in service and leased by the end of 2005 and found that properties in the Northeast and Pacific regions had better median debt coverage and cash flow than properties in the Midwest, where tax credit rents and market rents tend to be very similar.

PROJECT MANAGEMENT

As in all real estate, the quality of management of LIHTC developments affects their financial and physical condition. In addition to facing the typical complexities of multifamily property management, LIHTC project managers must also screen applicants for compliance with required income levels, report to the HFA, and submit to property inspections. They may serve special-needs populations that require additional services.

In addition, the LIHTC program's design provides incentives for property managers to operate on very thin margins, with net cash flow frequently near zero. Importantly, LIHTC investors typically do not expect to receive their returns from cash flows, but from tax-related events. In addition to benefiting from the tax credits, investors may claim deductions for the project's depreciation and other expenses against other income, and positive cash flow reduces the value of the depreciation deductions (Usowski and Hollar, 2008). In practice, investors do not press for positive cash flow, but may instead encourage property managers to use operating income for property expenses. Some financing arrangements also provide incentives for partners to keep net income at or near zero: some soft loans, often provided by states or other government entities, require repayment only if cash flow is positive (Cummings and DiPasquale, 1998).

Managing the project's cash flow to achieve this balance adds to the difficulty of operating LIHTC projects. If cash flow is not managed successfully—for example, because cash flow projections made at the time of underwriting were too optimistic—the resulting negative cash flow may lead the project into a downward spiral of financial and physical deterioration. Although tax credit projects typically are of high quality compared with other nearby market-rate units when placed in service, over time inadequate operating income may cause property maintenance and physical condition to suffer, leading to increasing difficulty in attracting and retaining tenants.¹³ This can lead to a downward spiral by further exacerbating financial and physical problems as operating costs increase and rental income decreases (Korman-Houston, 2009).

13. Not surprisingly, the relationship between physical condition and occupancy is strong: one study found that mean occupancy was higher for properties in excellent condition (97 percent) than those in good and satisfactory condition (95 and 93 percent, respectively), and occupancy dropped sharply for properties in poor condition (85 percent) (Korman-Houston, 2009).

FACTORS RELATED TO LIHTC PROGRAM DESIGN

Healthy reserves are particularly important for properties operating on thin margins, and here the design of the LIHTC program works against the financial stability of the properties. When LIHTC properties are financed and decisions are made about budgeting for operations, reserves generally are budgeted at a higher level than is typical for conventionally financed properties. Unlike conventional properties, however, LIHTC properties are expected to operate for 15 years without raising capital for repairs by refinancing. LIHTC reserves—constrained by the property’s projected cash flow—generally are not funded at a high enough level to cover capital needs that arise over that period. The problem of inadequate reserves is exacerbated when negative cash flow leads to the use of reserves to cover operating costs. Several studies of the financial health of LIHTC properties find that a significant minority operate with negative cash flow, at least temporarily. More detailed discussion of this is presented in chapter 5.

The financial health of LIHTC projects—and the need for reserves—is also affected by production standards, including how much rehabilitation is done to older properties. In her analysis of Enterprise’s portfolio of tax credit projects, Korman-Houston (2009) found that rehabilitation projects were more likely to experience cash flow underperformance than new construction. Rehabilitation projects were also less likely to be in good condition than new construction projects, suggesting that the initial quality of rehabilitation projects is lower than that of new construction. For this reason, rehabilitation projects typically contribute more to replacement reserves than new construction projects (Ernst & Young, 2010).

1.2 THE EARLY YEAR LIHTC PROGRAM

As of 2009, more than 11,000 LIHTC properties, with more than 400,000 housing units, had reached their 15-year mark. These were properties placed in service under LIHTC between the start of the program in 1987 and 1994. Exhibit 1.1 shows, first, that the program grew steadily from 1987 through 1994, although it did not reach the 100,000 units per year that became typical in later years. Average property size grew as well, but remained relatively small even in 1993 and 1994, with 44 or 45 units per LIHTC development on average in those years. The percentage of larger properties, those with 100 units or more, also grew steadily, but during the 1987 through 1994 period less than 9 percent of all properties had that scale. This is reflective primarily of properties placed in service from 1987 through 1992. More than 11 percent of properties placed in service in 1993 and 1994 had at least 100 units.

During the first 3 years of the program, more than one-half of the properties were rehabilitated existing structures. By 1990, more than one-half of properties were new. During the period as a whole, about 57 percent of properties were newly constructed. The share of properties with nonprofit sponsors grew during 1987 through 1994, but for the whole period, only about 10 percent had nonprofit GPs.

Perhaps the most notable feature of the early year LIHTC program is the substantial use of the program for housing with Rural Housing Service (RHS) Section 515¹⁴ loans, 31 percent for the period as a whole. In contrast, a very small percentage of early year properties were financed with tax-exempt bonds.

14. Following the Department of Agriculture Reorganization Act of 1994, the USDA’s Office of Rural Development was created and took over administration of Farmers Home Administration (FmHA) activities, and the FmHA Section 515 loans became known as Rural Housing Service (RHS) Section 515 loans.

2. OWNERSHIP AND FINANCING

2.1 HOW ARE LIHTC DEVELOPMENTS FINANCED?

Conventional multifamily housing is financed with a combination of debt and equity. Developers will borrow a portion (say, 75 percent) of the cost of acquiring and building a property, and will provide equity capital for the balance. Depending on their resources and business arrangements, developers may provide their own equity capital, or they may secure additional equity capital from other investors.

In exchange for their capital, investors in conventional housing hope to get returns from three sources:

- **Cash flow:** Cash available to be paid out to owners from rents after all operating expenses and debt service payments have been covered.
- **Resale value:** Investors hope that property will appreciate over time, and that they will be able to realize a profit on the eventual sale of the multifamily development.
- **Tax benefits:** For conventional real estate, tax benefits from the property are generally limited to reductions in taxable income because of depreciation of the property.

HOW DO TAX BENEFITS FROM DEPRECIATION WORK?

Under the U.S. Internal Revenue Code, depreciation enables taxpayers to convert the up-front cost of developing a property to tax-deductible expenses over a period of time. For example, suppose a multifamily development is built at a cost of \$5 million. Current federal tax law allows residential properties to be depreciated over 27.5 years, on a straight-line basis. Thus, each year, the owners can claim 1/27.5 of the depreciable acquisition and construction costs as an expense—\$181,818 per year. This \$181,818 is not a current use of cash: the development costs were paid for up front, from debt and equity, when the project was built. Nonetheless, the owners can use this noncash expense to reduce their taxable income from the property. Let's say, for example, that this property has \$500,000 in rent revenues and \$250,000 in operating expenses. Before depreciation, the owners would have to pay income taxes on \$250,000 in profits. After depreciation is taken into account, however, the owner's taxable income is reduced by \$181,818 to \$68,182. In essence, for that year, the owner gets to enjoy \$181,818 in cash proceeds on which no federal income taxes are due.

Depreciation is a deferral rather than an elimination of tax liability. Let's say that, after operating this property for 5 years, the owners sell it for \$6 million—\$1 million more than it cost to develop. Because they have depreciated the property over time, the book value of the property will be reduced by the amount of depreciation taken: \$181,818 for 5 years, or \$909,090 in total. The fact that the property has depreciated by this amount means that the owners will need to pay taxes not only on the \$1 million appreciation in the property's value, but also on the \$909,090 in depreciation that is essentially reimbursed by the sale proceeds.

The depreciation deduction is valuable despite the fact that it defers, rather than eliminates, taxes, for several reasons:

- First, taxpayers benefit from deferral of taxes because of the time value of money; investors benefit from the use of the dollars that would have been paid in taxes during the years intervening before the property is ultimately sold.
- Second, capital gains, and recaptured depreciation, may be taxed at a lower rate than income; so when taxes are ultimately paid on sale, the tax burden may actually be less than it would have been if income had not been sheltered by depreciation.

Although the tax benefits associated with real estate ownership are valuable to investors in conventionally financed and operated multifamily real estate, these benefits are usually of secondary value. Generally, much larger shares of expected returns for owners of conventional real estate come from cash flow and profits on sale.

Real estate financed with the LIHTC alters this conventional formulation in a number of ways. The LIHTC program is designed to motivate developers to build properties with rents restricted to levels affordable to low-income households. Restricting the rents changes the overall financing picture in a number of critical ways:

- Properties with restricted rents have less revenue with which to pay a mortgage, and thus can support smaller amounts of debt than properties at higher market rents.
- Properties with restricted rents will typically generate less cash flow for owners than properties with higher market rents, reducing a major benefit of ownership.
- To the extent that rent restrictions are long term, they will reduce properties' resale value, reducing another major benefit to owners.

The LIHTC program is designed to counter these effects of reduced rents by providing a tax benefit to owners that compensates for the loss of cash flow and resale profits. Unlike the depreciation deduction (from which LIHTC investors also benefit), the LIHTC program offers federal tax credits to investors—a flat reduction, rather than a deferral, in the amount of federal income taxes paid. A project with a \$5,000,000 development cost might, for example, be eligible for roughly \$420,000 in annual LIHTC credits. That credit entitles the owners to subtract \$420,000 from their federal tax bill every year for 10 years.

This tax benefit is of a generous enough size that it motivates owners to contribute much greater amounts of equity than would be justified by cash flow or resale value alone, compensating for the reduction in debt that results from lowered rents. Typically, then, LIHTC properties differ from conventionally financed multifamily properties as follows—

- A much greater share of the financing comes from equity: While the capital structure of conventional residential real estate might have 20- or 25-percent equity and 75- to 80-percent debt, a LIHTC property might have 50-, 60-, or even 70-percent equity in its capital structure, with one-half or less of development costs paid for by mortgage debt.

- A much greater share of the benefits flowing to owners comes from tax benefits as opposed to cash flow or resale value.
- The tax benefits going to the owners are largely 10 years of direct tax credits against their income taxes, with only a minority of tax benefits coming from depreciation and other tax losses such as interest owed on deferred debt, although both kinds of tax benefits are available in LIHTC properties.

2.2 WHO OWNS LIHTC PROPERTIES?

To take advantage of the federal tax reductions offered by the LIHTC program, owners need to owe taxes in the first place. LIHTC credits are really valuable only to firms that have large and predictable federal tax obligations. In most cases, real estate developers themselves do not have income that is large enough or predictable enough to be able to fully use 10 consecutive years of tax reductions worth hundreds of thousands of dollars per project. As a result, LIHTC projects have almost always been developed using a limited partnership ownership structure.¹⁸

In a typical tax credit project, the real estate will be owned by a limited partnership formed for the single purpose of developing and owning that property. The limited partnership will typically be owned by the combination of (1) one GP holding a minority interest (1 percent or less) in the limited partnership and (2) one or more LPs holding the lion's share of the ownership (99 percent or more). The GP, typically the sponsor/developer or its affiliate or subsidiary, has day-to-day managerial responsibilities for developing and operating the real estate, completing financial and tax reporting, and ensuring compliance with use restrictions, as well as seeing to long-term asset management. GPs make the bulk of their profits through developer fees, most of which are typically paid after a property is fully occupied and operating at or greater than break-even levels for a specified period of time. GPs may also have rights to some or all of the property's cash flow, often through fees structured to provide incentives for good management of the real estate.

The LPs have restricted responsibilities and managerial rights, although they hold the right to approve any major alterations to the project or its management team and the right to step in and remove the GP if the development runs into trouble. LPs get financial returns primarily from tax benefits, including both tax credits and tax losses.

Businesses known as syndicators emerged to broker these arrangements, recruiting investors and matching them with LIHTC development projects, structuring the investment vehicle to minimize risks and maximize investor returns, and monitoring the assets over time to ensure that the investors' returns (largely provided by tax benefits) are preserved.

Most syndicators are private, for-profit firms, working predominantly (but not exclusively) with for-profit developers.¹⁹ From the early years of the program, however, national nonprofit syndicators emerged, with the goal of raising equity to support the work of nonprofit developers of affordable housing. Enterprise Community Investment, Inc. (formerly known as Enterprise Social Investment Corporation) was founded in 1984; the National Equity Fund was founded by Local Initiatives Support Corporation (LISC) in 1987. Both firms participated in

18. In more recent years, many LIHTC properties are owned by Limited Liability Companies (LLCs) instead of LPs. These LLCs operate in much the same way as LPs, with a managing member playing the role of the GP and limited members in the limited partner role. This shift to LLCs happened only in the more recent years of the program, so the discussion here will refer to limited partnerships, but the discussion applies equally to LLCs.

19. For-profit syndicators interviewed for this study reported that 75 to 80 percent of their developers were for-profit and 20 to 25 percent were nonprofit entities.

syndicating LIHTC investments from the program's inception in 1986. They were created by the parent organizations to support the development of affordable housing by nonprofit, often community-based, organizations. For example, LISC was founded in 1979 by the Ford Foundation to connect community organizations with the resources to improve their neighborhoods. From the outset, LISC helped provide access to financing that might typically not be available from conventional lenders—for example, predevelopment loans for community-sponsored real estate. When the LIHTC program began in 1986, LISC created the National Equity Fund to assemble investment monies from businesses and invest them in community-sponsored LIHTC properties. Over the years, NEF has expanded its activities to include for-profit sponsored housing, but it has retained a great interest in nonprofit sponsored properties.

State and regional nonprofit syndicators began to form a few years later—Merritt Capital in California (1989), the Ohio Capital Corporation for Housing (1989), and the Massachusetts Housing Investment Corporation (1990), to name only a few. Currently, a total of 14 state-based and regional nonprofit syndicators exist around the country. Although they invest in both for-profit and nonprofit sponsored projects, they have always had a strong interest in working with projects sponsored by nonprofits such as community development corporations.

Interviews with long-time industry participants, along with a series of studies on LIHTC investment performance published by Ernst & Young, reveals patterns in LIHTC investment vehicles over time. In the early years of the program, both private individuals and public corporations invested in tax credit properties. In the LIHTC program's first years, many syndicators created public funds for LIHTC investment. Syndicators marketed these funds to wealthy individual investors, selling fund shares through public offerings. A single public fund might have dozens or even hundreds of individual investors and would make investments in a portfolio of affordable housing projects, often spanning the entire country. These public funds required SEC registration and reporting. Marketing of LIHTC funds to individuals effectively ended by the early 1990s, however, because LIHTC program rules severely limited the amount of active income that individuals could shelter with these tax credits, rules that did not apply to corporate investors. The original 1986 legislation authorizing the LIHTC program provided some transition rules for projects that were already in development that facilitated their being marketed to individual investors, but these rules also ended by the early 1990s. Moreover, marketing to corporate investors was simpler because SEC registration was not required for institutional funds and typically such funds had many fewer investors than funds marketed to individuals, so long-term reporting and fund management were less complex.

Other syndicators recruited corporate investors to purchase the tax credit equity in portfolios of properties, creating institutional funds. The nonprofit syndicators limited their investor recruitment to corporations rather than individuals from the earliest days of the program, as did some private sector syndicators. The entire LIHTC equity market shifted sharply towards corporate rather than individual investors in 1993 through 1994 (although one of the syndicators interviewed for this study reported offering private funds as late as 2003). Changes in the federal tax code in 1993 prompted this shift. First, the LIHTC program became a permanent part of the tax code, giving corporate investors greater motivation to invest the time and effort necessary to understanding LIHTC investments. At the same time, the 1993 changes in the tax code also limited individual taxpayers' use of passive losses (such as the losses generated by real estate in which the investors do not play an active managerial role) to offset passive income (that is, investment income earned without the taxpayer's active managerial involvement). The passive loss rule did not apply to corporations, so they remained able to fully use the losses generated by LIHTC investments to offset their taxable income. LIHTC investments thus became more valuable to corporate investors than to individuals. Finally, syndicators found that working with corpo-

rate investors was less labor-intensive: public funds require SEC reporting and ongoing communications with a large pool of individual investors. Selling LIHTC investments to corporate buyers does not entail SEC reporting, and, since institutional funds involve a smaller number of entities making larger capital investments, the volume of communications required with investors is much smaller.

While many corporations invested in institutional funds through syndicators, several corporations became major direct purchasers of LIHTC investments from the early years of the program. Rather than work through a syndicator, these firms created the internal capacity to reach out to the developer community to acquire limited partnership interests in affordable housing projects and to underwrite deals, as well as to oversee management of these investments over time. Direct corporate investors included financial services firms (such as Fannie Mae, J.P. Morgan, and Bank of America) and insurance companies (such as Hancock, SunAmerica, and Transamerica/Aegon). Today, financial services firms and insurance companies are the dominant investors in the LIHTC market, both through direct investment and working through syndicators. In the program's early years, a number of nonfinancial firms also made extensive investments in LIHTC properties (for example, Chevron, Clorox, and Edison). Even today, a scattering of other kinds of businesses invests in LIHTCs, including such firms as Verizon and Google.

Some LIHTC equity investors have been motivated by community issues, as well as by financial returns. Banks around the country are regulated by the federal Community Reinvestment Act, which requires them to provide some financial services to their local geographic area. When banks seek federal approval for such actions as creating new branches or merging with another bank, they are evaluated, in part, by their range of CRA activities. Investing in LIHTC properties qualifies as a CRA activity, so for many large financial institutions, this type of investment has become an important way of satisfying CRA requirements while also sheltering income from federal taxes. This combination of investment and tax shelter is a major reason why financial institutions have been among the most frequent LIHTC investors, both through direct investments and syndication funds. Over the years, increasing numbers of financial institutions have become interested in this double benefit.

