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Author

Cerf, Alan R.

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THE LOW INCOME HOUSING TAX CREDIT:
PUBLIC POLICY AND PRIVATE INCENTIVES

BY

ALAN R. CERF

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THE LOW INCOME HOUSING TAX CREDIT:
PUBLIC POLICY AND PRIVATE INCENTIVES

Alan R. Cerf, CPA, Ph.D.

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ABSTRACT

THE LOW INCOME HOUSING CREDIT

BY

ALAN R. CERF

Federal housing policy attempts to encourage the development of low income housing. To accomplish this objective it has provided rental assistance to supplement tenant rents. Federal mortgage insurance allows investors to invest less equity than would otherwise be possible. Direct financing subsidies are provided to reduce mortgage financing costs. Tax incentives enable investors to shelter some income from federal income taxes.

The Tax Reform Act of 1986 drastically reduced the tax benefits from multifamily housing. However Congress provided a credit for low income housing. This credit is intended to stimulate low income housing in an environment in which direct subsidies have been cut back significantly.

The objective of this paper is to consider whether the Congressional goals of providing a significant incentive to development and rehabilitation of low income housing will be accomplished. A second objective is to outline the relevant rules and the operating, financing and tax risks for investors considering an investment in low income housing.

This analysis indicates that the credit will be significant relative to other federal programs but still may not go far in solving the overall national problem because of the cut back in direct subsidy programs. It is likely that the credit will result in expected returns sufficient to induce development. The degree of success will depend largely on whether state or local subsidies are available.

The tax rules are particularly favorable for corporate investors because they are not limited by the passive loss rules. An individual investor must consider the normal risks associated with owning rental properties. In addition they must calculate the amount of additional return they will require for the special risks associated with low income housing. These risks are considerable and it is likely that investors will seek a significantly higher return than the amount required under a less risky investment.

INTRODUCTION

Congress has historically considered real estate favorably in the tax code. Housing has particularly benefited with low income housing receiving the largest tax preferences. The relative tax advantages of low income housing, residential housing, and commercial and industrial real estate have often changed as new Revenue Acts have been passed.

To stimulate low income housing Congress has provided rental assistance to supplement tenant rents. Federal mortgage insurance allows investors to invest less equity than would otherwise be possible. Direct financing subsidies are provided to reduce mortgage financing costs. Finally tax incentives enable investors to shelter some income from federal income taxes. Non tax subsidies have been cut back significantly in recent years. In addition certain low income housing projects built under previous federal subsidies are being converted to regular housing and thereby supply is reduced. The low income housing credit is introduced at a time of considerable need for stimulus for low income housing.

The Revenue Act of 1986 (Act) represented a drastic change in Congressional approach to tax preferences for real estate. Rather than targeting preferences for real estate and adjusting for abuses as in the past the Act removes the majority of tax preferences for real estate. It changes the relative merits of real estate and other investments. The ACT took away the majority

of the tax benefits that were provided for real estate under the Economic Tax Recovery Act of 1981.

Congress has long been concerned about incentives for low income housing. As far back as 1969, Section 167(k) was added to the code to give favorable treatment to the cost of rehabilitating low income rental housing. In the current ACT Congress has provided for a tax credit for investors in low income housing.

The objective of this paper is to consider whether the Congressional goals of providing a significant incentive to development and rehabilitation of low income housing will be accomplished. A second objective is to outline the relevant rules and the operating, financing and tax risks for investors considering an investment in low income housing.

What are the characteristics of investors that should consider an investment in low income housing? The tax rules are complex and there are many risks involved in low income housing. Different investors will be impacted in dissimilar ways by the rules. Whether an investor is an individual, a C corporation or a Subchapter S corporation is important. The attractiveness of an investment is influenced for an individual by the amount of taxable income and the amount of passive income or loss from sources other than low income housing.

Section I is concerned with the requirements which must be met to qualify for the credit. Significant risks are associated with low income housing. Operating, financing and tax risks are examined in Section II and Section III is concerned with the

question: Will the credit accomplish the goals of Congress? In Section IV there are suggestions of some potential development opportunities. Possible improvements in the credit are suggested in Section V.

I. EXPLANATION OF CREDIT

There are three different low income housing credits. The largest credit is for 9 percent of the depreciable basis of the qualifying units. This credit is for new construction or for expenditures on the rehabilitation of existing units.

A 4 percent annual credit is allowed for new construction and rehabilitation expenditures if these projects have received tax exempt financing or a subsidized federal loan.

The credit may be claimed over a period of ten years in a maximum annual amount equal to four or nine percent of the qualifying basis of the low income units in the project. For projects begun after 1987, the IRS has authority to adjust the four and nine percent figures based on changes in the applicable federal interest rate.

The credit is available on a per unit basis and a single building may have some units that qualify for the credit and some that do not. A low income housing project must meet specified requirements which are stated below. The project must continue to meet the requirements for a period of 15 years or a portion of the credit may be recaptured.

EXHIBIT I
Overview of Low Income Housing Credit(1)

Applicable Property	Credit
New construction expenditures and rehabilitation without federal assistance (2)	9 percent
New construction and rehabilitation with federal assistance (3)	4 percent
Acquisition cost of existing property including federally assisted projects placed in service ten or more years ago (4)	4 percent

(1) See text for detailed requirements.

(2) Federal assistance generally includes tax exempt financing or a below-market direct or indirect federal loan.

(3) Certain federal grants such as those from CDBG or UDAG are not treated as federal subsidies.

(4) Includes federally assisted projects. Can be used with other credits for doing rehabilitation.

Requirements for the Credit

Owners of "qualified low income housing projects" are eligible for the credit. Residential rental property that satisfy the following requirements meets this definition.

EXHIBIT II Summary of Requirements

MAXIMUM INCOME REQUIREMENTS

- (a) 20 percent or more of units in projects must be occupied by individuals who have incomes of 50 percent or less of area median income, adjusted for family size or
- (b) 40 percent or more of units in projects must be occupied by individuals who have incomes of 60 percent or less of area median income, adjusted for family size.

RENT RESTRICTIONS

Gross rent may not exceed 30 percent of the applicable qualifying income for a family of its size. This includes an allowance for utilities.

RECAPTURE PROVISIONS

If income targeting for a qualifying unit is not met in a specific year, the "accelerated" credit amounts for that unit for earlier years are recaptured, with interest.

If the minimum income targeting for the project is not met at any time during the first 10 years the "accelerated" portion of all credit amounts is recaptured. This recapture is phased out between years 11 and 15. (1)

(1) "accelerated credit" refers to fact credit is received over 10 years but is earned over 15 years. Thus one third of the credit received under the initial allocation is received early and is subject to recapture during the first 10 years with interest.

Minimum Set-aside

A project must set-aside a minimum of 20 percent of the units for households with incomes of 50 percent or less of area median income as adjusted for family size. Alternatively the set-aside may be for 40 percent of the units for households with incomes of 60 percent or less of area median income, adjusted for family size. The owner must irrevocably elect to come under one or other of these alternatives. In areas of unusually low income or high costs relative to family income, the Treasury Secretary may adjust income limits. The minimum set-aside must be met within 12 months of the date the project is placed in service. Given that these minimums have been met, the share of the project that qualifies for the credit generally depends on the share of the units whose residents meet the same income cut-off as was used to establish project eligibility.

Rent Restriction

The gross rent paid by families in a qualifying unit may not exceed 30 percent of the applicable qualifying income for a family of its size. For example, a four person family in a 40/60 project would pay 30 percent of area median gross income, even if that particular family earned only 45 percent of the median income. Gross rent includes utilities paid by the tenant, other than telephone expenses. It does not include payments under section 8 of the U.S. Housing Act of 1937 or similar federal rental assistance payments received on behalf of the tenant.

Certification

Owners of low income housing projects are required to file a certification with the IRS before claiming the credit. This must be done within 90 days after the end of the first tax year for which the low-income housing credit is claimed.

Requirements for Existing Buildings

There are three further requirements for existing buildings. The building must be acquired by purchase. The date of the acquisition must be 10 years or more after the later of the date the building was last placed in service or the date of the most recent "non qualified substantial improvements." The building cannot have previously been placed in service by the taxpayer or a person related to the taxpayer. "Non qualified substantial improvements" are capital improvements made within a two year period if the capital costs of the improvements are at least 25 percent of the adjusted basis of the building at the beginning of the period computed without depreciation. This applies if five year depreciation under Code sec.167(k) was elected or if ACRS depreciation applied to the improvement.

Sunset Rule

No credit may be taken for buildings placed in service after 1989. An exception is provided for buildings placed in service after 1989 and before 1991 if expenditures of 10 percent or more of the reasonably expected cost of construction, reconstruction, or rehabilitation have been incurred before January 1, 1989.

Computation of the Credit

The owner of a qualified low income housing project may take a low income housing credit in each of 10 tax years in an amount equal to the product of the following: (1) the applicable credit percentage appropriate to the type of project and (2) the qualified basis allocable to low income units in each qualified low income building.

New Construction or Rehabilitation

A maximum annual credit of nine percent is allowed for newly constructed or rehabilitated low income units that are not federally subsidized. Rehabilitation expenditures must average \$2,000 or more per low income unit.

Subsidized Construction or Rehabilitation

A maximum annual credit of four percent is allowed for newly constructed or rehabilitated low income units where the construction or rehabilitation is financed with tax exempt bonds or similar federal subsidies. The rehabilitation expenditures must average out to \$2,000 or more per low income unit.

Acquisition of Existing Housing

A maximum annual credit of four percent is allowed for the acquisition of existing low-income units. The property must be acquired at least 10 years after the later of: (1) the date the property was last placed in service or (2) the date of the most recent nonqualified substantial improvement.

Percentages for Years After 1987

Projects placed in service in 1987 will receive the same amount each year. Percentages will be different for projects placed in service after 1987. The credit percentage for 1988 will be determined in July 1988, based on interest rates at that time. The owners will receive a constant dollar amount for 10 years. The objective is to keep the present value of the credit the same regardless of what happens to interest rates.

Nine Percent Credit after 1987

The credit rates are to be computed so that the present value of the 10 annual credit amounts at the beginning of the 10 year period equals 70 percent of the qualified basis of the low-income units. The calculation will be made using the average interest rate on medium and long term federal debt adjusted for a 28 percent tax rate. The effect is that if interest rates rise by 1988 the actual percentage rate of the credit will probably be higher than 9 percent. The discount rate is determined as of the month the project is placed in service and is compounded annually. The present value is determined on the last day of the first tax year of the 10 tax year credit period.

Four Percent Credit after 1987

The substitute credit rates are computed so that the present value of the 10 annual credit amounts at the beginning of the 10 year tax period equals 30 percent of the qualified basis of the low income units.

Basis

The applicable percentage is multiplied by the qualified basis to determine the dollar amount of the credit. The qualified basis is the portion of the eligible basis allocable to low income housing units in the building. Thus the eligible basis must be determined.

Eligible Basis

The eligible basis of a project is its adjusted basis. The eligible basis of a building for the entire compliance period is its eligible basis on the date it is placed in service. The eligible basis is reduced by the amount of any federal grants received. For a new construction project, the eligible basis consists generally of development costs less land costs. For substantial rehabilitation projects, rehabilitation costs of at least \$2,000 per low income units, aggregated over a twenty four month period would constitute the eligible basis. Such expenditures must be chargeable to the capital account and must be for depreciable property, additions, or improvements.

Qualified Basis

The qualified basis is the portion of the eligible basis allocable to low income housing units in the building. The allocation is made by multiplying the eligible basis by the lesser of the "unit fraction" or the "floor space fraction." The unit fraction of a building is the number of low income units in the building divided by the total number of residential units in the buildings. The floor space fraction is the total floor

space of the low income units in the building divided by the total floor space of all residential units in the building.

There is a special provision to assure that low income units are not inferior to other units in the project. The average construction or acquisition cost of a low income unit must not be lower than the average for other units. If it is lower, then the average, the non-low-income units will not be included in calculating the eligible basis.

State Credit Authority

The total dollar amount of low income housing credit that may be claimed by all taxpayers is limited on a state by state basis. Owners of qualified projects must be authorized to do so by the appropriate state or local agency in order to be entitled to take the credit. A housing credit agency may authorize all or part of the credit to which the taxpayer is otherwise entitled. The taxpayer may not claim a credit in excess of the credit dollar amount allocated to his project. Taxpayers planning to claim a credit for a project financed by tax exempt bonds subject to the volume cap provided by Code Sec. 146 are not required to obtain this credit authority.

For each calendar year a state is entitled to allocate credits to taxpayers in a total amount equal to \$1.25 multiplied by the state's population. A state is required to allocate at least 10 percent of its allocable credits to qualified low-income housing projects developed with the material participation of a tax exempt organization having an exempt purpose of fostering low

income housing. Unused credit authority cannot be carried over to the next year. Each state's allocation authority may be divided among the various governmental units in the state by the governor or the state legislature.

Determination of Qualifying Incomes

There are four relevant factors to determine the tenant income ceiling for a unit to qualify. (1) Area median income is determined under the same procedure as under the HUD Section 8 program. (2) 50 percent or 60 percent of the area median income is determined. The 50 percent is used with the 20 percent minimum set aside and the 60 percent with the 40 percent minimum set aside. (3) The amount is adjusted for family size in the same manner as Section 8. This adjustment is 10 percent less for each fewer persons in family size below four. (4) The special adjustments applied under the Section 8 program to areas of very low median income or very high housing costs are made.

The determination of qualifying income is made on a continuing basis. Each year, the incomes of tenants in the qualifying units must be certified and compared with the income ceilings for that year for that family size. Tenants qualifying when initially occupying a rental unit will be considered to continue to qualify provided that their incomes do not exceed the maximum qualifying income by more than 40 percent.

Recapture and Compliance

During a 15 year period beginning on the first day of the first taxable year in which the credit is claimed the project must be in compliance. Failure to comply results in a recapture of a portion of all credits plus interest.

Recapture occurs in any year during the 15 year recapture period if at the close of the year any of the following events occur: (1) the project fails to meet the minimum set-aside requirements; (2) the gross rent charged to tenants of the low income units exceeds 30 percent of the qualifying income levels for those units; (3) the project obtains financing from federal subsidies or from proceeds of tax exempt bonds; (4) the owner disposes of his interest in the project (with certain exceptions); or (5) there is a decrease in the qualifying basis of the project even though the minimum set-aside requirement continues to be met.

The recapture from sale of a building can be avoided under certain circumstances. These are (1) the project has completed the 15 year compliance period or (2) a bond is posted with the Treasury by the seller. The new owner would be allowed to receive any remaining credits, using the same qualified basis and credit percentage as the previous owner.

Amount of Recapture

The "accelerated portion" of the credit is subject to recapture. The "acceleration" refers to the fact that the credit is received over 10 years but is in return for keeping a portion

of the project in qualifying use over a 15 year period. The accelerator portion of a credit is the aggregate of the credit taken over the aggregate credit that would have been allowable if the credit had been spread over 15 years rather than 10 years.

Investors and Passive Loss Limitation

Low income housing projects generally are subject to the same limitations on passive losses as other rental real estate. Losses arising from a passive activity may be deducted only against income from that or another passive activity. Excess passive activity losses for any year are carried forward indefinitely and are allowed in subsequent years against passive activity income. Upon a taxable disposition of a passive activity, these losses are allowed in full.

There is a special exception from the passive loss limit for rental real estate. Certain individuals may offset up to \$25,000 of income that is not treated as passive such as salary income or active business income by using losses from rental real estate activities with respect to which the individual "actively participate." The \$25,000 loss exception applies to the rehabilitation and low income housing tax credits in the following way. A taxpayer in the 28% tax bracket could claim a low income housing tax credit of up to \$7,000 against earned income or portfolio income. This is determined by multiplying the 28 percent tax rate times the deduction of \$25,000. The credit is available to limited partners as well as "active participants". The credit is phased out at incomes between

\$200,000 and \$250,000, rather than the \$100,000 and \$150,000 for most rental real estate. Unused credits can be applied against gain at time of sale, any credits remaining would be lost. If an investor does not have enough credit to offset \$25,000 in taxable income, losses from the project can be used to offset the balance.

The result of the above is that high income individuals with incomes above \$250,000 will not be attracted to low income housing investments. Other individuals will also be discouraged because many projects will generate large amounts of both credits and passive losses over a long period which will not be used unless the individual has significant passive income. Subchapter C Corporations are exempt from the passive loss limitation and therefore are good candidates as investors.

II. NATURE OF INVESTMENT: OPERATING AND FINANCING RISKS

The purpose of this section is to examine the risks involved in low income housing investments. Risks must be compared to rewards. The nature of low income housing investment is that it poses substantial risks. Thus an investor must have confidence that the rate of return will exceed returns on less risky investments. An investor contemplating such an investment would determine what potential return would be required to result in a decision to invest. This section considers the operating risks. The following section will discuss tax risks.

Operating Risks

A low income housing investment is subject to the normal risks found in the ownership of investment real estate. This would include fluctuations in occupancy rates, rents and expenses. The investment would be subject to changes in local economics, zoning laws and the potential of rent control. An increase in local unemployment or the construction of competing apartment units in the area could reduce occupancy rates.

An investor predicts future rents and expenses to determine potential return on a project. For example an investor may project an increase in rentals and in operating expenses of five percent a year. However in a period of inflation operating expenses may increase much more rapidly than rents. If governmental approval is required to raise rents this approval might not be forthcoming. Forecasts may not be realized because they are based on assumptions and estimates. They are unable to take into account unforeseeable events such as major economic changes or natural disasters, or changes in the tax laws.

The key factor in expected returns from low income housing projects is the low income housing tax credit. Many projects will result in annual cash flow deficits and capital appreciation is doubtful. There is substantial risk that there may not be an investor willing to purchase the development at a satisfactory price in fifteen years or that it could be refinanced on satisfactory terms. Since it takes a tax subsidy to cause investment now it is likely that a tax subsidy will be

required for prospective investors upon sale. One can not be sure that there will be such subsidies.

State or Local Subsidies

In order to qualify for the low income housing credit the development must meet certain requirements which are discussed elsewhere. In order to provide an attractive rate of return many projects will require state or local support. This means the project must then satisfy the requirements of these regulatory authorities and abide by their restrictions. These restrictions may limit the partnership's ability to increase rents and make distributions of cash flow. State and local support may require certain developments in the project such as development of green areas. They may also require that plans and specifications be approved by the authorities. Failure to meet development requirements could cause revocation of the local aid. Obtaining and making changes in plans and specifications means additional expense.

Certain low income housing developments will be aided by special financing from state or local agencies. These in turn will include certain restrictions on additional financing. Thus in the event that additional financing is required, consent of the authority and other lenders to the project would be required. There can be no assurance that such consent would be forthcoming.

The authority providing the special financing may impose various occupancy and rental restrictions on the development which last as long as the financing remains outstanding. These

restrictions may last beyond the time the partnership wishes to sell the development. This in turn may make it difficult for the partnership to sell the development at a satisfactory price.

Importance of General Partners

Limited partners do not have a right to participate in the decisions of the general partner. The partners are therefore dependent on the abilities of the general partners to properly do their job. There is a risk that the general partners will participate in other ventures which compete with the project.

The financial resources of the general partners should be sufficient to provide help to the development if needed. If the general partners have obligations in respect to debt repayment and they do not meet these obligations there is a danger the debts could be foreclosed. This could result in the limited partners losing their investment. In addition there would be adverse tax consequences which includes the recapture of all or part of the low income housing credits.

There is perhaps more risk in a low income housing development compared to other developments as to the likelihood that tenants will not pay their rent. Since the limited partners will not be active in management the limited partners are dependent on the ability of the management to see that rents are collected and the project is managed efficiently.

Compensation of General Partners

A potential investor should determine if the compensation paid to the general partners is reasonable. Is the compensation

paid to the general partners for services rendered in excess of the fees that would be charged for similar services by an independent party?

Conflicts of Interest

There may be potential or actual conflicts of interest if the general partners can participate in ownership and management of other residential developments which compete with the development. There may be conflicts of interest in allocating management time, services and functions between existing business interests and any future business interests. If major developments are undertaken in the future, the general partners ability to commit substantial time, effort and finances to the low income housing development may be limited.

Conflict of interest may result if the construction company and or the management company are affiliates of the general partners. If they are affiliates and they fail to perform adequately their functions a potential conflict exists with the general partner.

Construction Risks

There are construction risks which must be considered. If the cost of completing the development exceeds estimated costs, the partnership and the general partners may not be able to make up the deficiency. Then the limited partners may have to advance funds to make up the deficiency so the development can be completed. This may occur even though the obligation of the limited partners is limited by the partnership agreement.

Financing Risks

Payments on the loans will have to be made regardless of whether there is any operating income from the project. The limited partners might find it desirable to contribute additional funds to cover such a default on the loan since such a foreclosure could result in adverse income tax consequences. They might find it necessary to do so even though they are not required to do so. Many developments require the investor to contribute capital on an installment basis. These obligations are usually unconditional and the limited partners are obligated to make payments without regard to the progress of the construction and the operation of the development.

Illiquid Investment

An investment in low income housing subject to the credit is likely to be long-term and illiquid. It is unlikely that a market for limited partnership interests will exist.

Tax Risks

The desirability of an investment in a low income housing project is largely dependent upon anticipated tax benefits. A large portion of these benefits are expected to be derived from the low income housing credit. If the project did not qualify for such credits or if the project did not continue to meet the requirements to be treated as low income housing during the required 15 year compliance period, the limited partners might lose these credits or a substantial portion might be recaptured with interest. If a limited partner disposes of his interest

during the 15 year period there could be recapture of the credit with interest.

Type of Investor

Tax consequences are complex and specific to the particular investor. The specific tax impact will depend on such facts as whether the limited partner is an individual or a regular or Subchapter S corporation. Tax liabilities are impacted by the sources and levels of other income, the nature of the investment portfolio, and the nature and amount of tax deductions unrelated to the project.

Individuals, regular corporations, and Subchapter S corporations are subject to different tax rules. Examples are deductions for losses from passive activities, the availability of the low income housing credits, and tax rates on ordinary income. The alternative minimum tax includes different tax rates, adjustments and tax preferences items for regular corporations than for individuals and Subchapter S corporations.

Future Changes in Tax Law

The Internal Revenue Code, Treasury regulations, internal revenue rulings and court decisions influence tax consequences of an investment.

However an investor has no assurance that future legislation will not significantly change the rules. In addition future changes may or may not be retroactive.

Classification as a Partnership

Tax benefits depend on the classification of the partnership as a partnership rather than as an association taxable as a corporation for Federal income tax purposes. If the partnership were treated for Federal income tax purposes as an association taxable as a corporation in any taxable year, income, deductions and credits of the partnership are reflected on its tax return. They would not be passed through to the partners. The result would be taxation at the corporate level at corporate tax rates. Losses, credits, and other items could not be deductible by the limited partners on their income tax returns. Also any cash distributions made to the limited partners would be treated as ordinary income to the extent of the current and accumulated earnings and profits.

Advance Rulings

The Internal Revenue Service has issued certain revenue procedures which provide for several conditions to be met before advance rulings with respect to the classification of organizations as limited partnerships will be issued. These rules tend to deter developers from seeking advance rulings.

These conditions relate to the following: (1) net worth of a corporate general partner, (2) allowable deductions by the partners in the first two years in relation to their capital invested, (3) creditors providing a loan and not acquiring an interest in profits, capital or property, (4) the interest of the general partner in income, gain, loss, deductions or credit must

be equal to a least 1%, (5) restrictions on granting of options to purchase securities of the corporate general partner by the limited partners, (6) contributions of the general partner to the partnership on termination or dissolution of the partnership. (Revenue Procedures 72-13, 1972-1 C.B. 735, 74-17, 1974-1 C.B. 438, 84-67, 1984-2 C.B. 637.)

Low Income Housing Credit

Violation of Requirements

There are numerous requirements which must be met in order to qualify for the low income housing credit (IRC sec. 42). These are discussed elsewhere. If any of these requirements are not met the result may be recapture of the low income housing credit. The project must meet the qualification requirements during the entire 15 year compliance period. Problems would result under the following conditions: (1) the minimum set-aside requirements were violated, (2) the rent restriction test was violated, (3) the number of low income units decreased, and (4) any change of ownership occurred (with certain exceptions). If any of these recapture events occurs the amount of the recapture is the accelerated portion of the credit allocated to the basis of the building that is no longer eligible for the credit for all prior years of the development, together with interest (IRC sec. 6621).

Change of Ownership

Generally, any change in ownership of a building during the compliance period will result in recapture. An exception is provided if the seller posts a bond with the Secretary of the

Treasury in an amount satisfactory to the Treasury and if it can reasonably be expected that the building will continue to operate as qualified low-income housing for the remainder of the compliance period.

Non Recourse Loans

Many developments will include non recourse loans in their financing. Partners are not personally liable on non recourse loans. If an event occurs such as a sale or a mortgage foreclosure such a loan would no longer be treated as a non recourse partnership obligation. In this situation each partner would be treated as having received a cash distribution equal to his share of the non recourse loan. Each partner would recognize a gain to the extent that such constructive distribution exceeds his or her basis. In a mortgage foreclose it would be unlikely that the partners would receive cash distributions large enough to satisfy this tax liability.

Cash Distributions

The amount of taxable income or loss allocated to a partner in any given year is likely to be different than the amount of cash actually distributed to such partner. Thus it is possible that limited partners will be allocated taxable income in an amount greater than the cash distributed to them.

Internal Revenue Service Challenges

Any development will be structured with tax considerations in mind. Even though this is done with caution there is still

the possibility that the method of handling an allocating income, losses, deductions, and credits will be challenged by the IRS. Some of these possibilities are examined below.

Deductible Expenses

The availability of tax losses depend in part upon the deduction by the partnership of a number of costs and expense. Some deductions may be challenged and disallowed by the IRS in whole or in part. Further there could be adverse legislative, judicial or administrative changes in the tax laws with respect to such deductions. An example of an item that might be challenged is one that has not been negotiated at "arm's length." An example would be payments made to the general partners by the partnership (IRC sec. 707(aa), 162(a), 263).

Lack of Profit Motive

Care must be taken that there be a profit motive for the development. Otherwise the IRS may take the opposite position and if successful, the IRS could disallow the deduction of expenses in excess of the income other than interest and real estate taxes.

Allocation of Income and Deductions

The IRS might challenge the allocation between the general and limited partners of income, gain, deductions, losses and credits if they believe that they are without substantial economic effect.

Likelihood of Audit

The IRS has indicated that it intends to undertake a special examination of any tax return of a partnership satisfying certain tax shelter-related criteria. Many low income housing partnerships may meet these tax shelter related criteria. If the partnership return is audited the individual returns of the limited partners may also be audited. Such examinations could result in adjustments to partnership income and deductions and also items unrelated to the partnerships.

Taxpayer Penalties

The 1982 Act imposes penalties on taxpayers when there is a substantial understatement of income tax liability unless there is either: (1) substantial authority for the tax treatment claimed by the taxpayer or (2) disclosure of the relevant facts pertaining to such claimed deduction on the taxpayer's return. These and other penalties are applicable to limited partners in a limited partnership under certain circumstances.

Uncertainty of the 1986 Act

There are presently very few regulations or administrative interpretations of the 1986 Act. Interpretations or regulations having retroactive effect may be adopted in the future and adversely impact an investors position.

Risk and Reward

An investor contemplating an investment in a low income housing development must consider the normal risks associated

with owning rental properties. In addition they must calculate the amount of additional return they will require for the special risks that have been outlined above. Because these risks are considerable it is likely that investors will seek a significantly higher return than the amount required under a less risky investment.

III. WILL THE CREDIT ACCOMPLISH THE GOALS OF CONGRESS?

The purpose of the credit is to cause developers and investors to embark on low income housing projects that otherwise would not be undertaken. Developers must perceive an acceptable profit and investors must feel a satisfactory rate of return will be realized on their investment? This section considers whether the credit will in fact accomplish its goals.

Presumably Congress expects that the benefits in low income housing development will outweigh the costs of the program. The credit is estimated to reduce fiscal year budget receipts by \$67 million in 1987, \$324 million in 1988, \$705 million in 1989, \$1,011 million in 1990, and \$1,139 million in 1991.(1)

The quantity of projects that will actually be implemented because of the credit are obviously dependent on the mix of the use of the 4 percent and 9 percent credit. Early predictions indicate that the program will be significant relative to other federal programs but still may not go very far in solving the overall national problem.

Certain writers have estimated the quantity of projects that will be undertaken if all the allocation is used. Goldstein and Edson predict the program could support the construction, rehabilitation and transfer of up to 100,000 units of housing annually. This would make the program potentially the largest federal housing program since the demise of HUD Section 8 program.(2) Diamond estimates that if all the credits were used for new construction with an average depreciable basis of \$40,000 per unit, 83,333 units would be constructed to receive 9 percent credits. If all the allocation was used for rehabilitation expenditures averaging \$20,000 per unit, twice as many units could be authorized. He considers that both of these figures are probably large compared to the total number of units ordinarily constructed or rehabilitated for low income households.(3)

One commentator feels there is not enough incentive. Smith does not think the potential volume is likely to be substantial. He asserts that this is virtually the only incentive to development of new low income housing so "this volume is puny."(4)

Potential for Realistic Rates of Return

Examination of some of the projections in the literature indicates that the credit will in fact result in returns sufficient to induce development. Certain classes of projects are potentially more attractive than others.

Diamond analyzes several types of projects using the National Association of Home Builders rental simulation model. He concludes that the credit may be effective only for certain types of projects, depending on the appreciation potential or the presence of other subsidies.(5) Key assumptions include a required after tax internal rate of return of 13 percent, a 75 percent loan to value ratio, expected inflation of 5 percent, expected increases in rents of 3.5 percent and a holding period of 15 years. The 15 year holding period avoids any recapture problems.

100 Percent Low Income Project

The objective of the credit is to generate new construction or rehabilitation. There are substantial reasons why new construction will not be forthcoming as a result of the credit unless there are additional non federal subsidies. Unless there is significant appreciation potential financial feasibility is only marginal according to Diamond. Individual investors who can use large amounts of credits and absorb the large tax losses will be difficult to find.

100% low income projects (9% credit) are not likely to generate sufficient returns for individual investors without additional subsidy. Returns for corporations are likely to be sufficient to provide incentives for investment because they are not constrained by the passive loss rules.

Employing the NAHB model, Diamond indicates that the rent levels permitted under the credit could be met and the project

would yield the specified rate of return. There are however several reasons to expect that such a project will not be feasible without additional, non-federal subsidies. An important consideration is the equity value at the end of the 15 years. If there is no appreciation potential the financial feasibility of a 9 percent credit project is marginal. The value of the project in 15 years will depend heavily on future tax law, subsidy programs, and market trends at the project's location over the period. It is conceivable there is likely to be no equity value at all at the end of 15 years.

These projects are likely to have large continuing cash deficits and after tax losses. Cash deficits may be met out of the tax savings from the credits. There is a problem in obtaining individual investors capable of using the large amounts of credits. It also would be difficult to find a conventional source of financing for the project. Diamond concludes that "In the case of both an inability to use all credits and/or losses, and in the absence of significant appreciation potential, such projects do not appear to make economic sense without additional subsidy." (6) High bracket individual investors will not be able to use the credit against other than passive income. Details on the passive loss rules are discussed in a prior section.

Smith also points out that development of low income housing without federal subsidy will result in enormous operating deficits. He warns individual investors to be wary of buying into the 9 percent credit properties unless the projects are likely to achieve breakeven operations within a few years of

completion.(7) Smith also is concerned about the potential of a repeal of the credit before the end of the life of the project.

Goldstein and Edson report on a projection for Sequoyah Equities, Inc, Knoxville, Tenn. which is a low income housing project employing the 9 percent credit and a development cost of \$7,600,000 and equity requirements of \$4,948,422.(8) This case study points out that attractive returns are likely to be available to a corporation but not to individuals unless they have passive income. Assuming the project is sold for the balance of the liability in 15 years an individual has a 2.80 percent internal rate of return. Compare this to a 30.47 percent internal rate of return for a cooperation. The projects result in large cash operating deficits and large annual taxable losses. The difference in return between the individuals and corporations is a function of the use of the ability to use tax credits.

Smith believes that investors will be motivated primarily for tax shelter.(9) Cash flow will not be a primary investment objective because most new construction or rehabilitation properties will incur cash deficits. Residual value will be reduced by the type of property which is eligible for the credits and the fifteen year required holding period. Smith believes that the market place will place a zero valuation on the residual value. Most investors will not be able to use the large passive losses because they will not have much passive income.

State or Local Subsidies

Guarantees, interest subsidies, or other support from local or state agencies increases the feasibility of the 9 percent credit project. The credit could provide impetus to public-private partnerships and to state and local housing initiatives. Smith feels 9 percent credit properties will have to be augmented with some form of local or state operating subsidy. (10) He reports that under the Massachusetts Housing Financing Agency State Housing Authority assistance for Rental properties a developer receives an annual cash subsidy which is independent of tenants' incomes and independent of the property's operating results. This subsidy is a loan and the full balance must be repaid in fifteen years.

Rehabilitation to Existing Buildings

Diamond indicates the credit may cause moderate amounts of rehabilitation to existing buildings in stable or rising low and moderate income area. Upgrading rehabilitation property may be economically feasible through the use of the credit. This assumes that the buildings are priced to offer reasonable returns under current market conditions and rents are at or under the prescribed rent limits.(11)

Tax Exempt Financed Projects

A 4 percent credit is available for tax exempt financed projects if rent limits are accepted on the low income units (see previous discussion of 4% credit). Diamond suggests that users

of tax exempt financing will also utilize the low income housing credit.

In order to make multifamily tax exempt financing attractive in the future it is probably necessary for market rents to rise from current levels. Diamond projects that the 4 percent credit will likely provide the means for meeting the required income and rent limits if the following conditions are satisfied: (1) the 20 percent set-aside at 50 percent of median income is chosen, (2) the entire project is expected to appreciate to the same degree as an all-market rate project, and (3) the market rate units are feasible in their own right under the law. He feels that the third condition is currently unrealistic because market rent levels had not risen to meet the post 1986 predictions. (12) Smith feels that the 4 percent credit provision is too lean to stimulate much new construction. (13)

Income Eligibility and Rent Levels

Congress has targeted low income taxpayers in a superior manner than in prior law. There are restrictions on income levels for eligibility and on the rent that may be charged to a low income tenant. The low income housing credit is provided only of households with incomes not exceeding 50 percent or 60 percent of area median income. These income limits are further adjusted for family size. This was done to correct abuses under prior law. A General Accounting Office report of tax exempt bond financed residential rental projects found that above average income renters could qualify under prior law as "low" or

"moderate" income tenants because incomes as high as 80 percent of area median income were eligible to occupy units reserves for low and moderate incomes tenants and it was not required for household incomes to be adjusted for family size until after 1985.(14)

The low income housing tax credit limits the rent that may be charged to a low income housing tenant and therefore ensures that the subsidized housing is affordable to low income individuals. The tax credit is designed to compensate the owners of low income housing for the required reduction of rent.

Diamond characterized the new rule as tight targeting of the subsidy to households with very low incomes.(15) For a nationwide median family income of about \$28,000 and a household size of two, the maximum qualifying income would be \$11,200 (40% of \$28,000) for the 20 percent set-aside at 50 percent of median income. It would be \$13,400 for the 40 percent set aside at 60 percent of median income. The corresponding maximum gross rent levels (30 percent of monthly qualifying income) would be \$280 and \$336.

Diamond calculates that a discount of up to \$324 below market monthly rent could be offered based on the value of the nine percent credit. This would imply a rent of about \$200 a month which would be under the rent limits for a two person household in areas with median incomes at or above the \$17,000 - \$20,000 range. This is based on a total cost of development of a low income unit of \$45,000, of which \$40,000 is the depreciable basis and thus eligible for the credit.(16)

Smith feels these limits are too stringent. He claims that at current market debt service costs the limits are too low to support new construction. Substantial income subsidy or favorable financing would be required to cause development.(17)

Investor Suitability

What are the likely characteristics of investors who will invest in low income housing? Investors will be attracted to low income housing investments because of tax benefits resulting from projected tax losses and low income housing credits. These projected benefits are particularly attractive if an investor is not subject to the limitation on losses and credits under the passive loss rules such as a regular corporation or has sufficient passive income to utilize the passive losses and credits. An investor must be able to project an annual tax liability which is sufficient to permit the use of the benefits through the life of the investment.

Individual investors will be attracted primarily by the tax credits. The typical individual investor will likely have little passive income from other sources so the passive losses will not be of significant value. Cash flow will not be a primarily objective because most new construction or rehabilitation properties are projected to initially lose money.(18) Appreciation will not be an important objective because residual value is not likely to be high given the type of property that is eligible.

Passive Loss Exceptions

An important exception is made to the limitation on passive losses for individuals owning rental real estate. The \$25,000 exception from the loss limitations is available for purposes of the credit. This permits the use of up to \$7,000 in credits for an individual who does not have any passive income. The exception phases out at income between \$200,000 and \$250,000. Unused credits can be applied against gain at time of sale.

To value the tax benefits fully individual investors will need to be confident that their income and tax status over the life of the project will be such that the benefits can be used. This uncertainty together with the need for large future cash contributions will be negative for many individual investors.

The phase out of the exception rule for taxpayers with incomes between \$200,000 and \$250,000 seems to be a major deterrent. Individuals in the high brackets have been typical investors in past low income housing projects. It seems that if Congress was to make an exception to its elimination for tax shelters in the 1986 Act for low income housing than it would not have provided this deterrent for high income investors. Rather than using private offerings to very high bracket investors it will be necessary for promoters to use public syndications. This results in large syndication costs and professional fees which may in turn remove the economic viability of many projects. Corporations are likely to be investors since they are exempt from the passive loss rules. The exception applies to Subchapter C corporations and not Subchapter S corporations. As noted

C corporations and not Subchapter S corporations. As noted earlier the projections for one project indicated an internal rate of return in excess of 30 percent for corporate investors.

Diamond suggests that a feasible procedure for using the credits or new construction may be to have a non profit sponsor draw upon state or local subsidies and the credit to build low income units, with the credits and losses being syndicated to a group of major corporations. The non profit corporation could facilitate getting the credits and add to the public relations aspects of the corporate involvements.(19)

Summary

Has the goal been met to significantly stimulate investment in low income housing? Commentators feel that the credit will be significant relative to other federal programs but still may not go far in solving the overall national problem. It is likely the credit will result in expected returns for many projects sufficient to induce development.

The success of the 9 percent credit projects will largely depend on whether state or local subsidies are available. Large credit projects will probably not attract individual investors because of the large cash outflows and uncertainties as to their ability to use the tax credits. Use of tax credits are limited by the passive loss rules. Further there is an uncertainty that the law might change so that benefits can not be received. It is more likely that the four percent credit properties might attract individual investors under the right

by the tax credit because they are not limited by the passive loss rules.

IV. PROMISING OPPORTUNITIES

Whether a project qualifies for the nine percent credit or the four percent credit depends on whether there is federal assistance. The use of the credit for an investor depends on whether he or she is an individual or a corporate entity. Given these limitations as well as many others, certain potential promising opportunities have been suggested.

Diamond suggests moderate amounts of rehabilitation to existing buildings in stable or rising low-and moderate income areas may be feasible. Provided the buildings are priced to offer reasonable returns under current market conditions, and rents are under the prescribed rent limits, then upgrading the property through the credit may be attractive.(20)

A specific example is an existing six-flat building in an inner-city neighborhood. An investor in such a building is eligible to apply for a 4 percent credit on its entire depreciable basis provided the building's date of construction or last resale is ten years or more prior to the resale. All units should be occupied by tenants with incomes that qualify under the rent restrictions. Expenditures for rehabilitation would be eligible for a 9 percent credit assuming they received no "federal assistance."

A developer may combine the credit with tax-exempt financing to do a moderate income new construction project similar to those built with tax exempt bonds in 1985. Provided the targeting requirements and the income requirements are met, the project may be entitled to the 4 percent credit on its set-aside units.

Rather than individual investors, developers may seek C corporations since they are exempt from the passive loss limitations. Individuals without large passive income will have difficulty in using the large amounts of both credits and passive losses over a long period that are likely to be generated by most projects.

Diamond suggests a feasible procedure for using the credits for new construction may be to have a non-profit sponsor draw upon state or local subsidies to build low income units. The credits and losses would be syndicated to a group of major corporations. The corporation could use all of the credit and losses. The credit could provide significant impetus to public-private partnerships and state and local housing initiatives, as long as they do not include federally subsidized financing.(21)

Packaging of projects may take a variety of forms. Individuals with incomes in the \$50,000 to \$150,000 range might be potential investors. Very high income individuals will not be attracted because of the \$200,000 phase out rule unless they have large amounts of passive income.

Some projects are set up as private placements with 35 investors or less. Above this number of investors, interests would be sold in public offerings registered with the Securities

and Exchange Commission. An alternative to obtain large numbers of investors is to establish umbrella partnerships. This partnership then buys interests in local partnerships. Perhaps corporations will be the most promising source for investment capital since they are exempt from the passive loss rules.

V. IMPROVEMENTS TO CREDIT

How can the credit be improved to result in more investment in low income housing? The overall stimulus to low income housing has been diminished significantly by reductions in non tax assistance programs and by changes in the tax law relating to depreciation, capital gains, and tax rates. Thus the low income housing credit needs to take a more prominent role in stimulating low income housing.

Costs of expanding the plan will have to be related to the potential benefits. The following recommendations will cause revenue losses. Congress may determine that expansion of the credit is less costly than alternative methods of stimulus. Increasing the allowable allocations under the program will allow for more projects to be developed. Extension of the allowable period for commencement of projects beyond the 1989 expiration date is important because of the long time lag involved in planning, developing and obtaining approval for projects.

The rent restrictions should be monitored so that more projects will in fact be feasible. Currently it is reported that there is very little cushion in the projects so that if anything

goes wrong, the projects will not develop their expected rate of return. Housing projects qualifying for the nine percent credit will have rents substantially below what is needed to break even. Therefore major local income subsidy will be necessary for the nine percent properties.

The recapture rules should be re-examined. They are sufficiently restrictive so that investors will devalue the credit and as a result less low income housing will be developed.

The phase out of the credit for investors with income above \$200,000 would allow for a superior market for investors. The purpose of a tax preference is to accomplish a stated objective. Since it is a tax preference it will therefore allow certain taxpayers to pay less than their normal share of taxes. If it is important enough to have a tax preference in the first place it does not seem logical to remove a class of taxpayers who may well be best able to take the risks involved in low income housing and who have historically been a primary market for tax shelter investments.

Tax preferences compared to non tax expenditures have the advantage of removing the need for a bureaucracy to manage the program. The state allocation process established in connection with the low income housing credit has in fact developed an administrative overhead. The state allocation process tends to be time consuming and restrictive. The necessity of having this process should be re-examined.

An audit of the results of the credit after the process has been in effect for a year or so appears desirable. If such an audit was conducted, perhaps at the end of 1988, Congress might then determine whether the program should be extended and what modifications are necessary to make it more effective.

FOOTNOTES

1. Commerce Clearing House, General Explanation of Tax Reform Act of 1986, p. 172.
2. R.S. Goldstein and C.L. Edson, "The Tax Credit for Low Income Housing," Real Estate Review, Vol. 17. No.2, summer 1987, p. 50.
3. D.B. Diamond Jr., "The Low-Income Rental Housing Credit," Home Building after Tax Reform, in Home Building After Tax Reform (Washington, D.C.: National Association of Homebuilders, November, 1986) p. 62.
4. D.A. Smith, "Qualified Housing Tax Credits," "The Only Game in Town," forthcoming in Real Estate Review, Vol.18, No.3 Fall 1987.
5. Diamond, op.cit., p. 67.
6. Ibid., p. 68.
7. Smith, op.cit.
8. Goldstein and Edson, op.cit., pp. 58-60.
9. Smith, op.cit.
10. Smith, op.cit.
11. Diamond, op.cit., p. 68.
12. Ibid., p. 63.
13. Smith, op.cit.
14. General explanation, op.cit., p. 153.
15. Diamond, op.cit., p. 63.
16. Ibid., p. 167.
17. Smith, op.cit.
18. Ibid.
19. Diamond, op.cit., p. 65.
20. Ibid., p. 69.
21. Ibid., p. 65.

