[Journal of Law and Policy](https://brooklynworks.brooklaw.edu/jlp)

Volume 6 | Issue 2 Article 2

1998

Improving the Supply of Affordable Housing: The Role of the Low-Income Housing Tax Credit

David Philip Cohen

IMPROVING THE SUPPLY OF AFFORDABLE HOUSING: THE ROLE OF THE LOW-INCOME HOUSING TAX CREDIT

David Philip Cohen[*]

INTRODUCTION

The low-income housing tax credit ("LIHTC"), which was created as part of the Tax Reform Act of 1986[1] and made permanent by the Omnibus Budget Reconciliation Act of 1993,[2] utilizes the Internal Revenue Code to provide an incentive for the construction and rehabilitation of low-income rental housing. By lowering the overall cost of producing housing units through the provision of tax credits to developers and owners of qualified rental projects, the intent of the LIHTC is to stimulate investment in low-income housing development. Accordingly, the purpose behind the LIHTC is to increase the supply of decent and affordable housing in the United States.

The LIHTC represents another step in Congress' increasing reliance on the private sector to supply low-income housing. The federal government first attempted to provide affordable housing to poor Americans primarily in the form of public housing, whose construction was subsidized by public funds and whose operations

---

* J.D., University of California at Berkeley (Boalt Hall) School of Law; A.B., University of Illinois, Urbana. The author is grateful to Professor Alan Auerbach, Jim Grow, Robin Linn and Lara Muldoon for their insightful contributions, and to my parents for their support.

[1] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[2] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

were managed by local public housing authorities.[3] During the 1960s and 1970s, Congress began placing more reliance on the private market to supply low-income housing. Congress created several housing programs, including programs to assist low-income home buying,[4] as well as rent subsidy programs, such as Section 8,[5] in order to provide incentives to private developers to create and maintain affordable rental housing units.[6] An even greater emphasis was placed on the private market during the 1980s, as the federal government reduced direct federal housing spending while manifesting a view that the private sector, rather than the public sector, was better able to provide low-income housing.[7]

With the continual decline in direct federal funding for low-income housing, the LIHTC has become a substantial housing program. In 1991, the tax expenditure for the low-income housing credit was $.6 billion, compared to the $1 billion that was spent on housing vouchers.[8] The Congressional Budget Office estimates that the low-income housing tax credit has the potential to become an even larger program, costing as much as $3 billion per year.[9]

The LIHTC replaced several tax incentives for rental housing development that existed under prior laws.[10] In an effort to curb real estate tax shelters, the Tax Reform Act of 1986 eliminated

---

[3] *See* Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 VILL. L. REV. 871, 877 (1993).

[4] 12 U.S.C. § 1715z-1 (West 1996); 12 U.S.C. §1715l(d)(3) (1998).

[5] 42 U.S.C. § 1437f(o) (1996); 24 C.F.R. § 982 (1996). Section 8 refers to Section 8 of the revised United States Housing Act of 1937.

[6] For a discussion of federal housing programs in the United States see NATIONAL HOUSING LAW PROJECT, HUD HOUSING LAW PROJECT, TENANTS' RIGHTS (2d ed.) (1994).

[7] *See* Janet Stearns, *The Low-Income Housing Tax Credit: A Poor Solution to the Housing Crisis*, 6 YALE L. & POL'Y REV. 203, 205-06 (1988).

[8] Congressional Budget Office, *The Cost Effectiveness of the Low-Income Housing Tax Credit Compared with Housing Vouchers: A CBO Staff Memorandum* (1992), *reprinted in* 56 TAX NOTES 493, 494 (1992) [hereinafter CBO].

[9] *Id.*

[10] Although the LIHTC is a tax incentive that does not involve the direct appropriation of federal funds, it is considered a tax expenditure since it results in a revenue loss to the federal government just like a direct appropriation. *See* 2 U.S.C. § 622(3) (1996); Stearns, *supra* note 7, at 206 n.27.

favorable tax treatment for expenses incurred in the development of rental housing, including special accelerated depreciation and full expensing of construction period interest and taxes.[11] While the LIHTC replaced these prior incentives for investment in low-income housing, the objective of the tax credit program was to target more assistance to low-income families than did the tax incentives available under prior law.[12]

Thus far, the low-income housing tax credit has aided the effort to provide affordable, quality housing, with many low-income rental units being constructed or rehabilitated through use of tax credits. However, the LIHTC has not and will not, as it is currently drafted, meet the goal of providing "a decent home and suitable living environment for every American family," a goal articulated nearly fifty years ago by the United States Housing Act of 1949.[13]

I. THE NATION'S HOUSING CRISIS

There is a critical need for affordable housing in the United States. Almost 8.4 million families, or 12.3 percent of all American

---

[11] The Internal Revenue Code formerly permitted special accelerated depreciation pursuant to I.R.C. § 168(b)(4) (CCH 1985) (amended 1986). The Internal Revenue Code now requires all residential rental property to be depreciated over 27.5 years. I.R.C. § 168(c)(1) (CCH 1996). The full expensing of construction period interest and taxes was formerly allowed pursuant to I.R.C. § 189(d)(1) (CCH 1985) (repealed 1986).

[12] CBO, *supra* note 8, at 493. The term "low-income families" is defined as those families with incomes that do not exceed 80 percent of area median income, with adjustments for family size. The term "very low-income families" means families whose income does not exceed 50 percent of area median income, with adjustments for family size. 42 U.S.C. §1437a(b)(2) (1996). "Extremely low-income families" refers to families with less than 25 percent of area median income, with adjustments for family size.

[13] 42 U.S.C. § 1441 (1996). The United States Housing Act of 1937 similarly states, in pertinent part, "[i]t is the policy of the United States . . . to remedy the unsafe and unsanitary housing conditions and the acute shortage of decent, safe, and sanitary dwellings for families of lower income." United States Housing Act of 1937, ch. 896, 50 Stat. 888 (1937) (codified as amended at 42 U.S.C. § 1437 (1996)).

families, live below the poverty line.[14] Furthermore, over 11.5 million families, or 16.8 percent of all families, have an annual income of less than $15,000.[15] Moreover, over 15 million American households are considered low-income, with approximately 9 million living at very low- or extremely low-income levels.[16]

To compound the difficulties that the poor experience, the supply of affordable housing has not kept pace with the demand. Nationwide, rents have increased at faster rates than has the median renter income, and average rents continue to remain near their 25-year peak (1987) levels.[17] Meanwhile, from 1980 to 1992, the supply of public housing grew only slightly, with an increase of only 2,200 units during that period.[18] Moreover, the number of public housing units under construction annually has declined from 20,900 units in 1980 to only 7,200 units in 1992.[19]

Due to the persistent shortage of affordable housing, rent burdens have been most severe on low-income tenants.[20] Federal subsidies have not done enough to alleviate this burden since the vast majority of low-income families do not receive Department of Housing and Urban Development ("HUD") funded rental assistance.[21] As a result, low-income renters are forced to search for housing in the unsubsidized market, where they face severe rent burdens and often live in structurally inadequate housing.[22] Nationwide, approximately 44 percent of all renters spend 30

---

[14] U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1995 at 474 tbl. 752 (1995).

[15] U.S. BUREAU OF THE CENSUS, *supra* note 14, at 474 tbl. 731. Figures are based on constant 1980 dollars.

[16] *See* JOINT CENTER FOR HOUSING STUDIES, THE STATE OF THE NATION'S HOUSING 31 (1994). For a definition of low-income, very low-income, and extremely low-income see *supra* note 12.

[17] JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 3.

[18] *See* U.S. BUREAU OF THE CENSUS, *supra* note 14, at 741 tbl. 1238.

[19] *See* U.S. BUREAU OF THE CENSUS, *supra* note 14, at 741 tbl. 1238.

[20] JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 15.

[21] JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 16-17.

[22] JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 17. *See also* THE REPORT OF THE MITCHELL/DANFORTH TASK FORCE ON THE LOW-INCOME HOUSING TAX CREDIT (1989) [hereinafter THE MITCHELL/DANFORTH REPORT].

percent or more of their income on housing costs.[23] A recent study found the rent burden to be most severe among poor renters, with 75 percent of low-income households spending 30 percent or more of their income on housing.[24]

Moreover, 71 percent of extremely low-income renters who do not receive housing subsidies, or a total of 2.7 million renters, paid more than half of their income in rent.[25] An additional 844,000 renters lived in housing that was structurally inadequate.[26] The LIHTC provides some relief for these renters by creating a tax incentive that makes it more attractive financially for developers to construct or substantially rehabilitate low-income rental housing.

II. EXPLANATION OF THE LOW-INCOME HOUSING TAX CREDIT

The low-income housing tax credit, codified in section 42 of the Internal Revenue Code, allows owners of qualified low-income rental housing to claim a tax credit annually over a ten year period. The LIHTC contains several complicated rules and requirements. The provisions with the most relevance to the analysis of this paper are explained in this section.

A. *Qualified Buildings*

Only "qualified low-income project[s]" are eligible to receive a low-income housing tax credit.[27] Both the new construction and the substantial rehabilitation of eligible residential rental properties may qualify for the tax credit program.[28] In addition, a taxpayer who places an existing building in service as a low-income project

---

[23] *See* U.S. BUREAU OF THE CENSUS AND DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, SUPPLEMENT TO THE AMERICAN HOUSING SURVEY FOR THE UNITED STATES 1993 tbl. 3-2 (1993).

[24] Timothy S. Grall, *Households at Risk: Their Housing Situation*, *in* U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT CURRENT HOUSING REPORTS (H121/94-2) (1994).

[25] JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 17, 31.

[26] JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 31.

[27] I.R.C. § 42(c)(2), (g) (West 1996).

[28] I.R.C. § 42(d), (e).

may qualify for the tax credit as long as the building was acquired by purchase, was not previously placed in service by the taxpayer or related party and has not changed ownership or undergone major improvements for the past ten years.[29]

To qualify for the credit, the building must be a residential rental property and must set aside a minimum number of rent-restricted residential units.[30] Accordingly, the owner of a LIHTC rental project must elect to have either 20 percent or more of the building's residential units rent-restricted and occupied by renters whose income is 50 percent or less of area median gross income, or have at least 40 percent or more of its residential units rent-restricted and rented to tenants whose income is no greater than 60 percent of area median gross income.[31] These two elections are commonly referred to as the "20-50 test" and the "40-60 test." Once the election is made, it is irrevocable.[32] Furthermore, tax credits are available only for the number of units in the rental project that are rent-restricted and occupied by qualifying low-income tenants.[33]

The LIHTC places restrictions on the amount of rent that may be charged for the low-income units. For these units, the gross rent, including utilities but excluding any payment made under the Section 8 program, may not exceed 30 percent of qualifying income, using a family size equal to 1.5 times the number of bedrooms in the unit.[34] This provision limiting the maximum rent

---

[29] I.R.C. § 42(d)(2). Certain federally assisted buildings acquired during the ten year period that receive a waiver from the Secretary of the United States Department of Housing and Urban Development may qualify as low-income housing for purposes of the LIHTC. I.R.C. § 42(d)(6). The requirements concerning existing buildings are intended to prevent both the original and subsequent owners of a qualified housing project to claim the tax credit.

[30] I.R.C. § 42(g).

[31] I.R.C. § 42(g)(1).

[32] I.R.C. § 42(g).

[33] I.R.C. § 42(c), (g).

[34] I.R.C. § 42(g)(2). An efficiency unit is treated as if it is occupied by one person while all other units are treated as occupied by 1.5 persons for each separate bedroom. I.R.C. § 42(g)(2)(C). Therefore, a two-bedroom unit is considered to be occupied by a three-person family.

that may be charged is designed to ensure that the rent-restricted units are affordable for low-income tenants.

B. Credit Amount

The dollar amount of the tax credit that is awarded to an owner of a qualified building is calculated as a percentage of the owner's basis in the rental units that are set aside for low-income tenants.[35]

1. Qualified Basis

Qualified basis is determined by multiplying a building's eligible basis by the "applicable fraction."[36] The applicable fraction is the lesser of the unit fraction, which is the ratio of low-income units to total units in the building, or the floor space fraction, which is the ratio of total floor space of the low-income units to the total floor space of all residential rental units, whether occupied or not.[37]

For purposes of the credit, the eligible basis is the building's adjusted basis at the end of the first taxable year of the credit period.[38] Common areas may be included in the calculation of qualified basis.[39] However, a building's eligible basis must be reduced by the amount of certain federal housing grants provided to the building.[40] For buildings used, at least in part, to provide supportive services designed to assist homeless tenants in finding and retaining permanent housing, the qualified basis is increased by the lesser of 20 percent of the building's qualified basis before adjustment or the basis attributable to the portion of the building used throughout the tax year to provide the services.[41]

---

[35] I.R.C. § 42(a), (c).
[36] I.R.C. § 42(c).
[37] I.R.C. § 42(c)(1).
[38] I.R.C. § 42(d).
[39] I.R.C. § 42(d)(4)(B).
[40] I.R.C. § 42(d)(5)(A).
[41] I.R.C. § 42(c)(1)(E).

2. *Applicable Percentage*

The "applicable percentage" for LIHTC purposes depends on the characteristics of the building being placed in service. The applicable percentage is determined monthly by the Treasury Department, and it is set so as to yield, over the ten year period in which the credit may be claimed, a credit with a present value equal to 70 percent or 30 percent of the building's qualified basis, depending on the building's characteristics.[42] For new and substantially rehabilitated buildings that do not receive additional federal subsidies, the present value of the credit is equal to 70 percent of qualified basis.[43] Therefore, due to the time value of money, the annual credit that a taxpayer may take is approximately 9 percent of qualified basis.[44] Existing buildings and federally-subsidized buildings are eligible for a tax credit with a present value equal to 30 percent of qualified basis, or approximately 4 percent annually for the ten year period.[45] For existing buildings that undergo substantial rehabilitation, the eligible acquisition costs qualify for the 30 percent credit, but the rehabilitation expenditures may receive the 70 percent present value credit.[46]

3. *Special Rules for Projects in High Cost Areas*

A higher credit is awarded to buildings located in an area specifically designated by the Secretary of Housing and Urban Development as a "qualified census tract" or "difficult development area."[47] A qualified census tract is an area in which 50 percent or more of the households have an income which is less than 60 percent of area median gross income.[48] A difficult development

[42] I.R.C. § 42(b). *See* Jeanne L. Peterson, *The Low-Income Housing Tax Credit*, 73 MICH. BAR J. 1154, 1155 (1994).

[43] I.R.C. § 42(b)(2).

[44] I.R.C. § 42(b)(1)(A).

[45] I.R.C. § 42(b)(1)(B).

[46] I.R.C. § 42(e). *See* Rev. Rul. 91-38, 1991-26 I.R.B. 5.

[47] I.R.C. § 42(d)(5)(C).

[48] I.R.C. § 42(d)(5)(C)(ii).

area is an area in which there are high construction, land and utility costs relative to area median gross income.[49] For new buildings constructed in a qualified census tract or difficult development area, the higher credit amount is achieved by increasing the property's eligible basis to 130 percent of the otherwise eligible basis.[50] For existing buildings, the rehabilitation expenditures included in the eligible basis are increased to 130 percent of total rehabilitation expenditures.[51]

C. Credit Period

A qualifying taxpayer may take the tax credit annually for ten taxable years, beginning the year in which the project is placed in service.[52] If certain requirements are met, the taxpayer may elect to have the credit period begin in the taxable year succeeding the year that the building is placed in service.[53] A credit recipient also must agree to maintain the building's qualifying low-income status for at least fifteen years.[54]

The LIHTC requires that eligible projects maintain an extended commitment to low-income housing. Accordingly, a qualified project must remain a rental property and continue to meet the income and rent requirements for a minimum fifteen-year period.[55] Owners must continually monitor and recertify tenant incomes in order to ensure compliance since an increase in a tenant's income may disqualify the tenant.[56]

---

[49] I.R.C. § 42(d)(5)(C)(iii).
[50] I.R.C. § 42(d)(5)(C)(i)(I).
[51] I.R.C. § 42(d)(5)(C)(i)(II).
[52] I.R.C. § 42(f)(1).
[53] I.R.C. § 42(f)(1)(B).
[54] I.R.C. § 42(h)(6).
[55] I.R.C. § 42(g)(2), (h)(6), (i)(1).
[56] *See* Andrew Z. Blatter & Elena Marty-Nelson, *An Overview of The Low Income Housing Tax Credit*, 17 U. BALT. L. REV. 253, 260 (1988); Peterson, *supra* note 42, at 1156.

D. Credit Recapture

The Internal Revenue Code provides for the recapture of the low-income housing credit where, with limited exceptions, the LIHTC property fails to meet the income and rent limitation requirements.[57] However, a rental unit may continue to be treated as a low-income unit even if the occupant's income rises above the income limitation, as long as the occupant's income originally met the applicable income limitation, the unit continues to be rent-restricted and the occupant's current income does not exceed 140 percent of the income limitation.[58] Credit recapture may also occur when a project owner sells an interest in the property.[59]

E. Application of Passive Activity Rules

LIHTC properties receive favorable tax treatment under the Internal Revenue Code's passive activity rules. The Internal Revenue Code allows a taxpayer who "actively" participates in a rental real estate activity to deduct up to $25,000 of annual losses attributable to the rental real estate.[60] This allowance is subject to a phase-out reduction for taxpayers whose adjusted gross income exceeds $100,000.[61] However, the phase-out provision does not apply to investments in low-income housing funded by the credits.[62] Moreover, investors in LIHTC properties are not subject to the active participation requirement.[63] Therefore, an investor in a LIHTC project may take advantage of the $25,000 offset regardless of the investor's level of participation. This favorable tax treatment under the passive activity rules may further encourage investment in low-income housing.

---

[57] I.R.C. § 42(j). However, the credit recapture amount phases out in the 11th through 15th years. CBO, *supra* note 8, at 494.

[58] I.R.C. § 42(g)(2)(D).

[59] I.R.C. § 42(j).

[60] I.R.C. § 469(i).

[61] I.R.C. § 469(i)(3)(A).

[62] I.R.C. § 469(i)(3)(C).

[63] I.R.C. § 469(i)(6)(B).

F. *State Housing Agencies*

State housing agencies play an essential role in the LIHTC program. Credit authority is given to each state's designated housing agency, which is responsible for allocating the credits to qualified developers.[64] The LIHTC sets an annual credit ceiling on the aggregate amount of credits that each state's housing credit agency may allocate.[65] A state's annual credit ceiling is determined by multiplying $1.25 by the state population.[66] Each state's ceiling also includes the unused credit ceiling from the previous year and any unused credits returned during the calendar year.[67]

Each state's housing agency must establish a qualified allocation plan for the distribution of the credits.[68] The plan must set forth selection criteria, establish procedures to monitor noncompliance, and give preference in credit allocation to projects serving the lowest income tenants and projects obligated to rent to qualified tenants for the longest periods.[69] Moreover, the LIHTC mandates that the dollar amount allocated to a project may not exceed the amount that the state housing agency determines is necessary to ensure the project's viability and earn investors a fair rate of return.[70]

Accordingly, before issuing the credits, the state agency must consider the sources and uses of project funds, the proceeds expected to be generated by reason of the tax benefits, the percentage of the credit used for project costs other than intermediary costs, and the reasonableness of the proposed developmental and operational costs of the project.[71] Finally, the LIHTC requires that at least ten percent of a state's housing credit ceiling be allocated to qualified low-income housing projects in which a

---

64 I.R.C. § 42(h).
65 I.R.C. § 42(h)(3)(B).
66 I.R.C. § 42(h)(3)(C)(i).
67 I.R.C. § 42(h)(3)(C)(ii).
68 I.R.C. § 42(m).
69 I.R.C. § 42(m)(1).
70 I.R.C. § 42(m)(2)(A).
71 I.R.C. § 42(m)(2)(B).

qualified nonprofit organization owns an interest in the property, either directly or through a partnership, and materially participates in the development and operation of the project.[72]

III. HAS THE LIHTC MET THE LOW-INCOME HOUSING NEED?

By awarding a tax credit for new construction and substantial rehabilitation, the LIHTC is designed to help solve a prevalent problem among low-income individuals: the lack of affordable housing. Therefore, it is important to consider the effectiveness of the tax credit in stimulating the construction and renovation of low-income housing. The relevant measure in making this determination is the net additions to the housing stock of rental units developed through use of low-income housing tax credits that would not otherwise be provided by the unsubsidized market. It is also appropriate to consider the cost-effectiveness of the credit program.

To best measure the costs and benefits of the LIHTC, one needs to know not simply the number of units constructed or substantially rehabilitated with tax credits, but the number of units developed with the credits that would not have been constructed or rehabilitated without use of the credits. The benefit of these additional units would be determined based on the present value of the market rents that could be charged for the units and the decline in market rents resulting from the increase in the supply of rental housing.[73] However, this is difficult to measure since there is a general lack of data concerning the LIHTC and tax credit information from individual tax returns is not readily available. A 1983 study concerning the effectiveness of supply-side housing subsidies suggested that subsidized construction largely displaces unsubsidized units.[74] Still, there are no studies that specifically focus on the effect of the low-income housing tax credit on unsubsidized construction. Nevertheless, it appears from the available data that

---

[72] I.R.C. § 42(h)(5).

[73] JOINT COMMITTEE ON TAXATION, DESCRIPTION AND ANALYSIS OF TAX PROVISIONS EXPIRING IN 1992, at 78 (1992).

[74] *See infra* notes 125-128.

the LIHTC has not stimulated a sufficient production of low-income housing nor has it been cost-effective.

An article by Frank Racaniello, analyzing data contained in a report by the National Council of State Housing Agencies, provides some insight into the quantity and cost of units produced through use of the tax credits, at least during the initial years of the credit program.[75] Racaniello reported that in 1987, low-income housing tax credits assisted in the production of 33,575 low-income rental units.[76] In 1988, the number of units produced with credits rose to 77,825.[77] This amounts to an increased production of slightly more than 230 percent.[78] However, from 1987 to 1988, the utilization of the credit grew from 18 percent to 66 percent of the total credit dollars available, an increase of almost 370 percent.[79] Thus, in 1988, significantly less housing was produced per credit dollar expended than in 1987. Furthermore, in 1987, the credit cost per unit was $1,646.[80] In 1988, the credit cost per unit increased to $2,598.[81] In 1989, the credit cost per unit decreased slightly to $2,434, but again increased in 1990 to $2,855.[82]

In California, for example, from 1987 to 1996, the California Tax Credit Allocation Committee allocated $362.4 million in federal low-income housing tax credits to 54,862 units.[83]

---

[75] Frank A. Racaniello, *Extending the Low-Income Housing Tax Credit: An Empirical Analysis*, 22 RUTGERS L.J. 753, 761 (1991) (citing NATIONAL COUNCIL OF STATE HOUSING AGENCIES, STATE INITIATIVES TO INCREASE LOWER INCOME HOUSING DEVELOPMENT USING THE LOW-INCOME TAX CREDIT (1989)). Another primary source of statistical data that Mr. Racaniello used was THE MITCHELL/DANFORTH REPORT, *supra* note 22.

[76] Racaniello, *supra* note 75, at 761.

[77] Racaniello, *supra* note 75, at 761.

[78] Racaniello, *supra* note 75, at 761.

[79] Racaniello, *supra* note 75, at 761.

[80] Racaniello, *supra* note 75, at 761. The average credit cost per unit of $1,646 was derived by dividing the 1987 actual allocations ($55,285,954) by the total number of low-income units produced by the credit ($33,574).

[81] Racaniello, *supra* note 75, at 761.

[82] Racaniello, *supra* note 75, at 761-62.

[83] Letter from Mary Low, Program Analyst, California Tax Credit Allocation Committee, Sacramento, CA to David Cohen (Nov. 22, 1996) (on file with author).

Moreover, $45.4 million in federal tax credits were allocated to 6,184 units during 1996.[84] Nationwide, the LIHTC has provided over $2.9 billion in tax credit allocations over the ten year period from 1987 to 1996.[85] To date, 842,438 units have been constructed or rehabilitated using low-income housing tax credits nationwide.[86]

The above data calls into question the cost-effectiveness of the LIHTC, especially due to the high cost per unit. Furthermore, given the relatively low production effect, the number of units developed through the LIHTC still does not satisfy the overall need for low-income housing in the United States. In fact, the amount is insufficient to house just the low-income renters paying more than 50 percent of their income in rent.[87] Furthermore, because there is no source of information that reveals the number of low-income units that would have been constructed if the credit program did not exist, because of the data limitations noted above, it is difficult to determine whether the credit program has resulted in any net additions to the low-income housing stock. Given the assumption that tax credit units have displaced at least some unsubsidized low-income units, especially those unsubsidized units that would have been built or maintained without the tax credits but now receive credit subsidies, the net addition of rental units to the affordable housing stock is less than the estimated number of total units produced with the tax credits.

Moreover, the type of units that have been produced with the housing tax credits do not necessarily meet the needs of many low-income families. For example, the LIHTC does not place any restrictions on the number of bedrooms that the subsidized rental units must contain. As is similar with many other project-based housing subsidies, the LIHTC does not guarantee that the housing produced will be of appropriate quality, location and size for low-income families.[88] Accordingly, although low-income families can

---

[84] *Id.*

[85] Telephone interview with Jim Tassos, National Council of State Housing Agencies, Washington, D.C. (Dec. 4, 1996).

[86] *Id.*

[87] *See* JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 17, 31.

[88] CBO, *supra* note 8, at 496.

often be quite large, less than 14 percent of the total units subsidized by tax credits issued in 1987 and 1988 contained three or more bedrooms.[89] Consequently, the rental units that are produced may not be of sufficient size for families that are most in need because many units are too small to house large low-income families and there are simply not enough multi-bedroom units being developed.

Before next considering why the low-income housing tax credit has not been able to produce housing that is sufficient to meet the needs of poor families, it is useful to first consider the rationales that support the government-funded provision of housing. In other words, why should we be concerned about the supply of affordable housing, and more importantly, why is it the government's responsibility to ensure that these low-income rental units are provided?

One rationale is paternalism. Paternalism not only applies to government-sponsored housing programs but also runs across other social welfare programs, such as food stamps and AFDC.[90] With respect to these programs, the government assumes a key role in providing the necessities of life for those who, for any number of reasons, are unable to provide for themselves. If the government did not assume this role, the beneficiaries of the programs would have great difficulty providing food and housing for their families. Accordingly, the government takes on a paternal role in order to prevent low-income heads of households from failing to provide for their families, and thereby the government assistance prevents the families from falling deeper and deeper into poverty, a likely result for many poor families without the assistance of the government programs.

A second rationale is that current expenditures on housing will have a future benefit by lowering future cash outlays for welfare programs. The provision of affordable housing will not only allow low-income renters to acquire decent shelter, but it will also enable them to become more self-sufficient and less in need of government assistance in the future. Providing low-income families with decent

---

[89] CBO, *supra* note 8, at 496.

[90] *See* Food Stamp Act of 1977, 7 U.S.C. § 2011 (1998); 42 U.S.C. § 601.

and affordable housing will produce a positive externality in that it will give the heads of households an added opportunity of finding work. In turn, the addition of these individuals to the workforce will not only bolster the economy but it will also enable more family heads to become self-sufficient and provide a better future for their children.

This second rationale assumes, in part, that the housing produced through the low-income housing tax credit program will be located near job centers. The assumption will likely hold true with respect to housing funded by tax credits since the majority of tax credit developments will not consist of only low-income units, but rather, will contain a combination of low-income and market-rate units, with the majority of units typically being rented at market-rate rent levels.[91] In order to attract renters who are paying full market-rate rents for their units, the housing will need to be developed in areas that appeal to these renters. Therefore, it is likely that the majority of the LIHTC developments will be built outside of the inner city, with many projects appearing in areas of new development and job growth.

IV. WHY THE LIHTC DOES NOT MEET THE HOUSING NEED

A. *There Is Not Enough Incentive to Rent to the Poorest Families*

Without the low-income housing tax credit or other federal housing subsidies, there would be little incentive for developers to provide low-income housing. Developments with low-rent units typically do not experience adequate appreciation in value that keeps pace with other fair market investments and do not generate sufficient cash flow from rents to be attractive to investors.[92] By providing developers and investors of qualified projects with

---

[91] *See supra* notes 30-33.

[92] *See, e.g.*, 132 CONG. REC. S8152 (daily ed. June 23, 1986) (statement of Senator Cohen illustrating the lack of incentives for investments in low-income housing); JOINT CENTER FOR HOUSING STUDIES, *supra* note 16, at 15; JOSEPH GUGGENHEIM, TAX CREDITS FOR LOW-INCOME HOUSING 104, 131 (1992).

additional cash flow in the form of tax savings through tax credits, the low-income housing tax credit was designed to provide an incentive for the development of the greatest number of affordable housing units for low-income families.[93]

The enactment of the LIHTC reflected a Congressional concern that the federal tax preferences for low-income housing existing prior to the Tax Reform Act of 1986 did not effectively meet the housing needs of low-income tenants, including the "most needy low-income individuals."[94] Additionally, the express provisions of the LIHTC require that state housing agencies give preference to projects serving the lowest-income families.[95] However, there are no requirements within the LIHTC mandating that the rents charged in qualified projects be restricted to levels that are affordable to families with income below 50 percent of area median income.

Instead, a housing development can qualify for favorable tax treatment under the LIHTC by renting just 20 percent of its residential units to families with income equal to 50 percent of the area median income, or alternatively, by renting 40 percent of its residential units to families whose income is 60 percent of the area median income. Since owners of qualified projects can generate larger cash flows by renting to tenants with the highest income levels within the LIHTC guidelines, there is no incentive for these owners to restrict rents to levels that are affordable for families with very low- or extremely low-income. Furthermore, the LIHTC may add to the difficulty that the poorest families face in finding affordable housing. Federal guidelines define "affordable rent" as rent that is no greater than 30 percent of a family's monthly income.[96] Thus, tenants, especially those with low incomes, are advised to spend no more than 30 percent of their income on housing so that they have funds available for other important needs,

---

[93] *See* THE MITCHELL/DANFORTH REPORT, *supra* note 22.

[94] S. REP. NO. 99-313, at 758 (1986) (stating that the prior tax preferences "operate in an uncoordinated manner, result in subsidies unrelated to the number of low-income individuals served, and fail to guarantee that affordable housing will be provided to the most needy low-income individuals"). *See also* Blatter & Marty-Nelson, *supra* note 56, at 253.

[95] I.R.C. § 42(m)(1)(B)(ii)(I) (West 1996).

[96] 42 U.S.C. § 1437a(a)(1) (1996); I.R.C. § 42(g)(2).

such as food and clothing. In fact, tenants residing in most federally subsidized housing pay only 30 percent of their monthly income as rent. However, since the supply of federally subsidized housing is inadequate, and therefore, many poor families must turn to the private market for housing, these families are often forced to spend more than 30 percent of their income on housing.[97]

The difficulties that poor families experience in finding affordable housing can be illustrated by the following example. Given the national median income for a family of four ($36,959), an extremely low-income family of four may have income of only $9,240.[98] Therefore, using the 30 percent-of-income affordability standard, this family should spend no more than $231 per month in rent.[99] It is highly unlikely that the family will be able to find a two-bedroom apartment, or even a one-bedroom unit, on the private market that charges a monthly rent of $230. In Los Angeles, for example, the fair market rent ("FMR") for a two-bedroom apartment is over $800 per month.[100] In Las Vegas and Phoenix, where average property values are typically lower than in Southern California, the FMR for a two-bedroom unit is roughly $600, which is still unaffordable for the majority of poor families.[101]

Using the same example, a very low-income family of four will have an annual gross income of approximately $18,500, or $1,540 per month.[102] Again, given the 30 percent-of-income affordability

---

[97] *See* Stearns, *supra* note 7, at 204.

[98] U.S. BUREAU OF THE CENSUS, *supra* note 14, at tbls. 732, 738. The income of the extremely low-income family was derived by taking 25% of the national median income ($36,959).

[99] This amount was derived by taking 30% of the family's monthly income of $770.

[100] *Fair Market Rents for the Section 8 Housing Assistance Payments Program: Fiscal Year 1997*, 61 Fed. Reg. 49,576 (1996). The actual fair market rent (FMR) for Los Angeles is $854. Fair market rents are estimates of gross rent published by the Secretary of the U.S. Department of Housing and Urban Development. 61 Fed. Reg. 49,576. HUD sets the FMRs primarily to assure that a sufficient supply of rental units are available to participants in certain HUD programs, mainly the Section 8 Rental Certificate Program. *Id.* The FMRs include rent and utility costs, except telephone. *Id.*

[101] *Id.* The actual FMR is $630 for Las Vegas and $574 for Phoenix.

[102] These figures were derived by taking 50% of the national median income

standard, the family should spend only $462 for rent. Rent in most major metropolitan areas will be unaffordable for this family as well, forcing the very low-income family to pay more than 30 percent of its gross income for rent.

Since projects receiving low-income housing tax credits must set their rents for the low-income units based on the income limitations of either 50 percent or 60 percent of area median income, even the low-income rental units in these developments will typically be unaffordable for most poor people. For example, again consider a low-income family living in Los Angeles. In 1994, the area median income in Los Angeles was $39,035.[103] For the purposes of this example, consider a family with an annual income of $15,000, or almost 40 percent of the area median income. Using the 30 percent-of-income affordability standard, this family should pay monthly rent of no greater than $375. Further, consider a project financed with low-income housing tax credits that sets its rent levels for the low-income units based on 60 percent of the area median income. The maximum rent that this project can charge for a rent-restricted unit and still be in compliance with the LIHTC would be $585 per month.[104] This is nearly half of the monthly income of the family in our example. Moreover, it is roughly 20 percent higher than the national median rent in 1993.[105] Even if the rents for the project's low-income units were based on a qualifying income level of 50 percent of area median income, the rent charged would be $488, which is still well above the affordable rent level for the family in the example.[106]

Since the LIHTC does not require that qualified projects rent their low-income units to families with income below 50 percent or 60 percent of area median income, as long as there is a ready

---

($36,959).

[103] U.S. BUREAU OF THE CENSUS, COUNTRY AND CITY DATA BOOK: 1994 tbl. B (1994).

[104] This figure was derived based on 30% of the monthly income of a family with income equal to 60% of the area median income for Los Angeles ($39,035).

[105] In 1993, median rent was $487. U.S. BUREAU OF THE CENSUS AND DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, SUPPLEMENT TO THE AMERICAN HOUSING SURVEY FOR THE UNITED STATES 1993 tbl. 3-2 (1993).

[106] For further examples see CBO, *supra* note 8.

pool of renters, an owner of a tax credit project has no incentive to charge rents below minimum levels. In an attempt to maximize cash flow, an owner will likely elect to rent to families with the highest qualifying incomes. Support for this position can be drawn from the 1987 and 1988 tax years, during which 90 percent of projects receiving a tax credit elected to satisfy the 60 percent of area median income test.[107] As a result, if a project owner elects to meet the 40-60 test, the rent-restricted units will be unaffordable for many low-income families.

B. Use of Area Median Income Is Flawed

An inherent flaw in the LIHTC is its use of area median incomes, rather than the national median income, in the determination of qualifying income limitations. By using area median income levels as guidelines, owners of rental properties in affluent areas may be permitted to take advantage of the LIHTC by receiving a tax credit while renting to families whose incomes are near the national median. For example, although the national median income is roughly $37,000, the median income for a family living in Marin County, California is over $59,000.[108] Therefore, a LIHTC project in Marin may receive a tax credit if it rents 40 percent of its units to families with incomes of 60 percent of the area median income, or $35,494.

Similarly, in DuPage County, Illinois, where the median family income is $54,920, or Douglas County, Colorado, where the median family income is $54,244, a project may qualify for a low income housing credit even though it rents to families with incomes of $32,500.[109] Even in Los Angeles, a project may qualify for a tax credit as long as 40 percent of the units are occupied by

---

[107] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 75 (citing U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, EVALUATION OF THE LOW-INCOME HOUSING TAX CREDIT: FINAL REPORT, (1991)).

[108] The area median income for Marin is $59,157. U.S. BUREAU OF THE CENSUS, *supra* note 103, at tbl. B.

[109] *See* U.S. BUREAU OF THE CENSUS, *supra* note 103, at tbl. B.

families with incomes of \$23,000.[110] Therefore, projects in several areas of the country may qualify for housing tax credits even though they are not serving families who are of truly low income.

C. *Inefficiency of the Credit*

Although the LIHTC encourages investment in low-income housing, there are several inefficiencies associated with it. Private, for-profit developers, as well as public housing authorities and nonprofit organizations with no tax liability to offset the tax credit, use their tax credit allocations to attract funds.[111] In order to raise capital for project development, developers often seek investors who are willing to make equity contributions in exchange for tax credits. However, in a tax credit transaction, the developer typically receives less than the full value of the credit in equity since a portion of the credit dollars covers the costs of the transaction and is profit to the investors.[112]

The overhead and administrative costs associated with the LIHTC are a primary source of its inefficiency.[113] The increased bureaucracy resulting from the requirement that state housing agencies allocate the credits leads to high administrative costs at both the state and federal level. In general, the administrative and overhead costs associated with a low-income housing program appear to be much higher if a low-income housing unit is subsidized with tax credits rather than with housing vouchers.[114]

The use of housing tax credits in the development of low-income housing results in other transaction costs, particularly those costs associated with the involvement of various parties in the development process. For example, developers may hire lawyers, consultants and accountants to assist in acquiring additional financing, create limited partnerships, structure other syndication

---

[110] *See* U.S. BUREAU OF THE CENSUS, *supra* note 103, at tbl. B. This amount was derived by multiplying 60% the median income for Los Angeles (\$39,035).

[111] *See* Peterson, *supra* note 42, at 1155.

[112] Stearns, *supra* note 7, at 218.

[113] CBO, *supra* note 8, at 493.

[114] CBO, *supra* note 8, at 493.

arrangements and ensure that the project meets all of the requirements necessary to qualify for the LIHTC. One HUD study found the syndication costs in LIHTC transactions to be substantial, averaging approximately 20 percent of the total cost of the transaction.[115] These transaction costs add significantly to the total development costs, although they do not directly result in the production of housing units. Furthermore, these costs can often have high price tags, which tends to reduce the amount of tax credit dollars available to bring rents to truly affordable levels.[116]

The Congressional Budget Office ("CBO") has suggested that some of the inefficiency associated with the LIHTC results from the surplus benefits of the credits accruing to builders rather than to renters. The supply-side subsidization of housing through tax credits, as opposed to demand-side housing subsidies which are given directly to tenants and can be used like cash in making rent payments, may enable developers and their investors, rather than tenants, to capture the majority of the benefits.[117] Since the credits are provided directly to developers rather than to tenants, the developer can keep any excess benefit and has no incentive to pass them along to the tenants. Although the provisions within the LIHTC requiring rent restrictions and oversight by state housing agencies are in place to protect tenants' interests, available evidence suggests that these measures are relatively ineffective at ensuring that excess benefits accrue to the tenants.[118]

Efforts to target the credit in order to ensure that the subsidy reaches the tenants have also significantly increased the administrative costs of state housing agencies, HUD and the IRS. For example, Internal Revenue Code section 42(m) mandates that each state housing agency make a determination of the minimum amount of credit dollars necessary to maintain the financial viability of a

---

[115] CBO, *supra* note 8, at 497 (citing U.S. DEPARTMENT OF HOUSING DEVELOPMENT, EVALUATION OF THE LOW-INCOME HOUSING TAX CREDIT: FINAL REPORT (1991)). The HUD study noted that the statistics may be biased because of lack of response. CBO, *supra* note 8, at 499 n.6.

[116] *See* GUGGENHEIM, *supra* note 92, at 132.

[117] CBO, *supra* note 8, at 493.

[118] *See* CBO, *supra* note 8, at 493.

qualified project for the entire credit period.[119] However, attempts by state housing agencies to minimize the excess profits earned on individual projects places a substantial administrative burden on the government agencies as well as on the developers who are required to submit this information. As a result, any excess profits recovered are typically used to pay for the additional administrative costs instead of assisting low-income individuals, with little or no increase in the overall efficiency of the tax credit program.[120]

Another source of the inefficiency arises from the displacement of unsubsidized low-income units. Developers who would have planned to build a low-income project or would have substantially rehabilitated an existing structure even without the availability of a tax credit, will now likely try to gain tax credit support for their projects.[121] As a result, this now subsidized project replaces an otherwise unsubsidized building, with no net gain in the number of low-rent units.[122] Moreover, a tax subsidy for low-income housing construction may induce resources that without the tax credit would have been used for other housing to instead be devoted to low-income housing.[123]

In examining the cost-effectiveness and budgetary impact of the tax credits, the CBO has pointed out that the low-income housing tax credit, like other supply-side mechanisms, is unlikely to cause a substantial increase in the supply of affordable housing.[124] Drawing support from a 1983 study concerning the effect of supply-side subsidies administered by HUD in the 1960s and 1970s, the CBO suggested that subsidized housing units may largely displace unsubsidized units.[125] The study estimated that for every three units of subsidized construction, unsubsidized housing

---

[119] I.R.C. § 42(m)(2) (West 1996).

[120] CBO, *supra* note 8, at 493, 495-97.

[121] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71.

[122] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71-72.

[123] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71.

[124] CBO, *supra* note 8, at 493.

[125] CBO, *supra* note 8, at 496 (citing Michael P. Murray, *Subsidized and Unsubsidized Housing Starts: 1961-1977*, *in* 65 REV. OF ECON. & STAT. 590, 590-97 (1983)).

construction declined by at least two units.[126] In fact, as many as 85 percent of government-subsidized housing starts may displace unsubsidized starts.[127] While the CBO noted that the study could not examine the effect of subsidized new construction on the quantity of existing housing available to the poor, it reasoned that to the extent that subsidized housing removes some low-income renters from the unsubsidized market, the demand for unsubsidized units would be lowered and would therefore be expected to cause some of the unsubsidized units to leave the affordable housing stock.[128]

Finally, the costs associated with the low-income housing tax credit program can be substantial. Although housing subsidized by tax credits is typically of better quality than the housing it replaces, the benefit provided to the tenant is only a fraction of the cost of the credits, with the improvement in quality often being worth less to the tenant than its cost to the government.[129] In addition, the provision of subsidies for new construction may produce an inefficiently large quantity of housing services by creating units with greater amenities or of a higher quality than that which low-income individuals would have been willing to pay for given an equivalent amount of money.[130]

However, the tax credit may produce a positive externality by increasing new construction starts in areas near job centers or by stimulating new construction and promoting the rehabilitation of dilapidated structures in run-down neighborhoods. Still, one HUD study estimated that for units not receiving other subsidies, the cost of the low-income housing tax credit was almost two times the cost

---

[126] CBO, *supra* note 8, at 494 (citing Michael P. Murray, *Subsidized and Unsubsidized Housing Starts: 1961-1977*, *in* 65 REV. OF ECON. & STAT. 590, 590-97 (1983)).

[127] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71. However, since this figure is based on both moderate and low-income housing starts, it may overstate the inefficiency of tax incentives solely for low-income rentals. JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71.

[128] CBO, *supra* note 8, at 496.

[129] CBO, *supra* note 8, at 494.

[130] CBO, *supra* note 8, at 494.

of vouchers to produce a similar unit of housing.[131] Even when units subsidized by tax credits result in net additions to the housing supply, the cost of providing the units can be quite high and typically exceeds the cost of providing affordable housing through vouchers.[132]

V. RECOMMENDATIONS

The low-income housing tax credit has flaws which must be addressed. Therefore, Congress should consider making changes to the LIHTC that will better enable the tax credit to meet the housing needs of low-income families. This section suggests three alternatives.

A. *Determination of Qualifying Income Levels*

As noted above, the use of area median income levels as income guidelines may permit owners of qualified projects to claim a tax credit even though their low-income units are not being rented to truly low-income families. Therefore, to avoid this result, a provision must be included in the LIHTC that requires the use of the national median income, instead of area median income, in the determination of qualifying income levels for tenants where the area median income is higher than the national level. However, since use of the national median income level may exacerbate the housing shortage in presently low-rent areas as well as in moderately-priced housing markets and rural markets, where area median incomes are below the national average, it would not be beneficial to determine qualifying income levels based on the national median income. Therefore, the LIHTC must adopt a two-tiered approach. In affluent areas, where the area median income is above the

---

[131] CBO, *supra* note 8 at 494 (citing U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, EVALUATION OF THE LOW-INCOME HOUSING TAX CREDIT: FINAL REPORT (1991)). The study noted that the statistics may be biased because of lack of response and that inferences about characteristics of new projects eligible for the credit may not be valid since the applicable law has been modified since 1988. CBO, *supra* note 8, at 499 n.6.

[132] CBO, *supra* note 8, at 496.

national median, the LIHTC program should use the national level to determine income limitations for qualified projects. However, where the area median income is less than the national median level, or where the local costs of living are below national averages, the area median income should continue to be used. This provision would accordingly provide better assurance that low-income housing tax credits are targeted to projects renting to families who are of truly low-income. While use of the national median income for markets where area median incomes are substantially below the national median may create a subsidy greater than Congress anticipated, this subsidy is necessary to support the development of housing that is decent and affordable to truly low-income families.

A potential result of the suggested two-tiered income approach would be for owners and investors of buildings in high-income areas to expect a lower return on their investment. In order to maintain eligibility for the low-income housing tax credits, owners of LIHTC projects in high median income areas will presumably be forced to adjust the rents that they charge based on a lower median income standard, the national median income. As a result, the rents charged on the low-income units will be less than present rental rates. Accordingly, the owners and investors of the buildings affected by this change in the tax credit program would experience a lower return on investment. This result may not be equitable since developers of low-income projects in high-income areas may face higher land and construction costs than are experienced in areas where the area median income is below the national level. If the return on investment is lowered due to a change in the LIHTC's income guidelines, such a reduction in the rate of return may create a disincentive for the development of low-income housing in certain areas. Therefore, at the same time that Congress considers the recommended change in the determination of median income levels used in the LIHTC program, there must be a recognition that the costs of development may be substantially higher in areas where the area median income exceeds the national median level due to higher land and construction costs. Accordingly, the LIHTC must provide for additional subsidies to developers of projects in these areas in order to place such developers on equal footing with other developers, and thereby provide the necessary incentive to stimulate development while enabling the housing units to be rented at rates that are affordable to truly low-income families.

B. *Greater Assistance to Projects Serving Lowest-Income Tenants*

The LIHTC does not provide enough incentive for developers and owners to provide housing that is affordable for our nation's poorest families. Although the situation faced by low-income renters is improved through the development of affordable housing under the LIHTC program, very low and extremely low-income renters may not realize any benefit under the present system since many units funded by low-income housing tax credits charge rents that are still unaffordable for these families. Without compromising the amount of disposable income a family has available for needs other than housing, many families with incomes below 50 percent of median will not be able to afford rents charged by most LIHTC projects. However, without additional subsidies, buildings with units that are affordable to the lowest income families will likely not be able to generate sufficient cash flow from rents or experience adequate appreciation in value to make them attractive to investors.[133] Thus, most projects with rents that are affordable to very low-income families will not be financially feasible for developers without additional financial assistance.[134] Furthermore, since the LIHTC does not require that the low-income units be rented to the lowest-income tenants, owners of LIHTC projects have little incentive to charge rents lower than the 50 percent or 60 percent of area median income level dictated by the LIHTC. Therefore, the LIHTC must establish better incentives for developers to maintain more than the minimum number of rent-restricted units for low-income tenants and to provide units that are affordable to very low- and extremely-low income families.

This outcome could be achieved by increasing the credit amount awarded to developments that rent to families with incomes of less

---

[133] *See supra* notes 92-93.

[134] GUGGENHEIM, *supra* note 92, at 87-104, 131.

than 50 percent of median income. One way for this result to be accomplished would be for the LIHTC to include a provision that allows such developments to increase eligible basis by a specified percentage, similar to the provisions concerning qualified census tracts and difficult development areas.[135] An alternative method would be to apply an increased credit percentage to buildings that serve very low-income families. For example, the LIHTC could permit projects that rent to very low- and extremely low-income tenants to qualify for a credit greater than the current 70 percent of present value credit. A higher credit percentage should lead to increased investment and development of housing that is affordable to the most needy families. Although such a provision would result in a reduction of tax revenue to the federal government, since higher credit amounts would be awarded to taxpayers, this is the price that must be paid if Congress continues to reduce direct federal housing spending while, at the same time, the affordable housing shortage continues to plague the nation's poor.

C. *Refundable Tax Credit*

The previous recommendations concerned suggestions to correct flaws in the LIHTC. The recommendations could be adopted separately or in conjunction in order to effect the necessary improvements. This final recommendation, however, advocates a complete change to the low-income housing tax credit program.

Rather than providing low-income housing tax credits to developers and owners of rental properties, as is done under the current system, Congress should instead consider providing the tax credits directly to low-income renters in the form of refundable tax credits. The tax credits would be renter-based rather than project-based, and they would be available for renters with income below a specified amount. This change in the LIHTC would provide low-income renters with an increased amount of disposable income to spend on housing, thereby allowing them to afford better housing and higher rents.

---

[135] *See supra* notes 47-51.

The effect of issuing a tax credit to renters with qualifying income would be similar to that of a direct subsidy, such as a housing voucher. A housing voucher is a demand-side subsidy that provides low-income tenants with more money to spend on better quality housing than they would otherwise be able to afford.[136] An example of a demand-side housing subsidy program is the federal Section 8 rental voucher program.[137] Under the Section 8 rental voucher program, the federal government provides a subsidy to low-income households in an amount equal to the difference between the rental unit's fair market rent and 30 percent of the renter's income.[138] In its present form, the LIHTC subsidizes the construction, acquisition and rehabilitation of units that are set aside at below-market rents; it funds development costs instead of subsidizing rents.[139] Both the voucher program and the housing tax credit program result in expenditures for housing, with the tax credit expenditure being in the form of a loss of tax revenue to the government.

On efficiency grounds, a refundable tax credit issued directly to renters would be superior to the current LIHTC.[140] First, a demand-side subsidy would improve housing opportunities for low-income families by increasing the families' ability to pay for housing.[141] Furthermore, a housing tax credit in the form of a refundable tax credit issued directly to renters should reduce the displacement of unsubsidized affordable housing units that occurs under the present system. Since the credits will be provided to tenants rather than to developers, developers will no longer have the incentive to remove unsubsidized affordable housing units from

---

[136] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 70.

[137] 42 U.S.C. § 1437f(o) (1996); 24 C.F.R. § 982 (1996).

[138] 42 U.S.C. § 1437f(o)(2).

[139] See JOINT COMMITTEE ON TAXATION, *supra* note 73, at 70.

[140] *See, e.g.*, Rachel Bratt, *Public Housing: the Controversy and Contribution*, *in* RACHEL BRATT, CRITICAL PERSPECTIVES ON HOUSING 351 (Chester Hartman & Anne Myerson eds. 1986)("Economic considerations alone suggest that the most efficient scheme is to give those families now eligible for public housing a cash subsidy, which the recipient can spend as he wishes so long as he lives in standard housing." (quoting Eugene Smolensky (1968))).

[141] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 70.

the affordable housing supply.[142] Rather, developers will have the incentive to produce more rental units to meet the demands of these new renters with greater abilities to pay for rent.

A refundable tax credit would also be more cost effective than the present LIHTC, and it would certainly reduce the overall administrative costs incurred under the current low-income housing tax credit system.[143] Targeting the credit directly to renters, rather than to developers and investors, would involve less administrative obstacles, thereby reducing overhead and administrative costs.[144] It would also lower the administrative expenses at both the state and federal level associated with the allocation of the credits and the monitoring of projects receiving the credits. Furthermore, a refundable tax credit would eliminate not only the transaction costs associated with developers hiring attorneys and consultants but also the syndication costs incurred in current tax credit transactions. Moreover, since the proposed tax credit would be awarded directly to renters rather than to developers, this new system would reduce the potential for developers to reap a windfall of profits from the credits.

There is, however, a potential problem with this proposed refundable tax credit system. A rent subsidy may not increase a family's expenditure on housing by the full amount of the subsidy since there is no guarantee that the family receiving the subsidy will use the total amount of the credit for housing. For example, a study of the Section 8 Existing Housing Program found that a typical family receiving a rent subsidy increased its expenditure on housing by only $22 for every $100 subsidy, spending the other $78 on other goods.[145] In other words, a family may rather spend

---

[142] *See supra* notes 122-129.

[143] *See, e.g.*, Anne L. Alstott, *The Earned Income Tax Credit and Some Fundamental Institutional Dilemmas of Tax-Transfer Integration*, NAT'L TAX J., Sept. 1, 1994, *available in* 1994 Westlaw 13462265 (discussing generally the position of advocates in favor of administering income transfers through the federal tax system).

[144] *See* CBO, *supra* note 8, at 493.

[145] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71 (citing W. Reeder, *The Benefits and Costs of the Section 8 Existing Housing Program*, J. PUB. ECON. (1985)).

at least part of a $100 subsidy on food and clothing rather than on housing.[146]

Some economists may argue that the above result is favorable since it allows parties to make their own utility maximizing decisions. However, this reasoning suffers several criticisms, particularly in the low-income housing context. It cannot be assumed that the parties receiving the subsidy will act in a way that maximizes their own utility or their family's utility. Moreover, the utility maximizing decisions of some heads of households may not be in the best interest of the entire family unit. If spending decisions are left to the discretion of the tax credit recipients, it may be that many of the recipients will not act in a manner that provides the most benefit for the family. For example, some family heads may receive the greatest enjoyment by using the $100 for entertainment, whereas the family would be made much better off by spending the money on housing. Although some families may be made better off by spending the amount of the credit on food or clothing rather than on housing, there is no guarantee that the government subsidies, without restrictions on their use, will be used in such a way. Therefore, the spending choices made available to the recipients of the refundable housing tax credits must be restricted to housing uses.

It is important that low-income families use the tax credit dollars for housing since the acquisition of decent quality housing may have several benefits beyond providing the family with shelter. First, decent quarters provide a better quality of living, which should improve the family's overall quality of life. In turn, this may provide family members with improved self-esteem and attitudes, empowering them to work toward self-sufficiency. Moreover, families receiving the tax credits will be able to afford housing in locations that are closer to areas of new job growth, thereby enabling heads of households to acquire jobs and get started in the right direction on the road to self-sufficiency.

---

[146] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 71 (citing W. Reeder, *The Benefits and Costs of the Section 8 Existing Housing Program*, J. PUB. ECON. (1985)).

There will be both winners and losers if a refundable tax credit system is adopted. Low-income renters who qualify for the refundable tax credits would certainly benefit. In general, the situation faced by low-income renters is improved through the development of affordable housing under the present LIHTC program, although very low and extremely low-income renters may not realize any benefit under the present system since many units funded by low-income housing tax credits charge rents that are still unaffordable for these families. The current credit system may also cause owners of unsubsidized, low-rent buildings to remove their units from the market, rehabilitate them or construct a new building in accordance with the provisions of the LIHTC, and take advantage of the credit, with no net addition of housing units to the affordable housing stock.[147] Low-income renters, especially those of very low and extremely low-income, would receive greater benefits if the tax credits were provided directly to them since they would have more money to spend on housing. A refundable tax credit system would increase the amount of money available for the qualifying taxpayers to use toward housing costs, thereby enabling them to afford better quality housing. This system would also benefit renters by eliminating the windfall profits that owners can receive under the present system.

Renters who do not qualify for a tax credit may experience some harm in the short-term; however, this harm would be alleviated over time. Under the recommended refundable tax credit structure, renters not receiving a tax credit, specifically those low-income renters who do not qualify for the credit, may experience some loss of well-being in the short-term since the market rents they face may increase. In response to the qualifying renters' ability to afford higher rents, market rents would be expected to rise in the short-term as families bid against each other for the available housing.[148] Over the long-term, the supply of decent, affordable housing would be expected to expand in response to market demands. This growth in supply would tend to push rents down, possibly below present rental rates. The increase in the supply of

---

[147] *See supra* notes 122-29.

[148] JOINT COMMITTEE ON TAXATION, *supra* note 73, at 70.

affordable housing would benefit all low-income renters, regardless of whether they qualify for a tax credit, by lowering rents.

Another beneficiary of the proposed system of refundable tax credits would be the owners of low-rent units, since they would presumably be able to charge slightly higher, although still affordable, rents for their units. Under the present LIHTC program, developers and owners of qualifying buildings benefit by receiving a tax credit. However, owners of buildings that are not subsidized by tax credits may experience a loss of well-being since they do not receive the monetary benefit of the credit, and they may lose tenants to LIHTC projects that charge lower rents. As noted previously, under a refundable tax credit system, the demand for housing would be expected to increase. Due to the time necessary to build or rehabilitate housing units, the housing supply may not be able to respond quickly enough in certain markets in the short-term to meet the increase in demand. Therefore, owners of low-rent units would benefit from an increase in demand for housing since they would be able to rent their units at slightly higher rates. Although this may be an unfair result to the low-income families not receiving a tax credit, this inequity would be alleviated over time by an increase in the supply of housing. In the long-term, the increased demand should spur development since developers will see opportunities for profit and will thus enter the market to produce more rental housing. Therefore, in the long-term, all parties should experience some benefit under a refundable tax credit system.

CONCLUSION

Nearly ten years after the low-income housing tax credit took effect, it appears that the program has achieved only partial success. Although tax credits have been used to construct or rehabilitate over 800,000 rental units, this amount has not met the affordable housing needs of low-income tenants. Moreover, while the low-income housing tax credit addresses the need for affordable housing, it has not led to the development of units that are affordable for the lowest-income families. However, the LIHTC cannot, by itself, solve the nation's affordable housing crisis. Therefore, in light of the persistent shortage of affordable housing, Congress must consider making changes to the low-income housing tax credit in order to ensure that the credit is utilized to best meet the housing needs of our nation's low-income families.