

# Learning from the Low Income Housing Tax Credit: Building a New Social Investment Model

*Barry Zigas*

*Consumer Federation of America*

In this issue, Terri Ludwig notes the parallels between the Low Income Housing Tax Credit (LIHTC) and social impact bonds (SIBs). She rightly points to their public-private structure, market-based pricing, and built-in program accountability measures as evidence of commonality. Importantly, however, the forces that led to the creation of the LIHTC program were rooted in a different set of priorities than those currently undergirding SIBs. In fact, “social impact” was a secondary concern of the LIHTC; the primary concern was the subsidy of below-market real estate development through the tax code. As we consider using tools like the LIHTC more broadly, as Ludwig suggests, it is important to reflect on the thought process that led to its creation in the first place, and to take note of areas where investment tax credits could be successfully tuned to social impact outcomes. This article briefly examines the origins of the LIHTC, delves more deeply into the credit’s business model and social impact features, and offers some suggestions about how the credit could be refined to increase its social impact and equity even further.

## Old Bottle, New Wine

Real estate is a capital-intensive, long-term investment that always has depended on a combination of cash flows to work—cash flow from operations, appreciation over time leading to capital gains, and tax benefits (both those available to any capital investor and those specifically tailored to real estate investment.)<sup>1</sup> The crucial dilemma for low-income renters is that the combination of market-rate costs of capital, operations, and investor returns requires rents that are simply beyond their ability to pay with a reasonable share of their income. This is a persistent gap with a long history, but today’s low-income renters face some of the most daunting challenges ever. The Joint Center for Housing Studies of Harvard University estimated in its 2012 “State of the Nation’s Housing” report that nearly half of all renter households were paying more than 30 percent of their income for rent, the

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<sup>1</sup> In addition to supporting real estate investment, the tax code greatly subsidizes homeownership as well. By allowing the deduction of mortgage interest and property taxes and offering forgiveness of capital gains for individual homeowners, government policy diverts about \$118 billion a year to support homeownership. The Bipartisan Policy Center’s Housing Commission’s 2013 report that tax subsidies for all forms of housing totaled \$138 billion in 2012. “Housing America’s Future: New Directions for National Policy,” Bipartisan Policy Center, February, 2013, p. 107, available at [http://bipartisanpolicy.org/sites/default/files/BPC\\_Housing%20Report\\_web\\_0.pdf](http://bipartisanpolicy.org/sites/default/files/BPC_Housing%20Report_web_0.pdf).

generally accepted federal standard for housing affordability.<sup>2</sup> For poor families, the figures are much worse. Fully 80 percent of all renter households with incomes below 30 percent of the area median income—roughly \$20,000 per year for a family of four at the national median—paid more than this amount, and nearly two-thirds of them paid more than half of their monthly income on rent. Meanwhile, the supply of homes these families can afford has been shrinking for decades. The need for what the credit provides is inarguable.

National housing policy historically has treated this market failure through one of two major approaches: subsidizing tenants and subsidizing housing producers. For many decades, starting with the public housing program in 1937, the government’s main approach was to subsidize buildings and the people who built, owned, and operated them. In 1968 the policy turned to subsidizing housing built and operated by private owners. The government sought to increase the supply of decent and affordable housing through a combination of mortgage insurance and interest rate subsidies. Tax benefits in the form of accelerated depreciation and other means complemented these direct subsidies. Mismanagement, high costs, poor quality, fraud, and racial and economic segregation exacerbated by tying assistance to specific units in specific places all contributed to discrediting both the public and private programs and dissolving their political support.

These challenges led the Nixon administration to declare a moratorium on the use of appropriated funds for these programs in 1973 and to promote what became the Section 8 rental assistance program in 1974. Providing tenants with housing vouchers, Section 8 was the first widespread use of demand-side subsidies. Under heavy lobbying by the housing industry, labor unions, and housing advocates, Congress added project-specific new construction and rehabilitation components to Section 8 in the Housing and Community Development Act of 1974, using the carrot of long-term rental subsidies to attract private investment to the construction of units that would be dedicated to their use.

National policy long combined these direct subsidies for construction and rehabilitation with special tax treatments like faster depreciation schedules under some of these programs. Tax-exempt bond programs also were harnessed to provide financing for some of the units, and investors were allowed to take all the usual deductions for interest costs and other tax benefits that accrue to all real estate.

By the middle of the second Reagan administration, support for these direct production programs once again had been cut off. Even tenant-based assistance, which the administration touted as a better approach, was zeroed out in the budget released in 1985. While Congress usually declared Reagan’s housing budgets dead on arrival, the budget wars and dramatic fiscal pressure of these years meant greatly reduced direct spending on housing assistance through any means.

When the Reagan administration proposed comprehensive tax reform in 1985, the long-

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2 Joint Center for Housing Studies of Harvard University, “The State of the Nation’s Housing 2012.” (Cambridge, MA: Joint Center for Housing Studies of Harvard University, 2012) available at [www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf).

standing preferential treatment that low-income housing properties enjoyed also was jeopardized. These benefits now comprised virtually the only federal support for construction and rehabilitation of low- and moderate-income housing. In the face of this threat, housing interests from every part of the spectrum rallied to try to preserve them.

But low-income housing advocates, led by the National Low Income Housing Coalition (NLIHC), among others, had long criticized the tax benefits as providing too many benefits to wealthy investors and too few to low-income renters. The NLIHC and other advocates pushed for a “preserve and reform” agenda in housing tax policy. The benefits’ protection from appropriations and the administration’s unrelenting push to eliminate direct spending threw their value into stark relief. But in return for support of the benefits, advocates developed a change agenda that included several key components:

1. Require rents for units receiving tax subsidies to serve tenants with much lower income than in the past so that the subsidies would address the most pressing housing needs.
2. Require investors to remain in the properties and preserve their benefits longer than in the past.
3. Establish tighter compliance requirements and penalties for violations.
4. Tie the subsidies as much as possible to the actual units serving low-income renters at affordable prices, rather than spreading them throughout a property.
5. Change the form of benefit to a credit, which would make it more attractive to a wider range of investors and easier to target to units that serve low-income residents.

This change agenda gained almost no traction in the House of Representatives, which completed its tax reform work in 1985 with only very minor tweaks in the terms of existing tax subsidies for assisted housing. But the game changed completely when Oregon Republican Senator Robert Packwood, chair of the Senate Finance Committee, dramatically announced that he was going to start with “a clean sheet of paper” and rebuild the tax code from scratch. In this atmosphere, the idea of a tax credit, which had been recommended in the NLIHC’s hearing testimony in both the House and the Senate, attracted the attention of Finance Committee staff. Real estate preferences were on the chopping block under Packwood’s plan. But the use of incentives to support affordable housing still had friends on the committee, most notably Senator George Mitchell (D-ME), and they reached out to the reform coalition.

The result was Senate adoption of a new approach in which all of the reformers’ ambitions were realized—the Low Income Housing Tax Credit. The LIHTC provides investors a credit of 9 percent of the cost of the project (excluding land), which can be claimed each year for ten

years.<sup>3</sup> The LIHTC was targeted to subsidize equity investments in rental units that had rents no higher than 30 percent of 60 percent of the area median income (AMI). This was a significant tightening from the prior standard of 80 percent of the AMI, although not as deep as advocates had originally demanded. The credits would only be available for the units that met this test, and a property had to have at least 40 percent of its units meet the test in order for any of them to qualify for the credit. (A second project test of at least 20 percent of the units at rents no higher than 50 percent of the AMI also exists but is not widely used.) Investors could lose most of the tax benefits if the property fell out of compliance during fifteen years from initial occupancy, even though the credits would only be available for the first ten years.

Two features that are often cited as critical parts of the LIHTC's success were adopted first as expedients rather than as well-thought-out program features. In one, the final tax credit provisions adopted by Congress capped the amount of credit to a per capita amount (subsequently raised) that would be distributed to each state as a way of limiting how much revenue would be lost. Having capped the credit, Congress had to devise some allocation scheme. Thus, Congress required the states to administer the credits, and in 1989 it further required the states to do so through Qualified Allocation Plans (QAPs). In another move, the final tax act also capped individual taxpayers' ability to use tax preferences to offset income by restricting such "passive" losses to no more than \$25,000 per taxpayer. This at first seemed like an insuperable problem. It would severely restrict the credit's marketability to the traditional consumers of tax preferences—wealthy earners seeking to lower their liabilities. What was not foreseen at the time, but is today one of the most beneficial features of the credit, was that corporations, which were not restricted by the passive loss cap, would become a prime market for the new LIHTC.

## Social Impact Model Features

The features that emerged from the 1986 work and subsequent congressional actions refining it strongly prefigure elements that are considered standards of social impact investing.

### *Private Capital Is Harnessed for Public Good*

The credit uses a tax subsidy to attract capital to an investment that is otherwise not attractive or economically desirable. This also was true of the earlier tax subsidies and interest rate subsidies for affordable housing. (Indeed, the same purpose is served through directly appropriated subsidies.) But because of the better targeting and other restrictions driven by the reform coalition, the LIHTC is focused more clearly and cleanly on this objective. Also, the credit pays for investments of equity, which replace debt that would otherwise require cash flow from rents to retire. Lower rents are the result.

3 Where the credits are used to acquire existing properties or are combined with tax exempt bond financing, the credit is 4 percent. Also, both credit amounts are adjusted monthly by the Treasury Department to reflect the credit's net present value, which fluctuates somewhat along with interest rates. Note that as part of the economic recovery program, the credits for new construction were fixed at 9 percent for projects placed in service from July 31, 2008, through December 31, 2013.

### ***Investor Return Is Premised on Social Outcome***

The credit is structured so that the benefits flow only to units that meet the public affordability objective, such as rents not above 30 or 60 percent of the AMI. To prevent it from being used to provide only incidental impact, no credit is available for any unit unless a minimum percentage of the units meet the rent/income test. The rents and tenants' incomes must be certified at occupancy and periodically thereafter.<sup>4</sup>

### ***The Benefits Must Be Durable***

The properties must be in compliance with the tax credit eligibility rules for a long time. The credit originally set a fifteen-year compliance limit, but Congress has extended this by another fifteen years, and states have extended it even further as part of their allocation and application process. Although tenants are not evicted if their income rises while they occupy a tax credit unit, if a unit becomes vacant, subsequent tenants must generally meet the same eligibility requirement to remain in compliance.

### ***The Investor Must Be at Risk***

The project's affordability restrictions are recorded in a Land Use Restriction Agreement. There are significant recapture penalties for noncompliance with LIHTC requirements in the first 10 years, which scale down annually through year 15. The recorded agreement assures that the affordability restrictions will be met for the subsequent fifteen-year period.

### ***Public Action Is Subject to Market-Driven Discipline***

The threat of losing tax benefits because of noncompliance ensures that investors and their representatives in LIHTC transactions pay close attention to the initial underwriting of project sponsors and to the subsequent operation of the property. The corporations that invest in LIHTC projects are especially sensitive to the reputation and financial risks of noncompliance. While past tax subsidies were consumed by large numbers of small investors who sought and could provide only the most minimal oversight of their investments, tax credit investors' approach is more direct and hands-on. The discipline that this has added to the investment and project selection process is borne out by the program's near-zero record of defaults and recaptures. It also has muted, if not eliminated, the political influence that can plague directly allocated subsidies.

### ***The Subsidy Can Be Tailored to Meet Diverse Needs with Little Bureaucracy***

The credit is a uniform and straightforward subsidy that requires little fine-tuning or project-specific tweaking, unlike direct subsidy programs. This commoditization of the subsidy itself has increased take-up among investors. At the same time, the use of state housing finance agencies to allocate the credits has enabled the subsidies to be deployed responsively to meet local needs and desired outcomes. Each state's QAP can focus its credits

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<sup>4</sup> Beginning in 2009, resident incomes in projects where 100 percent of the units are LIHTC qualified are subject to certification only on occupancy.

on priorities of its own choosing. For instance, a state might use the QAP to stimulate greater interest by sponsors in housing that serves people with special needs, or seniors, or formerly homeless households. It can prioritize projects that require compliance beyond the thirty years now required by the program. It can seek to favor projects that preserve existing affordable rental housing or encourage new production, or a mix of both that meets the specific needs of the state. The QAP is where the rubber of incentivizing specific social outcomes meets the investors' road.

## Opportunities for Improvement

This array of features and performance certainly makes a strong case for the credit's pedigree as an early and very successful social impact investment model. But in some other important respects, the LIHTC is an imperfect and potentially underdeveloped example.

### *Property, Not Household Support*

The credit is the latest in a long line of subsidies designed to reduce the cost of real estate. It is more progressive than its antecedents, but it is a limited, static subsidy designed to decrease the capital costs of a project, rather than to spur dynamic social outcomes over time. Moreover, the credit is predicated on a project's pro forma financial statement, which is scrutinized by the syndicator placing the equity to insure that the project will meet the credit's requirements before any money is invested. After that, it is the property operator's responsibility to keep the project in compliance.

The benefits in newer social impact models often are pegged to reduced public expenditures generated by the improved outcomes, such as fewer emergency room visits, lower insurance costs, and so forth. There is no analogue in the LIHTC. In fact, government typically has to add additional support to LIHTC projects in the form of below-market rate debt, grants, and Section 8 support for very low-income tenants; without it, projects often cannot meet either the basic tests of the code or the additional tests imposed by states through their allocation process.

Housing needs are greater for the lowest-income renters. States generally organize their QAPs to favor projects serving them, but the credit amount historically has been the same for a project serving households right at the maximum income level as for those that serve tenants with greater needs. The gap typically was filled by other public funds, although states were given wider discretion in setting credit amounts in 2008.

The LIHTC's benefit is tied to a static data point: the rent amount as a percentage of the AMI. Residents have to be income qualified to occupy the units, but their rent is not adjusted for their own income. In other words, a household with income at 50 percent of the AMI would qualify to live in a LIHTC unit and would pay a rent restricted to the LIHTC standard. But it would still be paying significantly more than 30 percent of its income for rent. Because the economics of the real estate deal have to be penciled out before any investor will commit equity, the LIHTC designers were forced to use a test that could be modeled before

any tenants arrived and would be unaffected by potential changes in the tenants' income over time. This does generate genuine social value. But it constrains the credit's impact on housing costs for the lowest-income residents, and it insulates investors by linking their investment to a static outcome that is known from the start. It shifts the burden of increasing any one project's social benefit from the investor to the sponsor and, often, the government through additional subsidies. Investors', lenders', and operators' need for confidence in any project's operating cash flow before committing to the investment makes reconciling equity investments in real estate with emerging themes of social investing more difficult.

On the other hand, this feature also means that residents' rents remain capped even if their income increases. Tenants do not have to move if their incomes rise above the level required at occupancy. This can encourage residents to increase their income without being concerned about the marginal "tax" that is charged by other subsidy programs, like Section 8, which calculate the tenant's contribution as a percentage of income. And it may encourage healthier communities by allowing incomes to become more diverse over time, more closely mirroring market-rate housing than traditional subsidized housing.

No comprehensive data on LIHTC residents were collected at the national level until Congress mandated it in 2008. The data collection process remains in development, but a 2012 study by the Furman Center for Real Estate and Urban Policy at New York University summarized data collected from more than 12,000 properties in fifteen states comprising more than 700,000 apartments and provides the most comprehensive view to date of LIHTC residents' incomes. Not surprisingly, LIHTC units serve residents with somewhat higher incomes than traditional direct subsidy programs. But encouragingly, more than 40 percent of the sampled units served households with incomes below 30 percent of the AMI, while only 7 percent of the residents in the sample had incomes above 60 percent of the AMI. More than 70 percent of the extremely low-income tenants received some form of additional rental assistance, and rent burdens still were highest for tenants earning between 30 and 40 percent of the AMI.<sup>5</sup> Nevertheless, there are instances where LIHTC equity investments subsidize rents for residents who no longer qualify for the assistance, and many LIHTC residents still pay more than the government's definition of an affordable rent, reducing the credit's social impact outcome.

### *Where You Live, Not What You Need*

Allocating the credits on a per capita basis was an expedient choice that eliminated the need for a federal process. But it meant that all states are presumed to have equal needs and that the best way to allocate a scarce subsidy to support renters in need is to let every state participate regardless of the extent of their need relative to others. This is a hard choice to dispute politically—every state has housing needs, after all, and such a formula short-circuits

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<sup>5</sup> "What Can We Learn about the Low-Income Housing Tax Credit Program by Looking at the Tenants?" (Furman Center for Real Estate and Urban Planning and Moelis Institute for Affordable Housing, New York University, October 2012) available at [http://furmancenter.org/files/publications/LIHTC\\_Final\\_Policy\\_Brief\\_v2.pdf](http://furmancenter.org/files/publications/LIHTC_Final_Policy_Brief_v2.pdf).

disputes among states or their representatives over the allocation.

But the credit's social outcomes could potentially be improved by rethinking this model. For instance, credits could be allocated on a per capita renter basis, rather than for the entire population. Similarly, the allocation could include factors like rental costs, rent burdens, homelessness, and other indices of need more directly related to the outcomes LIHTCs are meant to generate.<sup>6</sup>

In theory, the large and competitive market for LIHTCs among investors should assure a relatively uniform price, which translates to funds that reach the project. But this is not how things work in reality. LIHTCs are an especially attractive investment for financial institutions. This is partly because financial institutions were already familiar with real estate and quickly adopted existing risk and valuation models to the tax credit world. Another motivator is strong regulatory incentives for them to do so. The Community Reinvestment Act (CRA) requires federally regulated lenders to serve the credit needs of their communities, including low- and moderate-income communities and households. LIHTCs have become a popular way to help meet this test. Competition among lenders in the same markets drives up the price investors will pay for LIHTCs, which is very good news for sponsors in banks' footprints (and for the subsidy's efficiency). But in geographic areas without competing buyers, the price is lower, sometimes significantly so. Thus the actual social value generated from two LIHTC investments that are identical in every respect except for their location can vary greatly. The price the investor pays is not tied to the investment's relative social value, but to its value to the investor. This variation is not inherent in the LIHTC model. It could be ameliorated—though likely not eliminated—if financial regulators credited LIHTC investments anywhere, rather than just in a lender's service area, for instance. Such a change may be forthcoming in a CRA regulatory modernization. But in the meantime, this policy skews the LIHTC's social benefits.

Finally, the LIHTC's benefits do not come without costs. There is considerable value “leakage” caused by layers of sponsors, syndicators, lawyers, accountants, and others needed to create, track, and document the credit. Of course such costs are common to any subsidy effort, and LIHTCs may require fewer such costs than traditional direct investment subsidies do.

## Conclusions

The LIHTC is a hugely successful program. Since its adoption in 1986, it has created or preserved over 2.5 million housing units.<sup>7</sup> It has become the single most important form of federal assistance to preserve and expand the supply of affordable rental housing for low-

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6 To make such a change more palatable politically, Congress could increase the overall allocation of credits and use these population-sensitive factors to allocate only the increment, holding states' current allocations harmless. Some states would gain, but none would lose what they have today.

7 National Council of State Housing Agencies, “HFA Factbook: 2010 Annual Survey Results” (Washington, DC: National Council of State Housing Agencies, 2012), pp. 92, 100.



income households. It has done so virtually scandal free and with a default record that any private credit guarantor would die for. It has achieved and maintained bipartisan support through two decades of political climate change. It is the lifeblood of hundreds, if not thousands, of community-based and national nonprofit housing providers who specialize in sponsoring projects for credit investors and use the development fees they earn to support their work. Because its benefits are provided through the tax code, the credit's subsidy flow is not subject to appropriations and does not suffer from the "perils of Pauline" that Section 8 or other direct subsidy programs routinely face. It is equally beloved by community housing advocates, a thriving ecosystem of for-profit and nonprofit housing developers, for-profit and nonprofit intermediaries that collect equity commitments from investors and place them with specific projects on their behalf, and state agencies that allocate the credit. If a program can be judged by its friends, the LIHTC has written the book on how to find them, make them, and keep them.

If it can be judged by its results, the LIHTC is the most successful US government program to support production and preservation of affordable rental homes ever. If it is judged as a model for social impact investing, the LIHTC has been a highly successful means to attract private capital to a social objective, and to hold private investors accountable for the results promised. But as it is currently structured, the LIHTC model also lacks some features emphasized by social impact investing theory and could be improved in certain ways to increase its social impact and its return on the government's expenditures. The architects of the next wave of social finance should take these lessons to heart.

*Barry Zigas is the director of housing policy at the Consumer Federation of America (CFA). He was president of the National Low Income Housing Coalition from 1984 to 1993, where he helped lead the efforts to enact the LIHTC. He served on the Mitchell-Danforth Task Force that recommended further enhancements to the program in 1989. From 1995 to 2006, he served as senior vice president for community lending at Fannie Mae. He is the chair of the board of Mercy Housing Inc. and also serves on the boards of the Low Income Investment Fund (LIIF) and the National Housing Conference. In addition to his work with CFA, Zigas consults with nonprofits and foundations on strategy, leadership, and innovation through his firm Zigas and Associates LLC. He tweets at <https://twitter.com/zigassoc>.*