The Low Income Housing Tax Credit: A Valuable Tool for Financing the Development of Affordable Housing

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An earlier version of this article appeared in the Fall 2016 ACREL Papers.

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THE LOW INCOME HOUSING TAX CREDIT (LIHTC) is a federal tax credit available to help finance the private development and preservation of affordable rental housing. While the layering of governmental regulations presents a complicated landscape for developers interested in using LIHTC financing, the credit can generate 50-60 percent of the sources necessary to develop even very large-scale multifamily sites in some of the nation’s most expensive real estate markets.1 Passed by Congress in 1986 with bipartisan support, the LIHTC program has become the nation’s most important federal subsidy contributing to the development and preservation of affordable rental housing for individuals and families earning up to 60 percent of area median income.2 Well over two million affordable units have been developed or preserved using the LIHTC to date, representing a substantially larger portfolio than the stock of traditional public housing.3

This article begins by providing background on the LIHTC program and context regarding the shortage of

1. Other tax credits—the Historic Tax Credit, the New Market Tax Credit, the Investment Tax Credit, the Research & Development Tax Credit and various state tax credits—are available to finance different types of real estate developments.

2. In many jurisdictions, LIHTC developments are considered workforce housing. In high-cost markets, however, this is not the case. For example, in Los Angeles, tenants living in workforce housing typically earn between 120 percent to 200 percent of area median income, well above the threshold for qualifying to rent a LIHTC unit.

affordable housing across the nation. Next, this article sets forth the basic structure for LIHTC transactions, the mechanics for calculating available LIHTCs and the requirements for owning and operating a LIHTC-financed development. Thereafter, this article discusses debt financing commonly used to supplement LIHTC-generated equity. A discussion of consequences of noncompliance with LIHTC requirements follows, including remedies available to the federal government and state agencies. Finally, this article concludes with a description of a tax credit investor’s financial incentives and strategies for exiting a LIHTC transaction.

BACKGROUND • A Republican controlled Senate and a Democratic controlled House of Representatives, with the support of Republican President Ronald Reagan, created the LIHTC under the 1986 Tax Reform Act,4 as a temporary program designed to provide government incentives for the private development of affordable rental housing. Following the passage of the Tax Reform Act, the Internal Revenue Service (the “IRS”) codified regulations governing the LIHTC program into Section 42 of the Internal Revenue Code of 1986 (the “Internal Revenue Code”).5 As initially enacted, the LIHTC program required annual renewal which, in an era of budgetary belt tightening, mandated corresponding budget reductions to offset the cost of renewal; accordingly, the program suffered from a lower financial valuation of the LIHTC inherent in such political instability. The Omnibus Reconciliation Act of 1993,6 enacted by a Democratic controlled Congress and signed into law by Democratic President Bill Clinton as part of his cornerstone economic reforms, permanently extended the LIHTC, following several previous extensions of the credit and failed efforts to make the credit permanent. Permanent extension brought political and financial stability to the program and dramatically increased market valuation of LIHTC investment. Broad and bipartisan support for the LIHTC continues, although Congress occasionally passes new legislation or modifies existing provisions in ways that, as a practical matter, advance and impede the industry.

Thirty years after the creation of the LIHTC program, there continues to be a need for affordable housing. Following the crash of the real estate market in 2008, homeownership rates dropped precipitously, greatly increasing the number of individuals and families seeking rental housing.7 The ten years spanning 2004 to 2014 experienced the largest growth in renter households since the late 1980s, with relatively low vacancy rates and, consequently, ever-increasing rents corresponding to this rise in demand.8 At the same time, the gap doubled between the number of extremely low income renters (those earning no more than 30 percent of area median income) and the supply of units affordable to these families.9 Although certain LIHTC developments seek to provide housing to homeless individuals, without another form of tenant-based government assistance such as Supplemental Security Income or Section 8 vouchers, individuals earning less than 30 percent of area median income are typically unable afford LIHTC rents. Although the program provides critical assistance to low income individuals and families otherwise unable to afford decent rental housing, it is not intended to house the nation’s poorest individuals; rather, its primary focus has been described as assisting the working poor.

The LIHTC program is one of the few government resources dedicated to helping low income families find safe, decent and affordable housing. In the critically acclaimed book, Evicted: Poverty and Profit in the American City, author Matthew Desmond observes:

5. I.R.C. § 42.
8. Id. at 2.
9. Id. at 32.
Over the years, lawmakers on both sides of the aisle have restricted housing aid to the poor, but expanded it to the affluent in the form of tax benefits to homeowners. Today, housing related tax expenditures far outpace those for housing assistance. In 2008,...federal expenditures for direct housing assistance totaled less than $40.2 billion, but homeowner tax benefits exceeded $171 billion. That number, $171 billion, was equivalent to the 2008 budgets for the Department of Education, the Department of Veterans Affairs, the Department of Homeland Security, the Department of Justice and the Department of Agriculture combined.10

Federal housing assistance for low income renters continues to lag behind need;11 federal subsidy programs, such as the HOME Investment Partnerships Program, experience dramatic cuts and the affordability restrictions on millions of existing units across the county nears expiration.12

The Department of Housing and Urban Development, deems a unit “affordable” to a household at a defined income level if the household can rent the unit without paying more than 30 percent of its income towards rent and utility costs.13 Stagnating incomes and rising rents following the 2008 crash led to record rates of renters designated as “housing cost burdened” (paying more than 30 percent of income towards rent) with large segments experiencing “severe housing cost burdens” (paying more than 50 percent of income in rent).14 According to an American Community Survey, in 2014, there were 31 affordable and available units for every 100 households of extremely low income renters—those with incomes of 30 percent or less of area median.15 A housing cost-burdened family has limited resources to pay for other critical expenses such as food and healthcare. In 2013, low income and severely cost burdened households spent 70 percent less on healthcare and 40 percent less on food than families living in housing that was affordable at rents which were unburdened.16 In that same year, over 80 percent of households earning less than the equivalent of full-time pay at the federal minimum wage were cost-burdened.17

Ratios of cost-burdened households also increased in minority groups, single-parent households and expensive coastal markets.18

With variability in many federal, state and local funding sources available to assist cost burdened renters in search of decent housing options, the LIHTC program provides critical assistance and meaningful incentives for real estate developers and equity investors to engage in the development of quality rental housing affordable to low income populations.

BASIC STRUCTURE • The LIHTC constitutes an indirect subsidy made available by the federal government and administered by the states, which offsets federal income tax liability of eligible taxpayers on a dollar-for-dollar basis over the course of a ten-year period (the “Credit Period”). The Credit Period commences with the first year in which the development is placed in service,19 un-

11. The State of the Nation’s Housing 2015, supra note 7, at 5-6.
12. Historically, federal affordable rental housing subsidy programs impose income and rent restrictions extending for 30 to 55 years, depending on specific program requirements. However, federal programs have not successfully addressed replacement of units facing expiring affordability restrictions. Arguably, it is too early to determine whether the incentives available to extend the affordability restrictions imposed by the LIHTC program will maintain affordability levels of LIHTC developments beyond the required timeframes discussed in this article.
17. Id. at 30.
18. Id.
19. “Placement in Service” means the development may be legally occupied by qualifying low income tenants. In most
less the taxpayer elects to begin the Credit Period in the succeeding year. The LIHTCs are subject to recapture by the IRS for a period of fifteen years following the start of the Credit Period (the “Compliance Period”). Additionally, under the Internal Revenue Code, owners of LIHTC-financed developments must meet certain requirements—primarily, the obligation to keep the units affordable to eligible low income renters—for at least an additional 15 years following the expiration of the Compliance Period (the “Extended Use Period”). After expiration of the Compliance Period, remedies for noncompliance include damages and equitable remedies, but expressly exclude recapture of LIHTCs.

LIHTCs can be used in connection with new construction or rehabilitation of low income rental units as a function of either (a) 70 percent of eligible basis, translating into a yearly tax credit of about nine percent of eligible basis for each year of the 10-year Credit Period (the “Nine Percent Credit”), or (b) 30 percent of eligible basis if the development is also financed with federal tax-exempt bonds, translating into a yearly tax credit of about four percent of eligible for each year of the ten year Credit Period (the “Four Percent Credit”). Although IRS requirements for developments utilizing the Nine Percent Credit differ in some respects from requirements for developments utilizing the Four Percent Credit, the basic ownership and financing structure for these types of developments follow the same essential rules.

In exchange for an allocation of LIHTCs, the project owner must agree to rent units to low income individuals or families and to charge no more than 30 percent of such individual’s qualifying income level in rent. Notably, and unlike certain federal tenant-based housing certificate programs, the rent charged to a particular LIHTC tenant cannot exceed 30 percent of such tenant’s qualifying income level, not 30 percent of the tenant’s actual income; accordingly, if a tenant with annual income equal to 50 percent of area median income occupies a unit designated for a tenant with income at or below 60 percent of area median, such tenant may be required to pay rent equal to 30 percent of 60 percent of area median income. The sponsor of a proposed LIHTC development (typically, a non-profit or for-profit developer who will develop and manage the project) can monetize the LIHTCs awarded to the development by partnering with a tax credit equity investor willing to contribute equity for up to 99.99 percent share of the losses available to the owner of the development. Allocations of LIHTCs follow allocations of losses, and the tax credit investor allocated 99.99 percent of losses will therefore be able to claim 99.99 percent of the LIHTCs generated by the development. The sponsor and the tax credit investor will enter into a project entity agreement (generally, an agreement of limited partnership or a limited liability company operating agreement) governing the terms pursuant to which the tax credit investor will participate in the transaction.

Each year, the federal government allocates tax credits to the LIHTC program to be administered by states agencies established by each state for this explicit purpose (“Credit Agencies”). In addition, some states have sub-allocators at the city or county level. The Four Percent Credit is awarded on a non-competitive basis to developments receiving state-issued tax-exempt financing subject to the applicable volume cap. With respect to the Nine Percent Credit, however, states are allocated LIHTCs according to population, at a base rate per capita (indexed for inflation), totaling the equivalent of nearly $5 billion in annual budgetary authority to issue LIHTCs. Credit Agencies award

20. The IRS permits States to require Extended Use Periods of up to 55 years.
21. Differing IRS requirements regarding the Nine Percent Credit and the Four Percent Credit are outside the scope of this article but should be considered by a developer interested in financing a development through the LIHTC.