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EXCHANGE PLAN IN HOUSE RECOVERY BILL OFFERS BEST FIX FOR LOW-INCOME HOUSING TAX CREDIT

Adding Option to Trade In "4 Percent" Credits Would Further Strengthen Credit's Stimulative Impact

by Will Fischer

The economic downturn has sharply reduced the effectiveness of the Low-Income Housing Tax Credit, the nation's primary subsidy for development of affordable rental housing. Faced with lower profits and reduced access to capital, fewer corporations are willing to invest in affordable housing in exchange for the credits. As result, the LIHTC is supporting far less construction and rehabilitation of affordable housing and creating far fewer jobs than it has in the past. This is occurring at a time when the number of homeless families is rising and the already extensive need for affordable rental housing is likely to grow.

The economic recovery bill that the House of Representatives passed on January 28, 2009 contains a simple response to the problems in the LIHTC program. It would temporarily allow state housing agencies to exchange some credits for federal grants, which they would then distribute to developers to support the production of affordable rental housing. This exchange option offers the most cost-effective way to promptly and reliably restore LIHTC-funded affordable housing production — and consequently to stimulate substantial economic activity. A broad range of housing organizations — representing state agencies, homebuilders, tax credit syndicators, low-income advocates, and others — have expressed support for an exchange option like that in the House bill.

The recovery legislation that the Senate is expected to approve February 10, 2009 does not include the exchange option. Inclusion of the House provision in the final recovery legislation would strengthen the credit's stimulative impact. Congress also could make the provision's impact stronger by allowing exchange of a type of LIHTC (the "4 percent" credit) that the House provision does not cover.

Instead of the exchange, the Senate bill would provide $2 billion in appropriated grants that could be used in conjunction with LIHTCs and also includes a provision that increases the value of the credit by allowing investors to claim credits more quickly after housing is built than current law allows. These measures would help restore LIHTC-funded affordable housing production, and it would be worthwhile to include them in the final stimulus legislation (so long as the appropriated grants do not divert funds away from other important programs targeted more heavily on lower-income families than the LIHTC is). The exchange, however, is the most effective and efficient measure available and should form the core of any effort to address the LIHTC's current problems.

Recession Has Undercut LIHTC's Effectiveness

The LIHTC program provides tax credits to developers that agree to build or rehabilitate affordable rental housing, which is generally defined as housing that a family earning 60 percent of the local median income can afford without paying more than 30 percent of its income for rent and utilities. There are two types of LIHTCs: "9 percent" credits, which state agencies can allocate to developments in amounts up to a ceiling that Congress set for each state, and less valuable "4 percent" credits. Four percent credits are used together with the proceeds of tax-exempt bonds issued to support affordable housing development and, rather than being subject to a ceiling, are available to all developers that receive allocations of such bonds from the state. Both types of LIHTCs provide a stream of federal tax credits over a ten-year period.

Developers typically sell LIHTCs to investors for a price somewhat below one dollar for each dollar of tax credit. The proceeds from the sale of the credits then fund the development of affordable housing. Credit sales are necessary to the normal functioning of the LIHTC, because they convert the ten-year tax credit stream into upfront investment that can be used to build or rehabilitate housing. In addition, developers (some of whom are nonprofit entities) rarely have sufficient tax liability to derive the maximum benefit from the credit themselves.

Corporate Demand for Credit Has Fallen

The economic downturn has sharply lowered demand for LIHTCs, because it has reduced the availability of investment capital and cut corporate profits (and therefore tax liability against which credits can be claimed). The companies that purchased most credits prior to the downturn — including Fannie Mae, Freddie Mac, and a number of large banks — have been particularly hard hit. Due to this drop in demand, the typical credit price has fallen from over 90 cents on the dollar to 70 cents or lower. When LIHTCs are sold for low prices, the cost to the federal government remains the same (since the purchaser can still claim the full tax credit), but the credit provides less funding for affordable housing construction.

In many cases, developers simply cannot sell credits at prices high enough to fund development of affordable housing. Estimates suggest that at least $2 billion in credits allocated in 2008 (and perhaps substantially more) remain unsold, and the amount of unsold credits could rise further in 2009. Developers that cannot sell their credits must eventually return the credits, leaving the planned developments on the drawing board. Because the lack of funding from tax credit sales is usually the only barrier to starting construction or rehabilitation, stalled projects offer an opportunity to stimulate economic activity and generate jobs quite promptly.

Moreover, developers frequently have the greatest difficulty selling credits for developments that differ most from those typically built in the unsubsidized market. These include, for example, developments that are located in rural areas with small rental markets, provide supportive housing to the formerly homeless or people with mental or physical disabilities, or whose rents are affordable to the lowest-income families. These are often the developments that provide the greatest social benefit, precisely because they produce housing that the market would be unlikely to provide on its own.

Need for Affordable Housing Remains High

It is important to note that the reduced demand for LIHTCs is not driven by a lack of need for affordable rental housing. As of 2007, some 8.3 million renter households paid more than half of their income for housing, a figure likely to rise higher as a result of the recession. Large numbers of families are expected to fall into deep poverty during the recession, and despite the decline in the price of owner-occupied homes, the Consumer Price Index indicates that rents nationally continue to rise. In addition, data indicate that the number of homeless families with children has climbed in recent months.[1]

Exchange Would Increase Resources Available Through LIHTC at Little Long-Term Cost

The House exchange provision would allow states to trade in to the Treasury up to 40 percent of their 9 percent credits for 2009, and any unused 9 percent credits left over from earlier years, in return for upfront federal grants worth 85 percent of the value of the credits. The states would then allocate the grants to developers, which would be subject to the same affordability requirements as those that apply to regular credits.

This exchange option would increase the resources available to states to build affordable housing. It would do so in two ways.

- **States would receive more funds in exchange for the credits than developers can now obtain from private investors.** Because the exchange rate of 85 cents on the dollar is above the current market price of about 70 cents on the dollar, the grants would provide more funds for affordable housing development than investors would pay for the credits. In many cases, exchange grants would go to projects where developers now are unable to sell the credits they have been allocated at prices sufficient to build or rehabilitate affordable housing.

- **The exchange could stabilize or raise prices for credits that are *not* exchanged.** Tax credit prices are determined by supply and demand. As a result, the removal of a large number of unsold credits from the market could stabilize or even push up prices for those that remain (though it is difficult to predict the extent of the impact). Higher prices for remaining credits would increase the funds available for development of affordable housing.

Exchange Estimated to Be Nearly Budget-Neutral Through 2019

The exchange option would achieve these goals at little or no long-term federal cost. The option would have a significant short-term cost in 2009 — estimated at $3 billion by the Joint Committee on Taxation (JCT) — because the grants would be provided up front while the LIHTCs that would be traded in are normally claimed by investors over a period of ten years. By 2019, however, JCT estimates that the savings from the exchanged credits will have offset all but $69 million of the grant

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[1] Barbara Sard, "Number of Homeless Families Climbing Due to Recession," Center on Budget and Policy Priorities, January 8, 2009.

cost.[2] Trading in credits would generate savings even if the developers currently holding the credits would not otherwise have been able to sell them now, because the credits would have been used eventually and thus would ultimately have generated costs. (Unused credits are reallocated to other developers, and in some cases to other states. In virtually all cases, they eventually result in federal costs.)

One analysis has argued that because the exchange is nearly budget neutral it would not provide economic stimulus, but that is not the case.[3] The added resources the exchange would provide for affordable housing production would generate short-term economic activity that would not otherwise occur. While the exchange and current credit system would cost the federal government similar amounts through 2019, nearly the full amount of the exchange grants will go toward affordable housing construction or rehabilitation in the near term. Without the exchange, part of the expenditure will go to uses that will not generate as much short-term economic activity, including corporate profits (because more companies will be able to buy tax credits at deep discounts) and construction or rehabilitation in later years (because developments that cannot sell their credits will be forced to return the credits for subsequent reallocation to other projects).

Exchange Retains Most Features of LIHTC

Moreover, the exchange would leave in place the core characteristics of the LIHTC, which is widely seen as a highly effective mechanism for building affordable housing.

- **States would retain control over how LIHTCs are used.** State housing agencies would allocate grants received through the exchange to particular projects based on state priorities, just as they do in the normal tax credit process. Even the decision of whether to use the exchange would be made entirely by the state agency. Agencies that do not believe the exchange would benefit their state would not be required to use it.

- **Program standards would still be enforced.** State agencies would oversee exchange-funded developments to ensure that they comply with affordability standards and other program rules and would be required to recapture grants from owners who fall out of compliance.

- **Private investors would continue to play a central role.** Under the exchange proposal, the majority of LIHTCs still would be sold to private investors, so investors would continue to play

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[2] Eventually, the savings from the exchanged LIHTCs will significantly exceed the cost of the upfront grants, as the grant cost will come out to only 85 percent of the total exchanged LIHTC amount. The JCT estimates through 2019 do not include the full savings from the exchange, because JCT estimates that the ten-year credit period for some exchanged credits would not have begun until after 2010 (so a portion of the costs from those traded-in credits would have extended beyond 2019).

In addition, the exchange will generate substantial savings from sources other than the exchanged LIHTCs; these savings are left out of the JCT estimates. Purchasers of LIHTCs receive large equity stakes in LIHTC developments that enable them to claim other tax benefits beyond those the LIHTC provides directly — primarily due to tax losses resulting from depreciation of the developments. Developments funded through grants will tend to be owned by non-profit or for-profit developers that will have limited tax liability and consequently limited ability to deduct tax losses. These forgone tax benefits could increase the savings from the exchange by 10 percent or more.

[3] Ethan Handelman and David A. Smith, "A Cash-for-LIHTC Swap is an Incomplete Solution," Recap Update 73, Recap Advisors, January 28, 2009.

an integral role in the LIHTC program. Moreover, the exchange is designed as a short-term response to the sharp drop in investor demand for credits, and would apply *only* in 2009.

Other Efforts to Increase Benefits to Investors Uncertain to Work in the Short Term

A possible alternative approach to restoring production under the LIHTC is to enhance the benefits that the credits provide to investors in the hope of increasing investor demand and pushing up prices. A version of the tax stimulus package approved by the Senate Finance Committee on January 27 contained a provision that would allow the LIHTC and other business tax credits to be counted against tax liability going back five years. This "carryback" was dropped from the Senate package currently under consideration, and was replaced by an "acceleration" provision that would allow investors to claim a higher proportion of 9 percent credits early in the ten-year credit period.

The acceleration provision would be far less expensive than the carryback it replaced (costing about $2 billion, compared to $11 billion for the carryback), and it would increase the value of LIHTCs to investors more efficiently. But the short-term effect of either provision could be limited mainly to preventing investors currently holding credits from seeking to sell them to other investors. The provisions could also increase demand, but this is uncertain. Many potential investors are limited in their ability to purchase credits by a lack of available capital and likely would not respond to the proposed incentives. Even to the extent that the enhancements do encourage new investors to enter the market, they would be unlikely to do so immediately. LIHTC transactions are complex, and it typically takes some time for new investors to assess the benefits and begin to make purchases.

The exchange proposal, by contrast, would work promptly and with certainty. It would be worthwhile for Congress to include the acceleration provision in the final stimulus package, but it should do so in addition to — not in place of — the exchange option.

Allowing Exchange of 4 Percent Credits Would be an Efficient Way to Further Increase Affordable Housing Production

The House exchange provision on its own will not fully restore production under the LIHTC to the pre-downturn level. This is the case because it would apply only to 40 percent of the 9 percent tax credits for 2009 and would not allow exchange of any 4 percent tax credits. Some of the credits that would not be exchanged would likely remain unsold, and those that are sold likely would draw prices well below those offered in the past. Estimates suggest that even with the House exchange provision in place, as much as $5 billion in additional funding could be needed to produce the same amount of LIHTC-funded housing as could have been produced if credit prices had remained at the pre-downturn levels.

Part of this gap could be closed if enhancements to the credit are enacted and generate substantial private investment or if the exchange significantly increases prices for credits that are not traded in. But as noted above, these outcomes are uncertain.

A portion of the remaining gap could be bridged quite efficiently by expanding the exchange to cover 4 percent credits. There is no practical barrier to doing so. Congress could simply permit states to substitute grants at some or all properties in the state that would otherwise be eligible for 4 percent credits. Allowing exchange of 4 percent credits could provide states with more than $2 billion in additional affordable housing funding, with much of that amount directed to projects that are ready to go but have stalled because of unsold 4 percent credits.

Supplemental Grants Would Be Worthwhile Complement to Exchange Option but Should Not Divert Funds from Programs Helping the Neediest Families

The Senate bill would provide $2 billion in grants to states to support projects that meet the affordability rules and other requirements of the LIHTC, without an exchange requirement. Such grants would be far less cost-effective than an exchange. Because states would not be required to trade in tax credits to receive the grants, there would be no offsetting savings. And the grants would do nothing to reduce the supply of unsold tax credits, so LIHTCs would continue to be sold for low prices that make inefficient use of federal funds. For these reasons, it would be a poor use of federal resources to provide grants in place of an exchange.

But there is a strong case for providing supplemental affordable housing development grants at approximately the level in the Senate bill in addition to an exchange covering 4 percent and 9 percent credits. Even with the 4 percent exchange added, the resources available through the LIHTC could fall about $2 billion below pre-recession levels, unless supplemental grants are provided. In addition to building and rehabilitating affordable homes, such grants would stimulate economic activity and create jobs.

There is a risk that such supplemental grants, however, will result in less funding being provided for other housing programs. In considering the funding levels in the final stimulus legislation, Congress should give priority to forms of housing assistance that reach the neediest families. Research shows that families with incomes below 30 percent of median, half the limit for LIHTC-funded developments, have much greater difficulty affording housing than families with somewhat higher incomes. (Nationally, 30 percent of median income averages about $18,100 for a family of three, roughly equivalent to the poverty line.)

The House and Senate bills both provide funds for several programs, including homelessness prevention funding through the Emergency Shelter Grant program and the Public Housing Capital Fund, that should be effective in both providing stimulus and delivering benefits to needy families. While increasing funding for affordable housing development is a worthy goal, it does not justify shifting funds away from these other important programs.