

The Low-Income Housing Tax Credit: A Poor Solution to the Housing Crisis

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The homeless are indeed the most egregious symbol of a cruel economy, an unresponsive government, a festering value system.

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The genius of a market economy, freed of the distortions forced by government housing policies and regulations that swung erratically from loving to hostile, can provide for housing far better than Federal programs.

President Reagan's Commission
on Housing²

I. The Need for Affordable Housing

The diminishing role of the federal government in the development of low-income housing has had severe implications for low-income citizens. As the quotations above indicate, opinions about how large that role should be vary greatly. While the debate continues, however, homeless people are evident on the street corners of cities and towns throughout the United States. In Connecticut, approximately 20,000 people stayed in shelters or temporary housing in 1986.³ Nationally, between 250,000 and 350,000 people are homeless on a given night.⁴

While homelessness has many causes,⁵ it cannot be eliminated without the creation of affordable housing. According to the federal

1. Hayes, Thoughts, in *Homelessness in America* 3 (M. E. Hombs & M. Snyder eds. 1982) [hereinafter *Homelessness*]. Mr. Hayes founded and currently serves as counsel to the National Coalition for the Homeless.

2. Report of the President's Commission on Housing xvii (1982).

3. Patricia Wallace, *Housing Facts in Connecticut* 2 (Sept. 29, 1987) (unpublished data) (copy on file at office of Yale L. & Pol. Rev.). See also *N.Y. Times*, Nov. 29, 1987, at CN3, col. 1 (comments of Jane McNichol, Director, Connecticut Coalition for the Homeless).

4. Estimates of the Department of Housing and Urban Development (HUD) for 1984, cited in Hopper & Hamburg, *The Making of America's Homeless: From Skid Row to New Poor, 1945-1984*, in *Critical Perspectives on Housing* 14 (R. Bratt, C. Hartman & A. Meyerson eds. 1986) [hereinafter *Critical Perspectives*].

5. The causes of homelessness include the deinstitutionalization of the mentally ill, cutbacks in federal benefits programs, and unemployment. See generally *Homelessness*, *supra* note 1, at 5-7. See also *Current Topic, Homelessness: Halting the Race to the Bottom*, 3 *Yale L. Pol'y Rev.* 551, 552 (1985).

government, affordable rent is defined as 30% of gross income.⁶ Thus, tenants residing in federally owned housing must pay 30% of their income as rent.⁷ Many low-income persons, however, do not benefit from federal housing programs; these people must pay far more than 30% of their income for rent. For example, more than ten million renter households paid 35% or more of their income for rent in 1983; 6.3 million paid 50% or more; and 4.7 million paid 60% or more.⁸ The families who dedicate such large percentages of their incomes for housing often must routinely choose among such vital needs as shelter, food, clothing, and health care.

In recent years, market rents have grown at a faster rate than median income, making housing even less affordable than it was in the past. In Connecticut, between 1980-85, median renter income rose by 30%, while median rent increased by 84%.⁹ Currently, in New Haven, the average two-bedroom apartment rent is \$716,¹⁰ yet a low-income person with annual income less than \$14,000 can afford to pay only \$346 in rent.¹¹ To some individuals, this disparity between the market rent and the affordable rent—called the affordability gap—is the difference between having a home and being homeless.

This Current Topic will assess the federal government's most recent attempt to close the affordability gap through the use of tax subsidies to private developers. It describes the key provisions of the Low-Income Housing Tax Credit, enacted in the Tax Reform Act of 1986 (TRA),¹² and evaluates their potential effectiveness. The Current Topic will argue that the credit in its present form will be an insufficient incentive for the development of low-income housing and will propose revisions that would further encourage the

6. Hartman, *Housing Policies under the Reagan Administration*, in *Critical Perspectives*, *supra* note 4, at 368. Hartman reports that the federal government initially thought 20% of income was appropriate to spend on housing, and raised this figure to 25% in the 1960s. In 1981, the standard was raised to 30%. See Omnibus Reconciliation Act, Pub. L. No. 97-35, 95 Stat. 402 (codified at 42 U.S.C.A. § 1437a(a)(1) (West Supp. 1987)).

7. 42 U.S.C.A. § 1437a(a)(1) (West Supp. 1987).

8. Editor's Introduction, *Critical Perspectives*, *supra* note 4, at xiv.

9. Wallace, *supra* note 3, at 1.

10. *Id.* This figure was reported in a February 1987 rent survey conducted by the Connecticut Housing Finance Authority of 28,443 units in Connecticut. This average includes utility allowances.

11. This figure is based on calculations by the Connecticut Housing Finance Authority (CHFA). CHFA calculated the amount that a family at 50% of New Haven-area median income could afford in rent, including utilities, if it were to pay rent equaling 30% of its income. (Copy on file in office of Yale L. & Pol. Rev.).

12. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 § 252, as amended (codified at I.R.C. § 42 (1986)) [hereinafter Tax Reform Act].

Low-Income Housing Tax Credit

private sector to develop this housing. Finally, it will suggest that tax incentives, as presently designed, are an inefficient government policy with which to confront the current housing crisis.

II. The Privatization of Federal Housing Policy

With the adoption of the first National Housing Act in 1937 (the Act),¹³ the federal government assumed a central role in assuring that low-income housing would be produced. The Act's declared objectives were "to alleviate present and recurring unemployment and to remedy the unsafe and unsanitary housing conditions and the acute shortage of decent, safe, and sanitary dwellings for families of low-income. . . ."¹⁴ The Act created the United States Housing Authority, and provided federal funding to states and localities to eliminate substandard housing and to build low-rent projects in its place. This legislation initiated the creation of 1.9 million public housing units, of which 96% presently remain occupied.¹⁵

In the past 50 years, through the creation of key housing subsidy programs, the federal government successfully has encouraged the private sector to develop low-income housing.¹⁶ The federal government reduces the costs of financing development through mortgage insurance, in which the government guarantees debt payments to private lenders.¹⁷ It also authorizes direct loans for low- and moderate-income families.¹⁸ The Community Development Block Grant program funds the administration of nonprofit development corporations, and land acquisition and site improvements for housing projects.¹⁹ Finally, government rent subsidy programs provide both vouchers to low-income tenants²⁰ and payments to developers who construct and rehabilitate low-income units.²¹

Despite these achievements, the federal government since 1980 has taken the view that the public sector has failed to provide low-income housing and the private sector can do better. In 1982, Presi-

13. United States Housing Act of 1937, 42 U.S.C.A. § 1401 (1937) (codified as amended at 42 U.S.C.A. § 1437 (West Supp. 1987)).

14. *Id.*

15. They're Still Cheating Housing, N.Y. Times, Nov. 22, 1987, at A26, col. 1. According to the editorial, the 4% of the public housing units that are vacant are in need of repairs for which Congress has not appropriated funding.

16. See generally National Housing Law Project, *The Subsidized Housing Handbook*, ch. 2, 2-1-2-33 (1982).

17. 12 U.S.C.A. § 1715l(d)(3) (West Supp. 1987).

18. 12 U.S.C.A. § 1701x(b) (West Supp. 1987).

19. 42 U.S.C.A. § 5301 (West 1985 & Supp. 1987).

20. 42 U.S.C.A. § 1437f (West 1985 & Supp. 1987).

21. 42 U.S.C.A. § 1437o (West 1985 & Supp. 1987).

dent Ronald Reagan's Commission on Housing argued that governmental functions should be "privatized," or transferred to the private sector.²² The Commission proposed increased reliance on private developers and minimal government intervention in these initiatives. The Department of Housing and Urban Development (HUD) agreed with this approach. "We're basically backing out of the business of housing, period," noted one HUD Deputy Assistant Secretary.²³ The most vivid example of this privatization strategy in operation is the sale of publicly owned and subsidized housing by HUD to private developers, requiring in return only a commitment that such housing remain dedicated to low-income persons for 15 years.²⁴

Further, the Reagan Administration has decreased dramatically funding for many essential direct subsidies. According to the National League of Cities, federal housing appropriations have dropped from over \$30 million in 1980 to less than \$10 million in 1987.²⁵ While 183,000 new HUD subsidized units were started in 1980, by 1985 the new start-up number had dropped to an estimated 28,000.²⁶ Not only has the federal government ceased to provide public housing, but also it has failed to spur private investment by removing the needed aid that makes low-income housing projects financially viable for the private sector.

III. Tax Incentives and Tax Shelters

The federal government has never limited its housing policy to direct appropriations; it has also encouraged the development of low-income housing through tax incentives. These incentives, or tax expenditures,²⁷ entice investment and development by creating tax benefits that supplement or replace profits lost to the developer as a result of developing units with below-market rents. Low-income housing requires these subsidies because affordable tenant

22. The Report of the President's Commission on Housing, *supra* note 2, xvii.

23. Statement of HUD Deputy Assistant Secretary, *quoted in* Hartman, *supra* note 6, at 373.

24. 12 U.S.C.A. § 1701z-1711. Note that Congress approved the property disposition program in 1978, as a means of preserving low-income units. But since 1980 HUD has implemented the policy in a manner that considers sale prices more than low-income housing commitment. Clay, Risk of Loss: The Endangered Future of Low-Income Housing Resources 10 (1987).

25. National League of Cities, A Time to Build Up: A Survey of Cities About Housing Policy, *reported in* 14 Hous. & Dev. Rep. (BNA) 801 (Feb. 23, 1987).

26. Hartman, *supra* note 6, at 364.

27. These incentives are called tax expenditures because, like direct appropriations, they result in a revenue loss to the federal fisc. *See* 2 U.S.C.A. § 622(3) (West 1985).

Low-Income Housing Tax Credit

rents usually cannot cover the owner's costs of construction, maintenance, and management.

Tax incentive programs have been controversial. Many tax incentives created to increase social welfare have been abused by individuals seeking to shelter their own income and thereby reduce their tax liability.²⁸ Private investors profit from tax incentives, while the government loses potential tax revenue. As one critic, Paul McDaniel, commented, "One problem is that every time Congress enacts a tax preference for a particular industry or economic activity, a highly skilled band of tax and financial advisors with a battery of computers is ready and able to convert that provision into a tax shelter for their high-bracket clients."²⁹

A tax shelter is a partnership or other investment arrangement designed to assist the investor minimize federal income tax liability.³⁰ An entity such as a limited partnership invests in a transaction expected to generate more than one dollar in tax savings for every dollar invested. The project produces tax savings because investors can deduct losses such as depreciation³¹ and interest³² from gross income before determining applicable tax. Tax credits, such as the historic rehabilitation credit,³³ also generate savings by allowing investors to subtract the credit amount directly from tax liability.³⁴ These tax preferences typically exceed the actual equity invested by the taxpayer because they are calculated on an amount that is not limited to the taxpayer's actual contribution and that includes borrowed financing.³⁵ Although these tax shelters affect many sectors of the economy, they have been most prevalent in real estate.³⁶

28. McDaniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. Ind. Com. L. Rev. 813, 822 (1973).

29. *Id.*

30. I.R.C. § 6661(c)(ii) (1986). Note that the Internal Revenue Code includes more than one definition of a tax shelter. See I.R.C. §§ 461(i)(3), 6111 (1986).

31. I.R.C. § 167 (1986).

32. I.R.C. § 163 (1986).

33. I.R.C. § 48(g) (1986).

34. A taxpayer receives the entire value of a tax credit, but only benefits from the amount of the deduction multiplied by the applicable tax rate. Deductions are thus worth more to those subject to higher tax rates than to those at lower rates; credits are worth an equivalent amount to all entities regardless of tax rate.

35. For a description of how tax incentives made the Manhattan Plaza project in New York City profitable for private investors while less than adequately meeting the needs of the low-income tenants, see Schur, *Manhattan Plaza: Old Style Ripoffs are Still Alive and Well*, in *Critical Perspectives*, *supra* note 4, at 277.

36. J. Birnbaum & A. Murray, *Showdown at Gucci Gulch 10* (1987).

IV. The Tax Reform Act of 1986

Advocates of tax reform in 1986 made the elimination of tax shelters one of their priorities. President Reagan called for their elimination with a plan that would "result in that 'underground economy' being brought into the sunlight of honest tax compliance."³⁷ In passing the TRA, Congress responded to the widespread perception that the existing tax code offered myriad opportunities for abusive tax shelters. The TRA restricts the extent to which an investor can use deductions and credits derived from tax shelters to offset earned income.³⁸ Additionally, by requiring the investor to be "at risk," or personally liable, for the amount of the debt that is included when calculating tax liability, the TRA limits the amount of borrowed funds that can be utilized to generate tax savings.³⁹

The TRA also repealed tax incentives specifically designed to encourage low-income housing production, prompting one commentator to write that the Senate Finance Committee "threw the baby out with the bath water."⁴⁰ Previously, the tax code had included provisions that allowed for more generous deductions, and thereby increased tax savings, for the costs of acquiring, developing, and operating low-income housing. The TRA removed such prior incentives as: (1) accelerated depreciation,⁴¹ (2) full deductibility of construction period interest,⁴² and (3) special capital gains treatment.⁴³ The TRA also restricted the issuance of tax-exempt bonds, the proceeds of which could be loaned by local governments to developers of low-income housing at below market interest rates.⁴⁴

In their zeal to eliminate tax shelter abuse, legislators went too far. At a time when the housing crisis was worsening and receiving increasing public attention,⁴⁵ the Senate repealed tax subsidies that facilitated the development of low-income housing without adopting alternative incentives. In response to the cries of lobbyists con-

37. President's State of the Union Address, Jan. 25, 1984, as reported in *id.* at 40-41.

38. I.R.C. § 469 (1986).

39. I.R.C. § 465 (1986).

40. Sheppard, Mitchell's Low Income Housing Amendment Adopted, 31 Tax Notes 1281 (1986).

41. I.R.C. § 167(k) (CCH 1981). This section is still in effect for expenses incurred prior to Jan. 1, 1987, for low-income projects. However, the TRA terminates this incentive for future low-income housing projects, rather than extends its effect.

42. I.R.C. § 189 (CCH 1981) (repealed by Tax Reform Act, § 803(b)(1)).

43. I.R.C. § 1039 (CCH 1981) (repealed by Tax Reform Act, § 301). See Schwartz, Real Estate and the Tax Reform Act of 1986, 16 Real Est. Rev. 28, 35 (1987).

44. See I.R.C. §§ 141-147 (1986).

45. See text accompanying notes 3-4 and 8-11.

Low-Income Housing Tax Credit

cerned about the effects of tax reform on low-income housing, therefore, the Senate Finance Committee Chair, Robert Packwood, first proposed the Low-Income Housing Tax Credit (LIHTC).⁴⁶ Packwood, who was commonly known as "an unabashed advocate of using the income tax to give incentives to private industry and to promote social action,"⁴⁷ was receptive to the coalition of low-income housing advocates and members of the real estate lobby searching to preserve politically acceptable tax shelters.

The legislative history of the LIHTC is scant. The credit was not in the version of the bill that Packwood presented to President Reagan on March 11, 1986, but it was included in the draft submitted at the full committee markup one week later.⁴⁸ The feasibility of the hastily drafted credit could not have been fully considered during this one-week period. In fact, problems with the drafting of the bill were substantial. The credit was first modified by the full Senate,⁴⁹ again in the conference committee,⁵⁰ and is the subject of many substantive revisions in the Technical Corrections Act of 1987.⁵¹

The LIHTC was the only new tax expenditure program in the TRA, and was created at a time when many tax shelters were eliminated. Its emergence can be explained by the presence of bipartisan support for the goal of assisting low-income housing. Even conservative Republican Senator Robert Dole endorsed the credit, remarking, "I support low-income housing and I recognize that federal participation in this type of housing is appropriate, as well as inevitable."⁵² The unanimous rhetoric in favor of the credit, however, should not be allowed to obscure the LIHTC's many inade-

46. 132 Cong. Rec. S8148 (daily ed. June 23, 1986) (statement of Sen. Mitchell).

47. J. Birnbaum & A. Murray, *supra* note 36, at 183. See also S. Surrey & P. McDaniel, *Tax Expenditures* 101 (1985).

48. Reports contemporaneous to Sen. Packwood's meeting with the President indicate that the bill was "tough" on real estate. 13 Hous. & Dev. Rep. (BNA) 831 (Mar. 10, 1986). See also J. Birnbaum & A. Murray, *supra* note 36. The version submitted to the committee included the LIHTC. 13 Hous. & Dev. Rep. (BNA) 874 (Mar. 24, 1986).

49. 132 Cong. Rec. S8158 (daily ed. June 23, 1986) (reporting approval of Amendment No. 2153).

50. Conf. Rep. No. 99-841, 99th Cong. 2d Sess. II-85-103, *reprinted in* 1986 U.S. Code Cong. & Admin. News 4076, 4173.

51. Technical Corrections Act of 1987, H.R. 2636 and S. 1350, 100th Cong., 1st Sess. (1987), *reprinted in* Joint Committee on Taxation, 100th Cong., 1st Sess., Description of the Technical Corrections Act of 1987 (P-H) (June 18, 1987) [hereinafter Technical Corrections Act]. At the time this article was written, it was anticipated that the Technical Corrections Act would be enacted by Congress in 1987. In fact, Congress did not enact these legislative amendments and, as of early 1988, no immediate action is expected.

52. 132 Cong. Rec. S8153 (daily ed. June 23, 1986) (remarks of Sen. Robert Dole).

quacies. A close examination reveals that the LIHTC is seriously flawed and that it will be an ineffective incentive program.

V. The Low-Income Housing Tax Credit

The speed with which the LIHTC was drafted belies its complexity. The tax credit, which provides an investor with a credit for a percentage of his or her investment in new construction, acquisition, or rehabilitation of low-income housing, contains many complicated rules and restrictions, the most significant of which are outlined below.

A. Credit Amount

The TRA provides for a 70% present value credit, which the taxpayer takes annually over 10 years, as approximately 9% of initial investment made for new construction and substantial rehabilitation that is not federally subsidized. For acquisition costs and for rehabilitation of new buildings with certain federal subsidies, the credit equals 30% present value, or approximately 4% over 10 years.⁵³ In either case, these percentages are applied to that fraction of residential units that are dedicated to low-income use.⁵⁴

The present value calculation is intended to recognize the "time value" of money. If the entire credit could be taken at once, it would equal 30% or 70% of the project costs. But because the tax benefits to the investor are spread out over a decade, the present value of the credit is worth less than its nominal value. Therefore, the total dollar amount of credits taken over 10 years is greater than its present value. For buildings placed in service after 1987, the Treasury is required to calculate the exact percentage that will satisfy the present value requirement.⁵⁵

B. Qualified Buildings

The credit applies to residential rental property meeting certain minimum standards. A developer must choose at the outset whether: (1) at least 20% of the units will serve individuals whose income is 50% or less of area median gross income (the "20-50 test"); or (2) at least 40% of the units will serve individuals whose income is 60% or less of area median gross income (the "40-60

53. I.R.C. § 42(b) (1986).

54. I.R.C. § 42(c) (1986).

55. I.R.C. § 42(b)(2) (1986).

Low-Income Housing Tax Credit

test").⁵⁶ While a developer can choose to dedicate more units in a project to low-income individuals, and thereby receive a greater tax credit,⁵⁷ these minimum standards set the threshold for utilizing the credit.

C. Rent Restrictions

For residential units that are dedicated to low-income individuals for purposes of the tax credit, the gross rent charged, including utilities, cannot exceed 30% of the maximum allowable income as defined under the 20-50 or 40-60 tests.⁵⁸

D. Recapture Provisions

If the low-income units do not continue to serve low-income individuals for a period of 15 years, the TRA mandates recapture of a portion of the credit.⁵⁹ This provision requires owners to certify annually that tenants continue to meet the income guidelines.⁶⁰

E. State Allocations

The TRA requires that each state be allocated a maximum amount of credit disbursement authority equal to \$1.25 per capita.⁶¹ Further, each state is required to designate a state housing agency responsible for the allocation of credits to developers, and to assure that more credits will not be promised to developers than are available under the per capita limits.⁶² In order for an individual to take the credit, he or she must obtain an allocation of credits from the applicable state agency.

F. Sunset Provisions

The new low-income housing tax credit requires that buildings be placed in service between January 1, 1987, and December 31, 1989,

56. I.R.C. § 42(g)(1) (1986).

57. The eligible basis is equal to the lesser of the ratio of low-income units to total residential units or the ratio of floor area space in low income units to total residential floor area. I.R.C. § 42(c)(1) (1986).

58. I.R.C. § 42(g)(2) (1986).

59. I.R.C. § 42(i)(1),(j) (1986).

60. 52 Fed. Reg. 23,432 § 1,42-1t(a)-h(2) (to be codified at 26 C.F.R. § 602) (temporary regulations, June 22, 1987).

61. I.R.C. § 42(h)(3) (1986).

62. A similar framework was adopted for tax-exempt bonds. I.R.C. § 146 (1986). Projects receiving tax-exempt financing are not covered by the LIHTC per capita limits. I.R.C. § 42(h)(4)(a) (1986).

in order to take advantage of the tax benefits associated with this program.⁶³

G. *Passive Loss Rules*

The TRA restricts the amount of deductions or credits from "passive" activities that an investor can use against earned income. A passive activity, according to the Internal Revenue Code (Code), is a trade or business in which the investor does not participate materially.⁶⁴ The exceptions to the passive loss rules are more generous for low-income housing investments than for other real estate activities.⁶⁵ Therefore, for individuals whose adjusted gross income does not exceed \$100,000, the Code generally allows maximum deductions of \$25,000 to offset non-passive income. The special rules applying to low-income housing allow individuals with adjusted gross incomes of up to \$200,000 to use the \$25,000 offset.⁶⁶

The amount of allowable credit is the "deduction equivalent," or the amount of tax savings generated by a \$25,000 deduction. The maximum amount of credit that can be taken is the highest tax rate of 28% multiplied by \$25,000, or \$7000. These rules apply only to individuals, closely held C corporations,⁶⁷ and personal service corporations.⁶⁸ Other corporations are exempt from the passive loss rules and are therefore able to invest without limits in the tax credit.

VI. *An Evaluation of the Low-Income Housing Tax Credit*

The LIHTC's success in addressing the housing crisis depends on its ability to induce private developers to finance, create, and maintain affordable housing units. The credit, however, has both substantive and procedural flaws that seriously hinder its efficacy as an incentive program.

63. I.R.C. § 42(n) (1986). The Technical Corrections Act provides for limited one year carryover after 1989 if for unforeseen reasons a building that received credit allocations could not be placed in service. Technical Corrections Act § 102(l)(17)(a).

64. I.R.C. § 469(c)(1) (1986).

65. I.R.C. § 469(i)(3)(B) (1986).

66. Note that the TRA enacted a phase-out of the passive loss rules above the maximum allowable income of \$200,000. For incomes ranging from the maximum to \$250,000, for every two dollars of excess income the passive loss limit is reduced by one dollar. See I.R.C. § 469(i)(3) (1986).

67. A closely held corporation is one in which a maximum of five individuals directly or indirectly own more than 50% of the corporation's outstanding stock. I.R.C. § 469(j)(1) (1986).

68. A personal service corporation is one in which services are substantially performed by an employee who owns stock in the corporation. I.R.C. § 269A(b)(1-2) (1986), as amended by § 469(j)(2) (1986).

Low-Income Housing Tax Credit

A. Development of Affordable Housing

The LIHTC is a mediocre substitute for the coordinated attack that is needed to provide affordable housing for the homeless. To qualify for the tax credit, a developer need set aside only a portion of the building for low-rent units; the rest of the building can serve moderate- and upper-income individuals. These set-asides, under either the 20-50 or the 40-60 rule, will be inadequate to induce the production of sufficient numbers of very-low-income units.⁶⁹

The tax credit delegates the choice between the threshold 20-50 and 40-60 options solely to the private sector. Economic reality will force many developers to minimize, either qualitatively or quantitatively, the production of low-rent units in order to maximize the rental income stream of the project. The rational developer will either place the minimum number of very low-income tenants in a project, or will allow more tenants at a higher income range. Planners of projects that will serve only very-low-income tenants will choose, out of financial necessity, to set rents at the higher 60% range.⁷⁰

The difference between the selection of the 50% or 60% area median income limits is significant. When an owner chooses the 40-60 plan instead of the 20-50 plan, the LIHTC makes little or no contribution toward bridging the affordability gap for welfare recipients. For example, in New Haven an individual receiving general assistance⁷¹ receives a housing allowance of \$300 per month.⁷² The maximum rent under the 20-50 plan would be \$303, whereas the maximum rent under the 40-60 plan would be \$363.⁷³ The additional \$60 would make this apartment unaffordable for a large part of the New Haven population that is in need of housing.

The federal legislation provides no additional incentives for the developer to shelter more than 20% of tenants at below 50% of median income. In fact, by requiring developers to choose between direct subsidies and the tax credit, the LIHTC fails to encourage the

69. In this section, I will use "very-low-income" to refer to incomes of less than 50% of area median income. "Low-income" will refer to incomes of less than 60% of area median income.

70. J. Guggenheim, *Tax Credits for Low Income Housing: New Opportunities for Developers, Non-Profits, and Communities under the 1986 Tax Reform Act* 10 (1986).

71. 17 Conn. Gen. Stat. § 273 (1985).

72. Interview with Edward Mattison, Assistant Corporation Counsel for the City of New Haven (Nov. 10, 1987).

73. Calculations by the Connecticut Housing Finance Authority regarding eligible rents under the LIHTC under the 20-50 and 40-60 plans, based on New Haven-area median income (copy on file with Yale L. & Pol. Rev.).

aggregation of funding sources that would enable greater numbers of very-low-income units to be created.⁷⁴ According to the president of one real estate firm involved in development and syndication of low-income housing, “[a]bsent other subsidies, it seems unlikely that projects will be built for the very low income since the rental rates will be outside their reach.”⁷⁵ The tax credit is not the deep subsidy required to spark the development of very-low-income units.

B. The Burdens of Recapture

The Code’s new requirement that investors either maintain the low-income units for 15 years or face recapture penalties will further deter investment in low-income housing. Prior tax incentive programs did not require such long-term commitments from developers, because the deductions were generally allowable upfront. In theory, the recapture provisions are an important response to complaints advanced by housing advocates under prior tax regimes—that private investors lacked continuing incentives for maintaining the housing for which they had received benefits. In reality, however, this solution creates new problems: investors face a spectrum of potential investments, and recapture may deter those who are already wary of the risks involved in low-income housing development.

The difficulty of encouraging low-income housing development is compounded by the fact that low-income tenants, especially those who recently have been homeless, often need special social services in addition to standard building upkeep. As a result, those developers who choose to invest in low-income housing are forced to consider the special needs of tenants residing in such units. A long-term plan for management of the properties is crucial. According to one expert, Charles Carlisle, “[d]evelopment of a management plan with special emphasis on low-income housing needs will be critical to the success of the venture.”⁷⁶

Although tenants have these needs, the National Housing Law Project reports that many managers, given the choice, “would rather not deal with large families, single-parent households, welfare cli-

74. The Code requires the investor to either exclude the federal subsidies from basis, the amount on which the tax credit is calculated, or take the lower credit rate of 30% of present value. I.R.C. § 42(i)(2) (1986).

75. Carlisle, *The Credit for Low Income Housing: Whose Shelter is it?*, 3 *Real Est. Fin.* 44, 57 (1987).

76. *Id.*

Low-Income Housing Tax Credit

ents, and other so-called problems."⁷⁷ Owners may have a natural tendency to "cream"—evicting tenants with the greatest behavioral problems and replacing them with less troublesome ones. One tenant residing in the Columbia Point Project in Boston, Massachusetts, which is being financed in part with the LIHTC, complained that, "[a]lready the new security is harrasing the teens and some families had to move."⁷⁸ Private managers must demonstrate sensitivity and commitment to assisting their low-income tenants.

Owners of low-income housing must be more than dedicated to assisting low-income tenants; they also need training in issues of financial management and tenant relations. These issues have plagued federal housing for 50 years.⁷⁹ For example, in Boston, the Housing Authority was placed in receivership for egregious financial mismanagement.⁸⁰ Similarly, the Pruitt-Igoe Project in St. Louis, Missouri, was demolished due to its poor conditions.⁸¹ The spectre of these troubled public housing projects is so strong that private developers will be unlikely to enter this market without greater assistance in tenant management. We cannot expect the private sector, within the brief amount of time allotted for use of the LIHTC, to be able to discover resolutions to these special problems, which have eluded public housing specialists for decades.

Additionally, the 15-year recapture rule necessitates annual monitoring and certification by the I.R.S. of the incomes and family sizes of all tenants.⁸² With this rule, Congress has tried to assure that these subsidized units would serve truly low-income people for a period of time. However, George Delta, a private practitioner, has called the reporting requirements "needlessly complex"⁸³ and suggested that these provisions will only further discourage private investors.

77. National Housing L. Project, *supra* note 16, at II-10.

78. Martha Bush *quoted in* Community Rises from Boston Slum, N.Y. Times, Nov. 15, 1987, at A59, col. 1.

79. Bratt, Public Housing: The Contribution and the Controversy, in *Critical Perspectives*, *supra* note 4, at 346-48.

80. *Id.* at 347.

81. *Id.* at 335.

82. 52 Fed. Reg. 23,432 § 1,42-1t(a)-h(2) (to be codified at 26 C.F.R. § 602) (temporary regulations, June 22, 1987).

83. Delta, A Critique of the Low-Income Housing Credit, 3 Tax Mgmt. Real Est. J. 114 (1987).

C. State Credit Allocations

Bureaucratic constraints further deter private developers from utilizing the LIHTC. By delegating to the states the responsibility for disbursing the tax credits, the TRA added an additional level of bureaucracy for the private sector to surmount. The states were surprised to discover that the TRA delegated them substantial new responsibilities,⁸⁴ particularly since the LIHTC was not a program for which they had lobbied, but one designed by the Senate Finance Committee without their prior consultation. The states had difficulty accepting these duties and establishing allocation systems. For example, although the tax bill was signed by the President on October 22, 1986, and went into effect on January 1, 1987, it was not until April 1987 that Connecticut's governor resolved a power struggle between three state agencies with responsibility for housing programs, finally designating the Connecticut Housing Finance Authority (CHFA) the LIHTC allocating authority.⁸⁵ Apparently, many other states encountered similar turf battles.⁸⁶

Delay in establishing state allocation systems was due in part to the Treasury Department's delay in promulgating guidelines. Temporary regulations, clarifying the procedure to be followed by the state allocating authority, were not issued until June 1987.⁸⁷ Under these regulations, a developer desiring to take advantage of the tax credit must apply to a state agency that will review the project in a process that may take up to two months. This review process is designed to ensure that a state does not over-allocate its fixed number of credits and that it properly certifies all allocations in writing to the Internal Revenue Service. Some consultants have expressed concern, however, that this review process will not completely prevent overcommitment. To minimize this possibility, they recommend that developers either monitor the state's allocation process or request that the state issue warranties.⁸⁸

Clearly, the complexity of the regulations means that additional bureaucracy will be required on the state level to administer this pro-

84. Remarks of Michael Ward, Connecticut Housing Finance Authority, Low-Income Housing Tax Credit Workshop, Hartford, Conn. (December 20, 1986).

85. Exec. Order No. 19, Apr. 24, 1987 (filed with the Connecticut Secretary of State, Apr. 27, 1987); interview with Carol A. Montesi, Planner and Program Analyst, Connecticut Housing Finance Authority (Dec. 7, 1987).

86. 14 Hous. & Dev. Rep. (BNA) 576 (Dec. 1, 1987) (statement of Carl W. Riedy, Jr., Executive Vice President, Council of State Housing Agencies).

87. 52 Fed. Reg. 23,432 (to be codified at 26 C.F.R. §§ 1.0-1—1.58-8 and 602) (temporary regulations, June 22, 1987).

88. Carlisle, *supra* note 75, at 55.

Low-Income Housing Tax Credit

gram properly. Federal regulations authorize the states to charge an administrative fee to help cover the costs of the program. Consistent with this authorization, CHFA, for example, is charging an application fee of \$250 to nonprofit developers and \$500 to for-profit developers, and assessing an additional processing fee. The state of Washington charges a commission ranging from 5-10% of the first-year credit amount.⁸⁹ Virginia imposes a flat fee of \$3000, while Texas levies \$5 per unit, with an ongoing annual fee of 2% of the credit amount.⁹⁰ Through these fee structures, states pass along program expenses to the private sector. These fees operate as yet another disincentive to developers contemplating a low-income project.

D. Sunset Provisions

Even if the LIHTC were to provide substantial incentives to new housing development, its impact would be blunted by the extremely brief duration of the subsidy. The tax credit is only a three-year program, for the years 1987 through 1989. The temporary regulations guiding key issues of program operation were not even issued until June 1987.⁹¹ On November 3, 1987, the Treasury Department announced that these temporary regulations, with one amendment, would serve as the "proposed" regulations; the comment period for these regulations ended on January 4, 1988, more than a year after their effective date.⁹² Thus, final regulations will not be effective until well into the second year of the credit. The proposed rules detail the state allocation process, but still leave many issues unresolved regarding the use of the tax credit.

Investors are naturally wary of experimenting with an untried and uncertain program. Yet by waiting to view the success of early projects, developers may not have sufficient time to complete their own housing projects before the legislation sunsets. To alleviate this concern, the Technical Corrections Bill provides for limited carryforward of credits allocated in 1989 for projects that had been started but not completed for reasons the developer could not have foreseen.⁹³ However, many credits allocated to the first year of the

89. 14 Hous. & Dev. Rep. (BNA) 1011 (May 4, 1987).

90. *Id.* at 951.

91. 52 Fed. Reg. 23,432 (to be codified at 26 C.F.R. §§ 1.0-1—1.58-8 and 602) (temporary regulations, June 22, 1987).

92. 52 Fed. Reg. 42,116 (to be codified at 26 C.F.R. §§ 1 and 602) (proposed regulations, Nov. 3, 1987).

93. Technical Corrections Act § 102 (l)(17)(a).

program's operation will end up unused, primarily because of the hesitation of investors to act in the absence of clear governmental guidance.

E. The Costs and Complexities of Syndication

The financing arrangements needed to optimize the use of the tax credit, in tandem with tax shelter reforms implemented by the TRA, have created further barriers to the success of this subsidy program. The TRA, by restricting the ability of individuals to shelter income, has altered the financing arrangements through which real estate transactions have traditionally been conducted. Because they could not use them all, developers, or sponsors, typically "sold" tax benefits to third parties in exchange for cash needed to cover project costs. Likewise, the LIHTC is not actually taken by the developers; it is transferred to individuals or corporate entities in exchange for equity contributions to the project. From a policy perspective, the problem is that the developer receives less than the full amount of the credit in equity; a portion of the credit covers the costs of the transaction and the profit to the investors.

Syndication, the predominant financing arrangement for real estate, allows investors to pool their resources in order to acquire tax benefits and to fund development.⁹⁴ Typically, the investors will be limited partners in a syndicate, thereby insulating themselves from risk yet securing the maximum tax benefits. The general partner will develop and operate the project. Federal securities laws require the partnership to comply with disclosure and registration rules if the transaction requires a public offering.⁹⁵ A private placement is sufficient, however, if only a small number of investors is involved,⁹⁶ or if the investors are institutional entities ("accredited investors") presumed not to require the protections afforded by SEC registration.⁹⁷

Syndication is cumbersome and costly.⁹⁸ Significant financial and legal expertise is required to maximize the tax benefits to investors within the limits established by the IRS. The price of obtaining the

94. See generally Berger, Real Estate Syndication, 69 Yale L.J. 725 (1960).

95. 15 U.S.C.A. § 77a-77aa (West 1981).

96. 15 U.S.C.A. § 77d(2) (West 1981) (exempts transactions by an issuer not involving a public offering). The Securities and Exchange Commission has determined that a transaction is not a public offering if less than 25 persons invest. General Counsel's Opinion, Securities Act Rel. No. 285, Jan. 24, 1935.

97. 15 U.S.C.A. § 77d(6) (West 1981).

98. See Hom, Does Real Estate Syndication Provide a Viable Financing Strategy for Low Income Housing?, 50 Brooklyn L. Rev. 913 (1984).

Low-Income Housing Tax Credit

necessary lawyers, accountants, and investment bankers to conduct a public offering can be prohibitive for the developer and can rapidly offset the benefits of the tax credit. Further, promoters of a public offering earn at least 10% of the proceeds of the offering in commissions and organizational fees. These commissions include discretionary accounts—which allow for, among other things, entertainment of investment bankers—all funded by the government's housing policy.⁹⁹ And, while this type of transaction may be commonplace for the major real estate developer, it may discourage the involvement of the less financially savvy persons desiring to produce housing for the homeless.

The TRA's attack on tax shelters has altered the structure of syndications and the composition of the parties to the syndication.¹⁰⁰ Deterred by the passive loss rules, high-income individuals are slowly being replaced by corporate investors. As many of their traditional government subsidies have been eliminated, nonprofit developers are attempting to expand their role in this arena of housing finance as general partners. These transitions take time, however, and forestall the use of the tax credit.

1. Individual Investors. Prior to the TRA, wealthy individuals comprised the vast majority of investors in real estate syndications. Even though the passive loss rules are more generous for investors of low-income housing than for those of other real estate transactions, they are not generous enough to permit the involvement of wealthy investors. One analyst, Janet Novack, notes the "schizophrenia" that shaped the design of the credit: "[T]he biggest hitch of all [in using the LIHTC] is that the credit is of little use to the high income individuals who would be suitable investors in these potentially high-risk deals."¹⁰¹

Individuals with income ranges of less than \$200,000 were not major investors of low-income housing before the TRA, and it is unlikely that they will have either the available income or the tax incentives to invest now. Taxpayers will quickly expend the strict limit on passive losses, and they may already be absorbing losses that were generated in past years from other investments.¹⁰² Fur-

99. Interview with Steve Stogel, Vice-President, McCormack, Baron and Associates, Inc. (Oct. 22, 1987) [hereinafter Stogel interview].

100. Caffee & Zelko, *The Low-Income Housing Credit of the Tax Reform Act of 1986*, 7 Real Est. Sec. J. 44-45 (1987).

101. Novack, *Hitch 22*, *Forbes*, Feb. 9, 1987, at 54.

102. The Internal Revenue Code allows for carryforward of passive losses. I.R.C. § 469(b) (1986).

thermore, these individuals must continue to qualify under the income guidelines over the entire 10-year period that they take the credit. As a result, an investor must anticipate at the outset that his or her position will not substantially improve.

The income and passive loss limitations also necessitate that more funds be raised from larger groups of individuals. The TRA has increased the likelihood of public offerings, and thereby the costs of raising capital for low-income housing production.¹⁰³ These costs, and the overall decline in the availability of individual investors, have led developers to seek new markets for equity contributors.

2. *Corporate Investors.* With many individual investors out of the picture, syndication of corporate investors is likely to be the predominant means of using the tax credit.¹⁰⁴ Corporations, exempt from the passive loss rules, can obtain greater tax benefits for equity contributions to a tax syndication than can individuals. Despite their promise of tax benefits, however, corporations have been slow to recognize the value of these investments.¹⁰⁵ Prior to the TRA, few syndicate promoters worked with corporations,¹⁰⁶ and these promoters are just beginning to educate corporate America about equity funds that can be used for the LIHTC.¹⁰⁷

Those corporations who do invest in low-income housing syndication deals are not motivated solely by tax savings. They appear to be influenced as much by community relations as by profits: They are interested in being perceived as socially responsible corporate citizens. Syndicate promoters attempt to appeal to these sentiments. For example, the Chicago Equity Fund advertises as a benefit of this investment, "[n]ational and local recognition for supporting a major new housing initiative with visible and significant impact across the city."¹⁰⁸

Nationally, the Local Initiatives Support Corporation, operated by the Ford Foundation, and the Enterprise Social Investment Corporation, operated by the Rouse Corporation, have taken the lead in building corporate equity funds.¹⁰⁹ The Chicago Equity Fund and

103. Carlisle, *supra* note 75, at 56.

104. *See supra* text accompanying notes 64-68 for discussion of passive loss rules.

105. *See* Stevens, Tax Incentives for Low-Income Housing: Another Look, 3 Tax Mgmt. Real Est. J. 167, 170 (1987).

106. Carlisle, *supra* note 75, at 56.

107. Novack, *supra* note 101.

108. Executive Summary, Chicago Equity Fund 1987 Partnership 2 (1987).

109. Tax Credits Produce Housing for Poor, N.Y. Times, Jan. 17, 1988, at R1, col. 2. Both LISC and Enterprise were also instrumental in lobbying for the tax credit, and were cited in the Senate debate on the bill. *See* 132 Cong. Rec. S8149 (daily ed. June 23, 1986) (statement of Sen. Mitchell).

Low-Income Housing Tax Credit

the Connecticut Equity Fund serve as regional vehicles for the corporate community to invest in low-income housing.¹¹⁰ To date, these funds have gathered more contributions than they have been able to invest in projects.¹¹¹ This is because they have just begun creating tax credit deals with general partners who have sites that they are interested in developing and operating. Site selection in a climate of community resentment towards homeless and low-income persons is difficult.¹¹² An additional explanation for the current surplus of corporate financing is that these funds will invest only in projects involving a nonprofit organization,¹¹³ and the nonprofit sector has been slow to enter the syndication market. Nevertheless, the emergence of these attempts at public-private partnerships to create low-income housing may be the most positive consequence of the LIHTC.

3. *Nonprofit Sponsors.* From the perspective of a nonprofit organization that is interested in operating low-income housing, the new world of financing has proven complicated. Traditional government subsidy programs did not require the same amount of technical resources to obtain a project. According to Karl Hilgert, of Christian Community Action in New Haven, "in the old days, they offered you low-income housing and you just had to sign on the dotted line."¹¹⁴ Under the Community Development Block Grant, for example, government officials worked directly with local housing nonprofit corporations and drafted simple contracts of understanding regarding the use of the funds.¹¹⁵ Applications for such federal grants did not require the assistance of an attorney. But nonprofit groups today have been forced by the decline of direct government subsidies to consider complicated tax incentive deals.

As a result, such organizations have confronted three problems. First, tax-exempt nonprofit organizations cannot use the credit themselves, because they do not have tax liability that the credit can

110. Remarks of Arthur Anderson, Executive Director, Connecticut Equity Fund, Low Income Housing Tax Credit Workshop, New Britain, Conn., Sept. 9, 1987.

111. Stogel interview, *supra* note 99.

112. Impediments to site selection for low-income housing include the not-in-my-backyard phenomenon. See generally A Response to Nimby, N.Y. Times, Aug. 4, 1987, at A22, col. 1.

113. LISC, for example, will only invest in projects that involve a community-based nonprofit organization. Remarks of Patrick Johnson, Executive Director, National Equity Fund, Low-Income Housing Workshop, New Britain, Conn., Sept. 9, 1987.

114. Interview with Karl Hilgert, Director of Christian Community Action, New Haven, Conn. (Apr. 1987).

115. Interview with Jennifer Pugh, former Administrator, Community Development Block Grant Program, City of New Haven, Conn. (Dec. 17, 1987).

offset.¹¹⁶ Instead, the tax-exempt entity must transfer the entire amount to taxable entities in exchange for equity financing. Considering the costs of syndication, the tax-exempt organization will surely never receive the full value of the LIHTC. Therefore, a nonprofit organization interested in operating low-income housing would prefer a direct subsidy to a tax incentive.¹¹⁷

Secondly, tax-exempt entities confront legal barriers that prevent them from assuming the position of general partner in a syndication.¹¹⁸ For example, tax-exemption may be threatened by profit-motivated deals such as a syndication. A fundamental conflict of interest exists between the dual obligations of the tax-exempt entity—its statutory duty to provide that “no part of the net earning . . . inures to the benefit of any private shareholder or individual”¹¹⁹—and its fiduciary duty as general partner to promote the investments of the private partnership.¹²⁰ As a result, nonprofit corporations must insulate themselves from the profit-motivated aspects of the partnership by explicitly waiving such duties in their partnership agreement.¹²¹

Even if fiduciary duties are waived, nonprofit entities face an additional legal concern. The allocation of profits and losses required under partnership tax is still problematic. The Internal Revenue Code requires income and losses to be allocated among partners to reflect the “substantial economic effect” of the transaction.¹²² But because nonprofit organizations do not have taxable income, they are unable to utilize the deductions from losses. A wholly owned for-profit subsidiary is able to take the losses, making this structure preferable for those nonprofit corporations using the tax credit.¹²³

Thirdly, even if the structural problems posed by the conflicts inherent in the tax and partnership laws are resolved, the costs of syndication may still be prohibitive. For nonprofit organizations to survive in the modern era of real estate finance, therefore, they will

116. I.R.C. § 501(c)(3) (1986).

117. *See generally* Warren & Auerbach, Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing, 95 Harv. L. Rev. 1752 (1982) (discussing analogous problem of tax incentives to for-profit corporations that do not have taxable income).

118. *See generally* Note, Low Income Housing Under the New Conservatism: Trickle Down or Dry Up?, 26 Santa Clara L. Rev. 461 (1986).

119. I.R.C. § 501(c)(3) (1986).

120. Uniform Partnership Act (U.L.A.) § 21 (1969).

121. Spring, Tax Considerations for Section 501(c)(3) Organizations Engaged in Real Estate Development Activities, 4 Preservation L. Rev. 2065 (1985).

122. I.R.C. § 704(b) (1986).

123. The Technical Corrections Act to the TRA envisions the use of a for-profit subsidiary of a nonprofit organization as general partner. While the subsidiary may resolve some of the legal issues, the nonprofit organization still requires legal assistance to establish such an entity. Technical Correction Act § 102(l)16.

Low-Income Housing Tax Credit

need substantial legal and financial guidance. This expertise is expensive, and most nonprofit entities do not have highly specialized lawyers and accountants to assist in the coordination of these public-private partnerships.

VII. Reforming the Low-Income Housing Tax Credit—A Short-Term View

With all its drawbacks, the LIHTC remains the predominant federal subsidy for affordable housing. Until it undertakes more fundamental reform of its housing policy, Congress should improve the LIHTC's effectiveness. Eight specific measures will enable the LIHTC to fulfill the expectations envisioned by its rhetoric.

First, the tax credit must be redesigned to maximize the amount of revenue that can be raised for low-income housing. Increasing tax shelter opportunities for wealthy individuals will encourage their financial contributions. To the extent that it is politically feasible to expand this one area of tax preference without concurrently expanding others, many investors could be prompted to contribute to low-income housing projects. So long as tax policy is the federal government's only means of encouraging investment in low-income housing, then tax shelters must be expanded to promote the important social goal of developing more affordable housing units.

Second, the credit amounts should be restructured to provide additional incentives to those developers who choose to dedicate more than the minimum 20% of the project to low-rent units. Additional credits also could be allowed to those who dedicate larger quantities of units to those with less than 50% of median income. A simple revision would allow for the 70% credit to be taken even if other federal subsidies finance the project, so long as more very-low-income people are served. Such a reform would acknowledge the economic reality that additional subsidies are essential when rental income is further constrained.

Third, HUD should facilitate the creation of workable public-private partnerships. The department is in a position to coordinate information on effective management efforts, drawing on the experience of public housing over the past 50 years. Annual reporting requirements should be relaxed, with HUD taking a more active role in assuring compliance. Further, HUD's legal and financial expertise could dramatically reduce the transaction costs of putting together the deals. By circulating sample partnership agreements and offering plans, the government could reduce the costs to the public sector of assuming responsibility for low-income housing. The IRS

already assists with the production of forms and agreements in other settings.¹²⁴ Providing such technical assistance in the housing area would do much to serve low-income Americans.

Fourth, the federal government should absorb the costs of administering the allocation of the credits. Although HUD should have been given this responsibility initially, now that the states are operating this bureaucracy, they should be reimbursed by the federal government for the administrative costs, rather than be permitted to pass them along to the developers in the form of application fees and commissions.

Fifth, Congress should act now to extend the authorizing legislation for the tax credit, and to allow for full carryforward of the credits. As they consider projects in 1988 and 1989, investors must feel secure that the credit will be available to them. Uncertainty is possibly the greatest barrier to future investment in low-income housing.¹²⁵

Sixth, the passive loss rules should be relaxed to allow individuals to achieve further tax benefits for investing in low-income housing. Individuals with incomes over \$200,000 are searching for ways to shelter their incomes; by opening this particular market, substantial revenue could be channeled into low-income housing. In addition to raising the maximum eligible income, the \$25,000 set-aside should be increased. This relief would lower the costs of generating needed revenue by decreasing the need for public offerings. Developers have identified this reform as a priority and are currently lobbying for such passive loss amendments.¹²⁶

Seventh, shortening the period of time over which the credit is taken also would make the incentive more attractive to developers. Investors have been wary of contributing funds to a project that requires them to wait a decade to achieve the return of these funds. The tax credit would be more palatable to private investors if the credit could be taken over five years, the period of time that they generally pay into the development, rather than the 10-year period provided by current law.¹²⁷

124. For example, the IRS helps nonprofits attain tax exempt status. Tax Exempt Status for Your Organization, IRS Publication No. 553 (rev. July 1985). Also, the Treasury Department has drafted sample pension plans that qualify for preferential tax treatment; TRA directed the Treasury to draft necessary amendments. Tax Reform Act § 1140(B).

125. Stogel interview, *supra* note 99.

126. *Id.*

127. Letter to John Sheiner, staff of the U.S. Congress, Joint Committee on Taxation, from Steve Stogel, Apr. 30, 1987 (copy on file with Yale L. & Pol'y Rev.).

Low-Income Housing Tax Credit

Finally, the tax credit should be refundable. The IRS should pay a nonprofit organization the excess of the allowable credit over the entity's tax liability. This innovation remedies the inefficiency of transferring tax benefits by allowing the taxpayer to receive the full amount of the subsidy, even if the taxpayer is without sufficient or any tax liability. The only credit currently refundable is the Earned Income Credit,¹²⁸ which was intended to exempt low-income individuals from the Social Security tax.¹²⁹ For fear of revenue loss, Congress has been resistant to extending the concept of refundability to other tax preferences. However, such a reform could significantly improve the targeting of tax benefits to those who are responsible for the development of low-income housing.

VIII. Tax Incentives as a Housing Policy—A Long-Term View

In addition to making short-term revisions to the tax credit, Congress needs to examine the wisdom of relying on tax subsidies, rather than on direct subsidies, to promote the development of low-income housing. For maximum impact, federal housing policy should be directed to assist those in need of affordable housing. A coherent Congressional debate on federal housing expenditures should include an assessment of the costs and benefits associated with every subsidy program.

Such a cost-benefit analysis reveals the inefficiency of the LIHTC. For every dollar of tax credit lost from the federal fisc, only about \$.50 will be contributed for low-income housing.¹³⁰ This disparity is common to real estate syndications. A 1977 Congressional Budget Office Report concluded:

Only about half of what the tax shelter subsidy costs the government in lost revenue, however, ever reaches builders and developers. The remainder goes in the form of payments to the outside investors for the use of their money, and in fees to the syndicators, lawyers, and accountants who are needed to put together and sell the tax shelter package.¹³¹

128. I.R.C. § 32 (1986).

129. S. Surrey & P. McDaniel, *supra* note 47, at 110.

130. Telephone Interview with Richard Goldstein, Lane & Edson (Feb. 9, 1988). For a discussion of the inefficiency of tax subsidies, see generally, Note, Multi-family Housing Bonds: Can the Tax Code Provide an Efficient and Effective Low Income Housing Program?, 5 Va. Tax Rev. 497 (1986).

131. Cong. Budget Off., Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives xiv (May 1977).

The report calculated that 44.5% of the total subsidy went to builders and developers, 7.4% to syndicators, and 48.1% to outside investors.¹³² Developers, syndicators, and lawyers stand to profit from preparing tax credit deals. These profits divert needed funding from the beneficiaries of the subsidy program—the low-income person.

This analysis should not imply that low-income individuals do not receive any benefits from tax subsidies to developers. Repealing tax preferences for low-income housing will detrimentally affect low-income persons as well as syndicators. "Thus, an elimination of tax provisions that reduce income taxes on rents from low and moderate income housing is likely to be reflected partially in higher rentals, thereby producing a burden distribution quite different from that suggested by the official estimates."¹³³ Although elimination of tax expenditures will undoubtedly affect rent levels, the substitution of a more direct incentive would optimize the use of federal funds and target benefits to the group in need.

The choice between the two funding methods has been shaped by political considerations. Not until the Congressional Budget Act of 1974 were estimates of tax expenditures included in the federal budget.¹³⁴ But this Act did not subject tax expenditures to the same budgetary procedures as were imposed on direct outlays. Mandated budget targets apply only to direct outlays, not to tax expenditures. Likewise, the Emergency Deficit Control Act of 1985, which imposes mandatory spending reductions to control the magnitude of the federal deficit, applies only to direct outlays.¹³⁵ Tax expenditures receive preferential treatment in the budget process.

This separation of tax expenditures from the annual budget process partially explains the Congressional impetus to adopt tax subsidies for housing even though they are less cost-effective than are direct outlays. Moreover, policymakers wrongly perceive tax expenditures as less expensive, simpler to administer, and more consistent with the American capitalism.¹³⁶ For some, "[t]ax

132. *Id.* at 10.

133. Graetz, *Assessing the Distributional Effects of Income Tax Revision: Some Lessons from Incidence Analysis*, 4 J. Legal Stud. 351, 365-66 (1975).

134. S. Surrey & P. McDaniel, *supra* note 47, at 1. *See generally* Congressional Budget and Impoundment Act of 1974, Pub. L. No. 93-344, 88 Stat. 298 (codified at 2 U.S.C. §§ 621-661 (1985)).

135. Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177, 99 Stat. 1063 (codified at 2 U.S.C. § 901 (1985)). Note that *Bowsher v. Synar*, 106 S. Ct. 3181 (1986) held unconstitutional a section of the statute that delegates to the Comptroller General the responsibility for implementing the budget reductions.

136. S. Surrey & P. McDaniel, *supra* note 47, at 99-102.

Low-Income Housing Tax Credit

expenditures have proven consistent with the ideology of free enterprise and individual initiative.”¹³⁷ Further, some legislators, like Senator Packwood, believe that tax expenditures result in less bureaucracy—the “absence of red tape” rationale.¹³⁸ Given the extensive bureaucracy that will be required to administer the LIHTC, this view is misguided.

The political debate is also disjointed by the fact that different committees in both the House and the Senate consider taxes and the budget. Internal discussion is exacerbated, and political struggles only fragment the selection of expenditure method. Without reform, we will continue to have a fiscal policy that tolerates the slashing of government outlays for low-income housing and community development programs while preserving tax benefits for such luxury items as vacation homes.¹³⁹ Only by considering the entire federal budget at the same table can Congress can begin to allocate scarce resources more rationally.

The political biases that affect the selection of the subsidy program ignore the actual economic differences between the direct subsidies and tax subsidies. Financial assistance through tax subsidies does not reach certain types of recipients, such as tax-exempt organizations and others that do not have taxable income. Only if the effect of the tax subsidy is equivalent to that under a direct outlay system should Congress consider the incentive programs as interchangeable.

The refundable taxable credit is equivalent to the direct subsidy. As discussed above,¹⁴⁰ refundability requires the government to pay taxpayers the amount of the credit that exceeds tax liability; for a nonprofit corporation, this refund would constitute the entire credit.¹⁴¹ If a nonprofit entity could raise equity from the government, it would not need to undertake the costs of syndication. More housing could be produced with less revenue loss to the government.

Enactment of this reform would remove the economic disparity between the effects of direct and tax subsidy approaches. Without reform, direct subsidies continue to be more efficient and effective

137. *Id.* at 101 (citing Haveman, *Tax Expenditures—Spending Money without Expenditures*, 9 *Nat'l J.* 1908 (Dec. 10, 1977)).

138. *Id.* at 101.

139. Sheppard, *Our Lopsided Federal Housing Tax Policy Analyzed by National League of Cities and Price Waterhouse*, 27 *Tax Notes* 233 (Apr. 15, 1985).

140. *See* text accompanying notes 128-29.

141. To be equivalent to a direct subsidy, this credit should be also included in taxable income. S. Surrey & P. McDaniel, *supra* note 47, at 110-11.

at providing financial assistance to the developer of low-income housing. Poorly designed tax incentives, like the LIHTC, will always be inferior to a direct subsidy alternative.

Conclusion

The low-income housing tax credit will help a few developers make ends meet, especially those already in the business of producing low-rent units. However, the credit will not encourage enough private developers to build affordable housing to fill the void left by the federal government's relinquishing the field. The private sector will not assume responsibility for providing affordable housing for the homeless until low-income housing becomes a more profitable industry. Therefore, reform efforts must again focus on the government.

An appropriate federal response may include a mix of private and public ownership and maintenance of housing units. But any private sector participation in meeting the need requires that the federal government provide generous subsidies, assure monitoring of the quality of housing produced, and facilitate the development of projects by presenting technical, financial, and legal expertise.

The problem of homelessness is not dissipating. The shortage of affordable housing will continue to increase into the 21st century.¹⁴² Congress must act now to appropriate funding for needed programs and to design workable incentives for the private sector. The Administration must support these critical government expenditures. Otherwise, the rhetoric of privatization merely serves as a smoke-screen for a deficit reduction plan that deprives low-income Americans of affordable housing.

142. Clay, *supra* note 24, at 4.