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The Low-Income Housing Tax Credit as an Aid to Housing Finance: How Well Has It Worked?

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Abstract

The Low-Income Housing Tax Credit program has been operating for over 10 years and has helped finance thousands of developments with units set aside for low- or moderate-income households. However, the program has been criticized for requiring additional layers of subsidy to leverage investment and for providing benefits to developers in excess of the amount necessary to induce them to invest.

An analysis of a sample of developments from Missouri finds that the tax credits are syndicated, with virtually all of the syndication proceeds (about 33 percent of the financing) used to pay for development costs. Conventional lending provides another 44 percent of the financing. Unfortunately, because these sources do not cover all of the costs, developers enter into a complex, costly process of layering additional subsidies, one on top of another, to fully finance the development.

Keywords: Low-income housing; Rental housing; Tax policy

Introduction

The Low-Income Housing Tax Credit (LIHTC) program, which is now over 10 years old, has become the nation's primary mechanism for encouraging the production of housing to be occupied by low- or moderate-income households (Wallace 1995). Efforts are being made to expand and improve on this program to make it more efficient and effective.

The program has been viewed as both a success and a failure. It has been a success in that it has generated many rental housing units that are now occupied by low- and moderate-income households. Although estimates vary, the program has contributed to the rehabilitation or construction of somewhere between 500,000 and 900,000 units (Cummings and DiPasquale 1999; Ernst & Young 1997). This success has been attributed to the program's flexibility. Units have been built across the country, in a variety of markets and serving a broad range of housing needs (Abt Associates, Inc. 1996; Cummings and DiPasquale 1999; Ernst & Young 1997; U.S. General Accounting Office [GAO] 1997). However, those who argue that the program is overly complex and poorly designed to serve the needs of low-income households view it as a failure (Stegman 1991). In addition, it has been criticized for giving excessive subsidies to investors, beyond what is required to induce them to develop the properties (Case 1991).

The research reported here addresses these criticisms. Using a sample of projects developed in Missouri during the first 10 years of the program, it is possible to determine the complexity involved in financing these projects. Specifically, what are the public and private sources of financing? Do the proceeds from the syndication of the tax credits get invested in the property or do they benefit the developer? What are the other sources of equity? Why are additional layers of subsidy needed to make these projects financially feasible?

Review of the program

The intent of the program is to provide enough incentives to ensure that there will be an adequate supply of low-income housing (Guggenheim 1994) by granting tax credits to the owners of selected rental housing developed for occupancy by low- or moderate-income households. Although the subsidy is provided entirely through the federal tax code, it is administered through state government agencies, generally the state housing finance agency. States may allocate these tax credits annually up to a total equaling $1.25 per capita.[1]

The program is discretionary; the subsidy is not given as an entitlement to all housing developments occupied by low- or moderate-income rental households. Rather, proposed developments are selected by the state administrative agency through a competitive process. Winners must develop their project, either through new construction or rehabilitation of an existing property. When the property is occupied, the program begins to grant tax credits against the tax liability of the property owners over a 10-year period, provided that the units maintain restricted-income occupancy for at least 15 years.

Since 1989, occupancy by low- or moderate-income households must be pledged for 30 years, but after 15 years, the owners of the development may notify the state administrative agency of an intention to convert the development to market-rate operation. If within 1 year of receiving this notice, the state agency cannot find a buyer willing to pay a price determined by statutory formula and willing to maintain the property in income-restricted occupancy, then the property may be converted to market-rate operation. If it is converted, however, the tenants at the time of conversion must be held harmless for a period of 3 years. This means that the guarantee of low- or moderate-income occupancy may run for no more than 15 to 18 years, but could run for as long as 30 years.[2]

[1] States may be able to allocate credits in excess of this amount, since they may receive credits from a national pool generated from credits recalled from states unable to use their full allocation.

[2] Many states call for developers to make income-restricted occupancy commitments of longer than 30 years, some for as long as 50 years.

The development's owners may claim credits only against units occupied by income-eligible households. No credits may be claimed unless either of the following conditions is met:

1. At least 20 percent of the units are occupied by households whose income is less than 50 percent of the metropolitan area's median family income, or
2. At least 40 percent of the units are occupied by households whose income is less than 60 percent of the metropolitan area's median family income

The developer must choose to meet one of these two standards before the housing begins operations.

Annual credits are granted against the costs of the buildings, site improvements, and equipment, which comprise most development expenses other than land cost. Credits are in the amount of about 9 percent of the depreciable costs of the new construction or substantial rehabilitation performed and about 4 percent of the acquisition cost. These amounts are approximate and are adjusted monthly by the government to maintain the present value of the 10 years of credits at 70 percent of the cost of new construction or substantial rehabilitation and 30 percent of the acquisition cost. The present value is calculated using a discount rate determined by the U.S. Department of the Treasury.

Credits of 9 percent are granted only against costs that are not funded through federal subsidies over and above the tax credits. These additional federal subsidies are generally found in the form of publicly assisted financing—for example, funding by the state's housing finance agency. If the development receives tax-exempt financing, then the 9 percent credit rate drops to 4 percent. In addition, if the development benefits from a grant provided through federal sources, such as the HOME program, then the basis against which the credit is applied must be reduced by the amount of the grant.

Rents on the units against which credits are claimed must be determined according to affordability standards set for the metropolitan area. These rents are based on what a family could afford if it paid 30 percent of its income for housing, including contract rent plus tenant-paid utility expenses. These rents vary with the number of bedrooms in the unit. What is important to note is that the allowed rents are based on metropolitan household income and expense criteria, not the income or utility expenses of the actual tenant residing in the unit. As a result, the program does not guarantee that an individual tenant household will not have to pay more than 30 percent of its income for rent, only that the rent will be held down to a level considered affordable by standards within the metropolitan area.

Adherence is enforced by the state administrative agency, which is also called on to periodically inspect the physical condition of the units and to review the process through which property managers certify the tenant household's income eligibility. If the development is failing to comply with any of the program's provisions, then a notice of noncompliance may be issued. If noncompliance becomes sufficiently severe, tax credits may be recaptured and penalties imposed on the property owners.

Program implementation

While the LIHTC program has many intricacies, its implementation tends to follow a relatively standard pattern. Within each state, the administrative agency announces a round of funding. Various developers, both for-profit and nonprofit entities, prepare proposals requesting tax credits for some or all of the units. The state administrative agency selects the most meritorious developments on the basis of published criteria and awards them credits.

If a development receives an award, the developer works to arrange the necessary financing to cover construction costs and to arrange the permanent financing to pay off construction loans when the project is completed. Debt financing is placed with one or more lenders (private sector lenders, public sector lenders, or both). At the same time, the developer seeks equity financing for the project. Usually, this is secured by bringing investors into a limited partnership that will own the property. Investors will make periodic cash contributions through the construction period and, frequently, through the early years of project operation as well. Contributions are given in exchange for the tax credits received over the first 10 years of operation. In addition, the investors may pay for any or all of the other benefits of ownership, including any cash flow that may be experienced, any surplus depreciation generated by the development, and any residual value the property may have when it is sold.

The project is built and goes into operation with periodic inspection by the state administrative agency. Tenants are selected for occupancy just as they are for any other rental property, except that they must also be screened for income eligibility.

Program history

Tax Reform Act of 1986. The LIHTC program was created by the Tax Reform Act of 1986, which significantly reduced the previously generous tax benefits available to all real estate, including low-income housing. During the period leading up to passage of the act, there

was a great deal of political pressure for general tax reform. However, a coalition of housing providers and advocacy groups recognized the harm that would be done to low-income housing development if the act contained no special provisions to protect it. Case (1991) describes the response of this coalition as a "panic" leading them to push for inclusion of the hastily drawn up LIHTC program in the Tax Reform Act. The act was passed, and the program came into existence. However, it began under the cloud of a sunset provision that would kill the program in three years unless Congress extended it.

Omnibus Budget Reconciliation Act of 1989 (Public Law 101–239). This act extended the life of the LIHTC program, but only for a year. At the time this act was being debated, the problems of expiring subsidy and preserving assisted housing in low-income occupancy were at the center of the debate over assisted housing. Possibly in response to this debate, the act extended the original occupancy period for LIHTC units from 15 to 30 years. The extension was considerably weakened by a provision permitting conversion of the units to market-rate operation if no buyer willing to purchase the development and maintain its restricted-income operation could be found. The act also reduced the annual allocation of tax credits from the original amount of $1.25 per capita to $.9375 per capita.

In the wake of the investigations of U.S. Department of Housing and Urban Development (HUD) scandals and misuse of federal housing contracts, the act prohibited combining subsidy from LIHTC with subsidy from the Section 8 Moderate Rehabilitation program.

The 1989 act also recognized the special problems of developing low- and moderate-income housing in high-cost and low-income areas. Beginning with buildings placed in service in 1990, the act permitted larger tax credits for certain developments. These credits could be 30 percent larger if the development is located in either of two areas:

1. A difficult development area (DDA), a county with high construction, land, and utility costs relative to the income levels of the area, or
2. A qualifying census tract (QT), a tract where at least 50 percent of the households have an income that is less than 60 percent of the area median family income

Finally, the 1989 act began to set minimum standards for the state administrative agencies in terms of how they selected the developments that received tax credits. Housing agencies were required to give highest priority to projects with "the highest percentage of the housing credit dollar amount to be used for project costs" (Section 7108). In other words, emphasis was placed on applying the proceeds of the tax credits to the development rather than having them retained by the developer. In addition, "the housing credit dollar amount…shall

not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project" (Section 7108). This meant that agencies had to check development costs with care, ensuring that, when the credit proceeds were added to available financing, no more credits were awarded than were required to cover development costs. Clearly, Congress had become concerned that credits were not being effectively applied toward the costs of developing housing for low-income households but were being squandered to the benefit of certain very savvy developers.

1990 amendments to the tax code. Only one year after reducing the annual per capita tax credit allocation to each state, Congress restored the allocation to its original $1.25 per capita level. In addition, the LIHTC program was extended for another year.

1993 amendments to the tax code. Up to this point, the LIHTC program was making halting progress, given that the development community could not be sure of its future existence. With the 1993 act, Congress finally made the program permanent. As a result, developers could begin to prepare proposals with the knowledge that the program would survive from year to year.

1994 subsidy layering rule. The federal government continued to be concerned that the LIHTC program was not being used as effectively as possible. Through Administrative Guidelines issued by HUD, administrative agencies were required to follow new, more detailed rules in allocating tax credits. These guidelines apply only to projects receiving additional subsidies from HUD, but they set an informal standard for the review of all projects. These rules mandated a minimum contribution that each credit recipient must make to the development, ensuring that no more tax credits are awarded to any project than are necessary to fully finance it. These guidelines spelled out, in some detail, how administrative agencies must go about estimating development costs and syndication proceeds.

The guidelines also specified rules with regard to syndication fees charged to offer the tax credits to investors. Total charges may not be more than 15 percent of the total credit amount for public offerings and no more than 5 percent for private offerings. In addition, when setting the amount of credits to be awarded to an individual project, administrative agencies may not estimate syndication proceeds at less than 42 percent of the gross tax credit amount.

Program performance

The LIHTC program began slowly but gathered speed quickly. During its first year of operation, only 16 percent of the available tax credit

authority was used (Herbert and Verdier 1987). This slow start was probably due to the problems associated with the development community's learning how to use it. Now, however, in all states the tax credits are viewed as a scarce resource. Typically, many more developments are proposed in each state than can be funded (Ernst & Young 1997). Currently, the LIHTC program supports about 1,300 projects a year, for approximately 56,000 units annually (Abt Associates, Inc. 1996).

Several studies have examined the portfolio of developments generated by the LIHTC program. These studies have focused on different periods of time in the program's history. Using data obtained from a telephone survey of 50 state program administrators, Herbert and Verdier (1987) examined the first year's production, while ICF, Inc. (1991), using data received from the developers of 104 projects, looked at the first two years of the program's output. Abt Associates, Inc. (1996), employing a national survey that obtained data from 47 of the 54 states and other agencies administering the program, recently examined program production from 1990 through 1994.[3] The GAO (1997) surveyed a nationwide sample of 423 projects placed in service from 1992 through 1994. Cummings and DiPasquale (1999) obtained data from four national tax credit syndicators on 2,554 properties nationwide. These different studies, plus others, found several common patterns in the types of developments produced by the program.

Income mixing

Mixed-income housing is not being produced in great numbers through the LIHTC program. Rather, the vast majority of the developments tend to be fully covered, with tax credits applied to all of the units.

The program probably intended to promote mixed-income housing, since it incorporated minimum requirements that envisioned the mixing of income-restricted units with market-rate units. The program made the minimum requirements less stringent for those developments serving low-income households (below 50 percent of area median family income) than for those serving moderate-income households (below 60 percent of area median family income). No tax credits can be claimed unless at least 20 percent of the units are set aside for low-income occupants or at least 40 percent are set aside for moderate-income occupants. This minimum requirement suggests that the program intended for developers to set aside some, but not all, of the units in a development for income-eligible households, leaving the remainder to be offered at market rates.

[3] Each state administers the program, plus there are separate agencies for Chicago, the District of Columbia, Puerto Rico, and the Virgin Islands.

Unfortunately, these minimum requirements did not prove to be the decisive factor in developers' calculations. Rather than responding to these minimums, developers looked at operating costs, such as higher management costs with low-income occupancy, and at the rewards offered for any level of program participation. Thus, if tax credits helped the developer create units where the financing would not otherwise be available, the developer would seek tax credits for all of the units, not just some of them. In addition, the program did not provide additional incentives to serve low-income rather than moderate-income households. The benefits derived from the tax credits are identical for low- and moderate-income units. However, allowed rents are higher for units designated for moderate-income households. Thus, designation for moderate-income occupancy brings in more income and the same amount of tax credits, making it very much preferred for low-income occupancy. As a result, units have been designated almost exclusively for moderate-income households.

Construction type and project size

New construction has been favored over rehabilitation. About 60 percent of all LIHTC units have been developed through new construction and the remainder through rehabilitation. Since tax credits are greater for newly constructed units, this is not surprising. While the actual construction costs of either new construction or substantial rehabilitation enjoy the same 9 percent credit rate, the nonland acquisition costs of a development earn only a 4 percent credit rate. Because all rehabilitation projects involve purchasing an existing building, this portion of the total development costs receives a smaller tax credit, making rehabilitation a less favorably treated form of construction.

Independent of construction type, developments tend to be small to medium-sized projects. In the early years, developments averaged about 28 to 30 units each. Now, the average size has grown to 42 units.

Market location

LIHTC units are distributed between metropolitan and nonmetropolitan areas in roughly the proportions found for the population as a whole. About 80 percent of the assisted units are located in metropolitan areas. Among all LIHTC units, 54 percent are located in central cities, 26 percent in suburban areas, and only 20 percent in rural settings. About 37 percent of the projects are located in DDAs or QTs. Given that DDAs and QTs cannot make up more than 20 percent of a jurisdiction's area, the added incentives to build in these high-cost and low-income areas seem to be having some effect, since developments seem to be disproportionately located there.

Developments also tend to be directed toward areas with high concentrations of racial minorities. About one-third of LIHTC units (34 percent) are located in areas with more than 50 percent minority concentrations, and almost one-half (46 percent) are in areas with more than 30 percent minority concentrations.

Typically, LIHTC properties are located in areas with high concentrations of poor households. Among all LIHTC units, 38 percent are located in neighborhoods where the median household income is below 60 percent of the area median family income, while another 26 percent are located in neighborhoods where the median household income is between 60 and 80 percent of the area median family income. While this appears to be targeting units to areas with concentrations of poor households, Nelson (1994) points out that the program is generally producing units with rents that only moderate-income households can afford. Thus, the program may be "creaming" those with the highest incomes in the eligible population and not reaching the households most in need of assistance. However, sample data used by Ernst & Young (1997) suggest that the LIHTC program is in fact serving the poor, with the average tenant's income at 45 percent of the area median family income.[4] The GAO (1997) study finds that three-quarters of the households in LIHTC units have incomes below 50 percent of the area median family income. Unfortunately, little more is known about these households beyond income. For example, their employment status and sources of income are not recorded in any of the studies published to date.

Rents for LIHTC units generally run between $350 and $500 a month. In their sample, Cummings and DiPasquale (1999) found an average rent of $436 in 1996. While this compares favorably with new-to-the-market units in market-rate developments, it is well above the rents found in various forms of subsidized housing. For example, Stegman (1991) found that rents charged for units in public housing run between $100 and $150. Not only are the rents in LIHTC units higher than those found in other subsidized housing, but the LIHTC units that are being produced tend to expand a segment of the rental housing market that may not be in short supply. HUD's own research finds that all regions of the nation have surpluses of units in the rent ranges households with 40 to 80 percent of area median family income can afford. Further, all regions except the Northeast have increasing vacancy rates in this price range (Nelson 1994).

[4] This particular sample includes only tenants not receiving additional rental assistance. Tenants with additional rental assistance tend to be much poorer, with an average income at 23 percent of area median family income (Ernst & Young 1997).

Development by nonprofit sponsors

Increasingly, nonprofit developers have been the sponsors of the housing projects receiving tax credits. In the early years of the program, about 9 percent of the developments had nonprofit sponsors. This has recently risen to about 24 percent (Abt Associates, Inc. 1996). While this is only about one-fourth of the developments that receive tax credits, the program has become a mainstay for nonprofit community development corporations (CDCs). A national survey finds that 94 percent of CDCs use tax credits (Walker 1993). This survey went on to note that, relative to for-profit developers, nonprofit CDCs tend to take on projects in high-cost, low-income areas. Thus, the risk of failure for these projects is high, but CDCs are committed to the location despite the high risk. However, the combination of high-cost locations and very poor tenant populations means that nonprofit developers must often cut corners to achieve financial feasibility. Such projects are often undercapitalized, leading to difficulties after only a few years of operation.

Summary of program performance

The tax credit program appears to have been absorbed into the rental housing development process, but it has not been adopted by market-rate housing developers. Rather, it has been adopted by either non-profit CDCs or by specialized developers building projects entirely dedicated to low- or moderate-income occupancy. The units are going into largely metropolitan markets containing heavy concentrations of poor, minority households but rents are being charged that make the units affordable to only those poor households with the highest incomes in these areas.

Financing

The LIHTC program has been criticized for being excessive in that it grants large subsidies to developers. Case (1991) calculated that the LIHTC program offers the equivalent of a 54 percent grant to developers.[5] This, Case claims, represents an increase in the rewards granted to low-income housing over previous eras of the tax code. The increase has overshot the mark, granting more subsidy than necessary. The program has also been criticized as being convoluted and irrational. Stegman (1991) has pointed out that it makes little sense

[5] This amount is the present value of the tax credits granted. Discounted at 10.6 percent, each $10,000 of tax credits offered to developers over the 10-year period is worth about $5,400 to the government during the year the credit was awarded.

to design a housing program where the poorer the income group served, the more complicated and costly it is to arrange the financing.

The research reported here finds that although the first criticism may have had some validity in the past, the systems put into place to prevent excessive profits from being realized from the LIHTC program seem to be working. Virtually all syndication proceeds are now being applied toward project costs, and excessive profits for developers have been squeezed out of the process. Unfortunately, however, this research suggests that the second criticism is very much on target. The LIHTC program fails to reach deep enough to make projects serving very poor households financially feasible. These developments must pursue the lengthy and expensive process of layering subsidies, one on top of another, until total development costs are covered.

The data for this research come from the Missouri Housing Development Commission (MHDC), which is the state's housing finance agency. In addition to its traditional role in operating multifamily and single-family loan programs, MHDC administers the LIHTC program in the state. The agency has made data available on its portfolio of developments that have received tax credits. The database is an improvement over the national databases mentioned earlier in that more is known about the sources of each project's financing. In addition, this sample covers the full 10 years of program operation, rather than the few years covered in several of the other studies. This span permits a more accurate assessment of the leverage capabilities of the LIHTC program, as well as the many other resources that developers tapped to bring their projects to fruition over the decade that the program has been in operation.

MHDC has participated in the LIHTC program since its inception, so the agency has had a decade of experience in administering it. Through 1996, MHDC allocated tax credits to more than 19,000 units in over 900 projects ranging from single-family dwellings to very large multifamily developments with hundreds of units. The projects are spread statewide but are predominantly found in the metropolitan areas of St. Louis and Kansas City and, to a lesser extent, in the Springfield area in the south-central portion of the state.

MHDC allocates credits to about 2,000 units a year in approximately 70 projects.[6] (See table 1.) These credits are currently worth about $6.7 million a year and are spread across a broad range of markets, ranging from inner-city slum areas to middle-income suburban areas to extremely low-density rural communities.

[6] These figures include only those units given credits from the state's annual allocation of tax credits. Additional units receive tax credits exempt from the annual allocation because they are existing developments using tax-exempt financing.

Table 1. **Projects, Units, and Tax Credits Allocated, 1987 through 1996, MHDC**

Year	Units	Projects	Federal Credit Amount ($)
1987	1,048	72	1,863,173
1988	2,946	82	5,503,491
1989	3,004	179	5,464,731
1990	1,075	106	3,126,555
1991	2,613	134	4,529,623
1992	884	67	2,337,165
1993	1,909	67	6,321,799
1994	2,488	78	8,182,202
1995	1,800	66	7,209,225
1996	1,996	55	6,732,283

Source: MHDC.
Note: The counts include only projects receiving tax credits from Missouri's annual allocation from the current year or carried over from previous years. No projects that use tax-exempt financing and received tax credits outside of the annual allocation are included.

MHDC is a good source of data in that it is in many ways typical of most administrative agencies. The total portfolio of developments that have received tax credits is very similar to the national database developed from the national survey by Abt Associates, Inc. (1996). Table 2 indicates that the projects awarded tax credits by MHDC are comparable to projects nationwide. Although somewhat smaller on average, the MHDC projects are distributed over central cities, suburbs, and rural areas in approximately the same proportions as the national portfolio. Through its Qualified Allocation Plan, MHDC seems to favor rehabilitation over new construction more than is found nationally. However, the distribution of MHDC projects according to market levels of poverty and concentrations of racial minorities are on a par with the national database.

MHDC differs from most agencies administering the LIHTC program in that it administers a state-funded tax credit program as well. Rather than operating independent of the federal programs, the Missouri tax credit program is used to augment it. State tax credits have been awarded to developments since 1992. Initially, they were awarded in the amount of 20 percent of the federal tax credit. This increased to 40 percent in 1994 and may now go as high as 100 percent.

State credits are awarded to all developments that can demonstrate a need for additional financial resources in order to make a project financially feasible. State tax credits operate the same way as federal tax credits. They are syndicated to investors subject to Missouri income tax. As with any other source of financing, the proceeds of this syndication are applied to cover the costs of the development. MHDC

Table 2. **Characteristics of Low-Income Housing Tax Credit Projects: Comparing Missouri Projects with the National Sample**

Characteristic of Developments	MHDC	National Sample
Average project size (units)	14	42
Percentage of developments with tax credits applied to all units in the project	92%	98%
Percentage of developments built through new construction	47%	61%
Percentage of developments in		
Central cities	60%	54%
Suburban areas	27%	26%
Rural areas	13%	20%
Mean percentage of the population below the poverty level in the tract	33%	32%
Mean percentage of the population in a racial minority in the tract	49%	40%
Percentage of developments in DDAs or QTs	41%	41%

Source: MHDC data and Abt Associates, Inc., 1996.

staff review all proposals for state tax credits the same way they review proposals for federal tax credits. Not only must each proposal demonstrate a need for the subsidy, but each must also demonstrate that the amount requested is not in excess of the sum necessary to make the project financially feasible.

A sample of 142 developments, including projects granted tax credits beginning in 1987 and running through 1995, was selected from the MHDC's entire portfolio. The sample was drawn in a stratified manner to reflect the total portfolio of developments in terms of location in the state, development size, and the year the tax credits were awarded. Cost certification documents were obtained for all developments. These documents disclose the form of ownership (to distinguish nonprofit from for-profit sponsors), the sources of debt financing (conventional loans, public sector loans, and grants), and the amount of the syndication proceeds applied toward the financing (and, in some cases, the amount of syndication fees paid). These data were merged with information on total development costs, location, and unit counts to form the database for this research.

Findings

What do projects receive from syndicating tax credits, and what does this cost?

Because the LIHTC program provides tax benefits to the owners of developments rather than providing a direct capital contribution toward building the development, some mechanism must be put in place to translate the tax benefits received over time into ready cash when construction begins. Syndication is that mechanism, and it is a complex one.

Investors make cash contributions to the development based on the tax benefits they receive. The amount of the contribution made at the time the development is built is less than the value of the tax credits. The amount of the discount is a function of the amount of time that passes between making the investment and receiving the tax credits as a return on that investment as well as the risk inherent in it (McClure 1990). The investment is made at the beginning of the construction period, which may take a year or more, while the tax credits begin to flow only after the project begins operations. There is no certainty that the development will be a success. If it fails to meet LIHTC program requirements or if it is a financial failure, the investor could lose the money or could have some responsibility to provide further resources. As a result of the time and risk involved in investing in low-income housing, the discount rate associated with syndication has been fairly high. Fortunately, very few projects awarded credits through MHDC have ever failed, and these tend to be very small projects (two to four units each) that encountered management problems.

Prior experience. John M. Ols Jr., director, Housing and Community Development Issues, GAO, testified to Congress on the discount rate applied to tax credits as part of the syndication process and stated that, for a sample of developments, developers typically receive investor contributions equal to about 43 percent of the tax credit amount paid out over the 10-year period (Ols 1990). This translates into a discount rate of about 19 percent. However, he found the variation in the discount rate to be fairly wide, ranging from a low of 10 percent to a high of 22 percent. The data did not permit detailed analysis of the variation, but higher risk seemed to be associated with developments built for family occupancy versus elderly occupancy, projects built through rehabilitation rather than new construction, and projects built in urban areas rather than suburban or rural ones. The Cummings and DiPasquale study (1999) found that the tax credit program had improved over time. For their sample of projects, the syndication proceeds were 47 percent of the tax credit allocation in 1987 but had risen to 55 percent in 1994.

The syndication process itself incurs costs as well. The firms that market tax credits to investors must be paid a fee for their services; this fee contributes to the discount between the gross amount of the tax credits and the amount of the net syndication proceeds the development receives. For publicly offered syndications, the fees averaged about 27 percent of the gross syndication proceeds in 1990 (Ols 1990). These fees also ranged widely, from 17 to 34 percent in Ols's sample and from 20 to 30 percent in a later study by Wallace (1995). Ernst & Young (1997) find that these fees have now fallen to less than 10 percent.

MHDC experience. Syndication plays an important role in financing MHDC developments. In the sample of developments, net syndication proceeds as a percentage of the total credit amount averaged about 47 percent over all years. There has been a slow upward trend in this figure over time. (See table 3.) The early years of the program (1987 to 1989) saw average net proceeds of 42 to 45 percent. This figure peaked at 53 percent in 1994 but fell again to 45 percent in 1995. However, MHDC now analyzes proposals for developments, estimating net syndication proceeds to be 52 percent of the gross credit amount, and routinely sees estimates in excess of 60 percent. A net proceeds amount of 60 percent translates into a discount rate of about 11 percent by the investor.

Table 3. **Net Syndication Proceeds as a Percentage of Total Federal Credit Amount, 1987 through 1995, MHDC LIHTC Developments**

Year	Average (%)
1987	42
1988	45
1989	43
1990	48
1991	47
1992	46
1993	47
1994	53
1995	45
All Years	47

Source: MHDC.

It is important to note that the 60 cents on the tax-credit dollar received through syndication proceeds often represents more than just the sale of the tax credits. Rather, it is the net amount received after a variety of benefits and costs have been factored into the transaction. On the benefits side, the investor receives the tax credits each year for the first 10 years of operation. In addition, the investor may be purchasing an interest in some share of any cash flow or surplus

depreciation deductions the project may generate after paying all other expenses. Finally, the investor may be purchasing some share of the residual value of the property if it is sold and generates a profit.

On the cost side, syndication proceeds will be reduced by the amount of the fees charged by the syndicator for structuring the investment. In addition, the syndicator may make a bridge loan to the development so that all the syndication proceeds are available at construction, well before the syndicator receives any contributions. Investors usually make their capital contributions over a period of years. However, because developers typically need all of the capital before construction begins, they must often take out a bridge loan to be repaid by the investors' capital contributions as they are received. Frequently, the syndicator provides the bridge loan, charging interest and fees for this service (Thorne-Thompson 1994). Such arrangements make it relatively difficult to separate out the exact amount of syndication fees paid, independent of the costs of the bridge loan. Thus, the 60 cents on the dollar represents the end payment after all of these items have been factored in. Few developments reported adequately on all of these factors. As a result, it is not clear how much of the increase in net syndication proceeds is due to decreases in the market's assessment of the risk associated with purchasing tax credits and how much is investment in expected cash flow, depreciation, or residual value.

Only a small portion of the developments in the MHDC sample fully disclosed the amount of syndication fees paid. Because syndication arrangements were very complex, it is doubtful that developments were willfully concealing any information. However, for those that did provide complete reports, the average amount of syndication fees paid was 25 percent of the total credit amount. These fees ranged from a low of 15 percent to a high of 44 percent. However, during 1994 and 1995, fees have consistently averaged 15 percent.

Have syndication proceeds gone to the developer or the development?

The net syndication proceeds from the federal tax credits amounted to about 33 percent of total development costs for developments not financed through the Farmer's Home Administration (FmHA).[7] (See table 4.) There is no apparent trend in this average figure: It has been relatively constant over time. This 33 percent of total development costs figure may be low, however. A few developments reported

[7] FmHA provided below-market interest rate financing to developments. This program was suspended in 1995 when the FmHA became the Rural Housing Service.

net syndication proceeds that appear to be very low. It is possible that these developments received more from syndication than was reported. They may have simply reported the amount pledged to the development. However, all of them were in the early years of the program, before tighter controls on the use of syndication proceeds were in place. If these suspect numbers are omitted, the net syndication proceeds are barely more than one-third of total development costs.

Table 4. **Percentage of Total Development Costs by Type of Financing**

	Non–FmHA Primary Lender			All Non–FmHA Projects	FmHA Projects
	Private	MHDC	Other		
Debt financing					
First mortgage	41.8%	31.0%	58.6%	39.9%	78.6%
Private subordinate	1.9%	5.4%	0.0%	2.7%	0.0%
Public subordinate	17.1%	23.8%	0.0%	18.1%	0.0%
Equity financing					
Syndication, federal credits	31.2%	36.9%	41.3%	32.9%	17.3%
Syndication, state credits	4.6%	1.0%	0.0%	3.6%	1.7%
Cash and other equity	3.4%	1.9%	0.1%	2.9%	2.4%
Total development costs	100.0%	100.0%	100.0%	100.0%	100.0%
Number of developments	81	26	4	111	31

Source: MHDC.
Note: Columns may not sum to 100 because of rounding.

Those projects receiving FmHA financing received 4 percent tax credits, rather than the standard 9 percent, because they are federally financed. As a result, their syndication proceeds are commensurately lower, averaging 17 percent of total development costs.

Net syndication proceeds are generally pledged to the development. They become a form of equity contribution by the ownership toward financing the development. For the vast majority of projects, owners applied all of the syndication proceeds toward the project's financing. In fact, when added to the various loans, additional equity contributions were still required with most projects. As a result, developers were not able to look to tax credits as a form of profit. Rather, they used the proceeds as one of many sources of financing. They had to look to developer's fees or management fees received as repayment for their efforts. In many cases, even developer's fees were waived in order to make the development feasible. This was especially true with nonprofit developers.

Although the proceeds from tax credits directly capitalized rental housing for most projects, some of the developments were overfinanced. For a few projects, the sum of various loans leveraged plus

the net syndication proceeds exceeded total development costs. Where this is the case, it is possible for a developer to pocket some of the syndication proceeds as a form of excess profit. This was true for 14 of the 142 sample developments, or about 10 percent of the portfolio. This small subset of developments did not appear to consist of any one type of project. Some had only conventional financing; some had subsidized financing. Some were located in rural areas, and some were metropolitan.

Before 1990, there were no guidelines on applying syndication proceeds toward project costs. Safeguards are now in place to prevent excessive allocation of tax credits and to ensure that all proceeds are applied toward the costs of completing the project. If a project is given an initial allocation that proves, on completion, to provide more syndication proceeds than are needed, the allocation of tax credits can be reduced.

What is the role of conventional financing?

Conventional financing was used in 81 of the 142 developments (57 percent). The remaining 43 percent relied entirely on public sector financing. Conventional financing was the only form used for 39 of the 142 developments (27 percent). Thus, almost three-quarters of the developments had to seek some level of financing from public sources.

Why were private lenders and investors unwilling to provide the necessary funds, which, when added to the syndication proceeds, would be enough to develop the project? The answer frequently offered is that the rents for LIHTC projects are too low to support the debt. This simple analysis is not adequate. Comparing the loss of debt leverage from program participation with the gain in syndication proceeds from receiving tax credits shows them to be about the same.

Private sector developments typically have 70 percent debt financing and 30 percent equity financing (Hess and Skinner 1997). The average loan-to-value ratio for the subset of developments that received conventional loans was 42 percent, clearly well below the 70 percent industry average. However, if setting the units aside for low- or moderate-income occupancy brings in syndication proceeds worth about 30 percent of the total development costs, then the reduction in the amount of debt financing from 70 percent to 42 percent would appear to be acceptable. Syndication proceeds would simply offset the reduced loan amount. Unfortunately, the problem is not so simple. Equity investors, who would normally finance about 30 percent of the total development costs in a market-rate development, will turn away from a LIHTC development. While investors are willing to purchase tax credits through syndication, they are no longer willing

to invest in the housing itself for the simple reason that the property is unlikely to generate an adequate return on investment.

One of the impacts of the long-term occupancy requirements is that the development cannot be sold, refinanced, and renovated periodically as is common with market-rate developments. Rather, the LIHTC property must remain in low- or moderate-income occupancy for anywhere from 15 to 30 years. This means that investors treat the property as having little or no residual value at the end of this period (Ernst & Young 1997; Thorne-Thompson 1994). As a result, investors see little opportunity for repayment of their investment from the appreciation of the value of the property. Also, the developments generally operate at or close to a breakeven level, generating little or no cash flow. Thus, investors see little opportunity for repayment of their investment from operating the property. Instead, to provide a return on their investment, investors must look to tax credits alone, not the cash flow from or the residual value of the property.

The result is that using LIHTC not only reduces rents below market levels, which reduces the ability to leverage conventional debt financing, but it reduces the developer's ability to raise equity. The developer can expect to receive loans from conventional lenders and the proceeds from syndication of the tax credits. If these two sources do not cover the full cost of developing the project, additional subsidies will be necessary. As table 4 suggests, conventional lenders reduce their loans from 70 percent of total development costs to about 44 percent for LIHTC projects. Equity investors reduce their participation from about 30 percent to only 3 percent. Thus, available financing is reduced by a total of 53 percent, while the proceeds from syndication generate only about 31 percent, leaving 22 percent of project costs to be financed through various layers of subsidy over and above the federal tax credit.

What is the role of additional layers of subsidy?

Only 15 percent of the developments had syndication proceeds from federal tax credits as the only form of subsidy. Put another way, only 15 percent of the developments were able to finance all development costs through conventional loans and the proceeds of syndicating federal tax credits alone. The remaining 85 percent of the developments had at least one additional layer of subsidy over and above the federal tax credit.

Most developments had several layers of subsidy, with two and three layers being the most common. About 35 percent of the projects had two layers, and 33 percent had three. In this layering, federal tax credits were counted as one layer, state tax credits as another, and

grants or loans from any public entity were each counted as additional layers. The average number of layers was 2.6, which compares favorably with the North Carolina experience, where the average was five layers (Stegman 1991).

The Missouri state tax credit generated anywhere from 1 to 8 percent of total development costs, depending on the amount of credits awarded. Among only those projects that were privately financed and received Missouri state tax credits, the proceeds from syndication averaged just under 5 percent of total development costs.

If the development is in a high-cost area or an area with extremely low levels of household income, the LIHTC program grants an increased basis against which credits can be claimed. This mechanism was an attempt to avoid the need for excessive layering of subsidies. The goal was to grant more tax credit subsidy where the situation warranted it, thus reducing the need for additional subsidies. The experience in Missouri with the DDAs and QTs did not reduce the need for additional layers. Of the projects located in DDAs or QTs, 92 percent had additional layers over and above the increased tax credits available to them because of their location. This is even higher than the 85 percent found among all developments.

The MHDC experience with nonprofit developers is also instructive. Compared with for-profit developers, nonprofit developers were able to cover more of their project's total development costs through syndication. Nonprofit developers obtained 37.3 percent of project costs through syndication, compared with 30.5 percent among for-profit developers. This higher level of syndication was experienced despite the perceived risk associated with the more difficult projects taken on by nonprofit developers. This risk is found in the lower loan-to-value ratios among conventionally financed developments. The conventional loans of for-profit developers averaged 50.4 percent of total development costs, while nonprofit developers were able to leverage only 22.7 percent. Despite the higher risk, nonprofit developers were able to gain just as many, if not more, housing resources out of the tax credits awarded to them.

Conclusion

Efficiency of the tax credit

It has been established that the tax credit is a very inefficient subsidy delivery mechanism (Stegman 1991). If the federal government grants tax credits of $1,000 ($100 a year for 10 years), then the present value of these credits to the government is about $780, discounting at

the government's long-term cost of borrowing.[8] When evaluating tax credits as an investment, however, investors employ an even greater discount rate, found here to be about 11 percent. This means that the $780 of housing subsidy from the government will produce only $590 in housing. Clearly this is a significant loss of value (about 24 percent) from the use of tax credits as the vehicle to deliver the housing subsidy. However, it is doubtful that the most efficient mechanism for providing government aid to the development of low-income housing—a capital grant—will be adopted in lieu of tax credits. If the tax credit mechanism is here to stay, its continued implementation needs to find all possible efficiencies.

Efficiency of syndication process

Assuming that the tax credit is to continue, is it becoming more efficient? The net syndication proceeds being realized by developments are going up as a percentage of total tax credits allocated. However, net syndication cannot increase much more. The improvements found in the past 10 years reflect a maturation of the LIHTC program. Investors have come to know and understand it, and syndicators have streamlined the process. This has brought greater efficiency to the tax credit program. A lower risk factor is being applied to investment in tax credits, and a lower percentage of the proceeds is consumed in fees. However, it seems unlikely that the discount being applied to tax credits can be pushed much lower. The current 11 percent discount rate is comparable to the performance of alternative investments with similar risk. If the return falls much lower, it seems doubtful that investors will move much capital into low-income housing tax credits and away from other investments. Syndication fees have been pushed down to less than 10 percent, and, again, it seems unlikely that they can go much lower. As a result, the 50 to 60 percent net proceeds being realized by developers from the tax credits are probably about as high as can be expected. Further efficiencies are being squeezed out of the process by selling surplus depreciation, cash flow, and residual value. This has raised syndication proceeds to 60 percent of the tax credit amount. While this is beneficial to developments, additional syndication proceeds are available only to those developments in markets capable of generating strong cash flows or high residual values. It is doubtful that these higher syndication proceeds will eliminate the need for additional layers of subsidy in most developments.

The increased efficiency is also found in the level of demand for tax credits. Table 1 lists the amount of tax credits allocated to projects from 1987 through 1996. What the table shows is that from 1993 on,

[8] In November 1998, U.S. Treasury 10-year notes were trading at 4.86 percent.

the state of Missouri has been able to award its entire $6.7 million dollar allocation of tax credits and exceed it by awarding unused tax credits carried over from previous years.

Excessive rewards to developers

In general, proceeds from the syndication of tax credits are applied toward financing the developments, and safeguards are in place to prevent their diversion into developers' hands. The contention that the tax credit program provides excessive grants to developers was true for only a small fraction of projects in the early years of the program.

Fixed credit rate

If the program is not providing windfall profits to developers and has become more efficient over time, why do so many developments have to seek out multiple layers of subsidy? The answer seems to be found in the fixed credit rate applicable to all projects. The property owner realizes the tax credit over a long period. However, it is not a subsidy to the operation of the property. Few rental housing developments generate any large amount of cash flow from operations that could be sheltered from taxation by a tax credit. This is especially true of developments with rents below market-rate levels. These developments frequently struggle just to break even. As a result, the tax credit is only very rarely a benefit to operations. Rather, it must be translated, through syndication, into a form of financing to cover the initial costs of development, just like any other loan or grant. It is here that the fixed credit rate (9 percent on most developments) becomes a problem.

For developments located in markets where the rents permitted in LIHTC units are close to market rate and where construction and development costs are relatively low, the 9 percent credit rate may be more than enough to make a project financially feasible. The net syndication proceeds combined with conventional financing may cover more than the total development costs. In these cases, so as not to waste scarce federal subsidies, the state administering agency must prevent the developer from pocketing any surplus syndication proceeds. However, where the rents in the LIHTC units are low and where construction and development costs are high (a combination found in most inner-city markets), the 9 percent credit rate is not enough to make a project financially feasible. Even if all the syndication proceeds are applied toward financing, the project is unable to secure all of the needed funds from conventional lenders. Such developments must seek out additional forms of financing, which usually means multiple layers of subsidized financing. This seems to be true for all but a few developments.

Attempts have been made to add more flexibility to the process by increasing the subsidy to developments in DDAs and QTs. While this is a step in the right direction, it has fallen short of providing the flexibility planners and developers need. The proceeds from syndication need to cover the shortfall between total development costs and the conventional loans available to the development. This will vary from project to project and from market to market. What is needed is a mechanism that permits planners to adjust the amount of the tax credits up or down. If planners had the flexibility to award higher credit amounts to more worthy developments, then layers of additional subsidy could be removed. If these credit amounts were enough to cover the shortfall between total development costs and conventional loan and equity amounts, the developers could be freed from the burden of chasing additional layers of subsidy to finance their projects. Given this flexibility, the agencies that administer the LIHTC program could use their ability to award different credit amounts to make developers address a range of housing needs. The agencies could induce developers who would not otherwise include low-income units in their market-rate developments to do so. They could induce developers to target some units to the poorest of the poor instead of those who have more income. Finally, they could help developers finance meritorious developments in markets where, even with several layers of subsidy, projects are simply not feasible.

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