



**The Disruption of the Low-Income Housing Tax Credit Program:
Causes, Consequences, Responses, and Proposed Correctives**

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Joint Center for Housing Studies
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WHAT WORKS COLLABORATIVE

Building Knowledge and Sharing Solutions for Housing and Urban Policy

The *What Works Collaborative* is a foundation-supported research partnership that conducts timely research and analysis to help inform the implementation of a forward-looking housing and urban policy agenda. The Collaborative consists of researchers from the Brookings Institution's Metropolitan Policy Program, Harvard University's Joint Center for Housing Studies, New York University's Furman Center for Real Estate and Urban Policy, and the Urban Institute's Center for Metropolitan Housing and Communities, as well as other researchers and policy experts. The Annie E. Casey Foundation, Ford Foundation, Kresge Foundation, John D. and Catherine T. MacArthur Foundation, Rockefeller Foundation, and Surdna Foundation provide funding to support the Collaborative.

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EXECUTIVE SUMMARY

As a result of the credit market meltdown, the Low-Income Housing Tax Credit (LIHTC) program, the nation's primary mechanism for producing and preserving affordable rental housing, was severely disrupted in 2008 and 2009. When the corporate investors on which the program relied—primarily large, national banks and Fannie Mae and Freddie Mac—swung from profitability to loss and could no longer use tax credits, demand for LIHTCs plummeted. As a result, the price of LIHTCs fell, creating funding gaps in projects that had received tax credit allocations in 2007 and 2008 but had not yet sold them. Thousands of projects and tens of thousands of units that would have otherwise been bought or rehabilitated stalled. It is important to recognize that the LIHTC crisis is due to a drop in investor demand in the wake of the worst financial crisis since the Great Depression, not with the performance of the program to date in delivering affordable housing at a very low loss rate.

In February 2009, the government created two programs as part of the American Recovery and Reinvestment Act—the Tax Credit Assistance Program (TCAP) and the Tax Credit Exchange Program (Exchange)—to address the absence of LIHTC private investment capital. TCAP was intended to provide gap financing for projects, and Exchange was designed to offset the drop in tax credit demand and pricing.

This paper examines the experience to date with these two stopgap measures. Its purpose is to assess whether TCAP and Exchange are effective and sufficient or if additional actions may be necessary to mitigate the vulnerabilities in the LIHTC program exposed by the recent financial crisis. The main finding of the report is that more needs to be done and that longer term issues surrounding investor demand must be addressed.

TCAP and Exchange were not intended to revive demand or improve the market price of tax credits. Indeed, demand and pricing for the tax credits remained seriously depressed in many markets in the fourth quarter of 2009. Bringing demand back will likely require: (1) a market workaround (such as a viable secondary market) that could be challenging to develop and would not be implemented quickly, (2) legislative solutions to one or both of two aspects of the tax

code (passive loss rules and the 10-year use and 15-year compliance period of the tax credit) that inhibit demand and result in lower tax credit pricing, and/or (3) an expansion of the Community Reinvestment Act (CRA) that provides regulatory as well as financial motivation for financial institutions to invest in tax credits.

The following summary of findings is based on interviews with over two dozen industry experts, a review of analysis conducted by others, and a focus session with leading stakeholders to discuss the current situation and assess several proposals for reform.

Salient Features of the LIHTC Program and the Investor Base

Understanding the challenges the LIHTC program faces and the prospects for improvement rests on grasping the following features of the program.

- **The LIHTC program depends on the sale of tax credits to private investors.** The LIHTC program is able to deliver apartments at rents affordable (at 30 percent of income) to households with low incomes (at or below 60 percent of area median) by selling tax credits to investors and using the net proceeds of the sale to reduce the debt the property must support.
- **The LIHTC program enjoys widespread support because it has been successful across the country and minimizes taxpayer exposure to failure.** Throughout the program's 23-year history, its default experience has been low by multifamily rental standards and extremely low relative to previous subsidy programs. This history includes a period of national rent deflation in the first part of the 1990s and rising rental vacancy rates in the wake of the 2001 recession. When properties do fail, the program rules require recapturing a fraction of the tax credits from private investors so taxpayers do not pay for affordable housing services that are not delivered. Typically, the property is transferred to new owners who restore it to financial viability and compliance. Taxpayer protections, low default rates, and allocation of credits on a per capita basis to all states have led to widespread support of the LIHTC program in Congress.

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- **Private capital drives excellent program performance.** Everyone we spoke with suggested that a key reason for the LIHTC program’s success was that private investors had significant capital at risk. “Having skin in the game” encourages investors to underwrite carefully and step in to support properties in temporary trouble to avoid recapture events. As discussed below, the investors which performed LIHTC underwriting this decade are sophisticated multifamily real estate investors with the best access to market information and the greatest ability to underwrite private capital investment.
 - **Passive loss rules and the long investment horizon of the tax credit, as well as its tie to the performance of residential real estate, narrows the investor base.** Although the LIHTC program initially relied on individual investors, passive loss limitations quickly shifted the investor base to widely held corporations that are allowed to use the credits and depreciation expenses generated by tax credit projects to offset their incomes. The same passive loss rules that made individual investment unattractive also limited the participation of sub-chapter S and closely held C corporations and other pass-through entities. Tax credit prices were initially low enough and yields high enough to attract some nonfinancial corporate investors without experience in real estate. The program, however, is designed so that tax credits are taken in each of 10 years from when a property is placed in service and compliance is maintained for 15 years from that date. Most corporate investors are reluctant to make such a long-term investment because they cannot dependably forecast their tax liability that far in advance. In addition, compliance requires that project sponsors maintain tenant income limits, adhere to rent restrictions, and make debt payments. Over time, therefore, large financial institutions with experience making long-term investments have been willing to bid more for the credit than other investors.
 - **Uneven regulation of financial institutions caused the LIHTC program to migrate to investors willing to pay the most for the tax credit and accept a below market return.** Not only did the investor base migrate to financial institutions best able to underwrite real estate investments and accustomed to longer-term investments, but also to those willing to bid the most for the credits. The financial institutions willing to accept low returns had more than just tax planning and financial reasons to invest.

Specifically, banks were motivated to buy LIHTCs in areas where they had branch operations to boost their scores on Community Reinvestment Act (CRA) examinations. Large banks tend to aim for higher CRA ratings and, therefore, had a special motivation to invest in tax credits. Fannie Mae and Freddie Mac were also willing to accept lower yields to satisfy mission regulators and because they are restricted to earnings from residential assets.

- **Tax credit pricing in the first half of the decade discounted recapture and tax liability risks.** By the mid-2000s, the height of the housing bubble, average prices for tax credits implied yields in only the low to mid-single digits. At such low yields (comparable to risk-free 10-year Treasuries), investors were clearly discounting both real estate risk and tax liability risk (the risk of not owing enough taxes to use the tax credits as planned). Though tax credits can be carried back for one year and forward for up to 20 years, pushing potential tax benefits forward into the future makes them much less valuable in the present to investors, especially when they also have net operating losses and foreign tax payments to carry forward.
- **The staging of capital in LIHTC projects left the nation's affordable rental production and preservation system vulnerable to a downward repricing of tax credits.** Developers (also called project sponsors) typically line up other forms of financing before receiving—let alone pricing—tax credit allocations. This left the system vulnerable to falling tax credit prices, causing financing gaps relative to pro forma expectations.
- **When demand from the existing investor base fell, areas without large banks concerned with CRA compliance faced especially severe disruption.** When Fannie Mae and Freddie Mac could no longer use the tax credits and withdrew from the market, large banks were the only significant source of tax credit investment left. These large banks concentrated on a limited number of large metropolitan areas where they were competing for CRA credit. Other places saw much lower, if any, bids for their tax credits. The departure of Fannie Mae and Freddie Mac meant that as much as 40 percent of the investment in tax credits according to some estimates evaporated nationally, and in small metropolitan and rural areas investment fell by much more. The falloff in demand drove tax credit prices down to the high 70 to low 80 cent range in the most competitive markets for tax credits and to

around the low 60 cent range or lower elsewhere. Average yields appear to have increased from a low of about four percent to nearly 10 percent in 2009. In 2009, though, the range of yields widened and the average price was biased upward by the fact that most tax credit investment was by a limited number of banks operating in only a small number of mostly large and coastal metropolitan areas. Outside these areas yields are well above average and prices well below average.

- **Making changes to the LIHTC program takes time because the federal government and more than 50 allocating and administering agencies must interpret and implement rule changes.** Another widely viewed strength of the LIHTC program is that it is allocated and administered primarily through state housing finance agencies and a few local housing finance agencies. This provides for local oversight and keeps the program sensitive to local needs and politically popular. It also means that when there are program changes, each allocating agency must develop a process for implementing and remaining in compliance with the new rules. With the creation of two new programs in February 2009, state housing finance agencies began planning their implementation while simultaneously anticipating necessary program guidance from the Department of Housing and Urban Development (HUD) and the U.S. Treasury. It would inevitably take at least several months before the guidance was issued and the allocating agencies could respond to it and reach a point where funds could be deployed.
- **Absent additional legislative action or the formation of a liquid secondary market, neither tax credit demand nor tax credit pricing is likely to return to mid-2000s levels any time soon.** Fannie Mae and Freddie Mac have no reason to return to the tax credit market because their losses are so great that they can already offset future taxes for many years to come. The same holds true for the large banks that remain in the market primarily to comply with CRA, and even this source of investment for new projects is at risk. In fact, existing owners without current tax liability have a powerful incentive to sell their tax credit investments to capture residual value. New investors must become comfortable with the long investment horizons of tax credits and will demand either high yields or some form of guaranteed return. Meanwhile, the current tax code discourages

individuals and closely held corporations from investing in LIHTCs because they cannot offset active income with credits and depreciation from these properties. This means tax credit prices, even if new investors can be found, will remain far below the levels reached before the financial crisis.

Operation and Effectiveness of the TCAP and Exchange Programs

The express aim of both the Tax Credit Assistance Program and the Tax Credit Exchange Program was to help ensure funding was available in sufficient volume to allow shovel-ready projects in the pipeline with 2007 and 2008 allocations and projects with 2009 allocations to proceed. While both stopgap measures were slow to start, investors and project sponsors increasingly report using the two programs successfully. While it is too soon to tell how much of the stranded pipeline will be cleared, funds are starting to flow. The following assessment reflects industry experts' perceptions of effectiveness to date.

- **Of the two programs, TCAP triggers greater additional compliance requirements.** Because TCAP funds are appropriated through the Department of Housing and Urban Development, TCAP projects must comply with many additional federal rules such as requirements for environmental review. LIHTC- and Exchange-funded projects do not have these requirements because they are provisions of the federal tax code. These additional requirements add to both delays and costs. There does not appear to be any way around this problem because of the funding mechanism for TCAP.
- **Allocating agencies had to take on new responsibilities and risks while ensuring compliance with new program rules.** For properties funded by Exchange without private capital, agencies have had to assume additional responsibilities for asset management and for recapturing funds in the case of noncompliance. Moreover, TCAP requires that agencies assume construction period risk and take responsibility for monitoring compliance with federal assistance requirements.

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- **Tighter credit terms add to project financing gaps.** Financing gaps are being caused not only by the drop in tax credit pricing but also by tightening credit terms. Changing debt markets have compounded the financing problems for project sponsors. Lenders are demanding more equity protection and tighter credit terms, including lower maximum loan-to-value ratios and higher interest rates.
 - **Exchange pricing may be inhibiting the return of tax credit demand in places where market prices are significantly lower.** In markets where tax credit bids are low, the 85 cents offered by the Exchange program is a powerful incentive for allocating agencies to swap larger shares of unused credits and fund projects with little or no limited partner capital. It is possible, therefore, that Exchange pricing may be forcing some investors out of the tax credit market rather than bringing them in at market prices.
 - **Even so, Exchange funds are critical to plugging funding gaps in places with low tax credit demand and may still prove insufficient to meet the need.** Demand for tax credits has reportedly fallen so sharply and debt financing become so costly in many areas that the TCAP and Exchange programs may be insufficient to fund the pending projects as well as new activity in 2009. The Exchange program was reportedly set at 40 percent of the 2009 allocation to make up for the exit of Fannie Mae and Freddie Mac. However, the 40 percent figure is applied pro-rata to all allocating agencies even though the withdrawal of Fannie Mae and Freddie Mac meant the loss of far more than 40 percent in areas without significant presence of CRA-oriented investors and far less in other areas. Indeed, New York and a handful of other states have so far refused Exchange funding, and instead have focused on using TCAP alone to plug gaps.
 - **Some aided properties may have little or no private capital, raising questions about asset management.** Reports that projects are being funded with little or no limited partner capital raise concerns that asset management may be weaker than when private investors have significant capital at risk of recapture. Several respondents even reported that some lenders might refuse to lend to such transactions. Others stated that suitable third-party

asset managers could be found, lenders under such circumstances would be satisfied, and that several states are already in discussions with such managers.

- **Disruption of the tax credit program damages many parts of the affordable rental housing delivery system.** Many respondents reported knowing project sponsors and syndicators that failed, were reorganized, could barely hold on, or sought to sell their investments in an effort to survive. In addition, the slowdown in activity reduced developer and syndicator fee income, jeopardizing their ability to temporarily support troubled LIHTC properties and resulting in layoffs of highly specialized staff.
- **The failure to extend Exchange to four percent tax credits makes it especially challenging to recapitalize affordable housing.** The four percent tax credit is used to fund the acquisition and moderate rehabilitation of rental housing. These credits are awarded outside the normal competitive allocation process by states to projects receiving tax-exempt bond financing according to a process laid out in states' Qualified Allocation Plans.
- **Opportunities to buy distressed unsubsidized housing at discounts are being lost because of the weak demand for tax credits.** Several people commented that with the Low-Income Housing Tax Credit market in such disarray, the nation may miss a rare opportunity to buy high-quality, older market-rate housing in good locations at a discount and add those units to the affordable rental inventory.

Proposed Policy Options

A number of policy options to reignite demand for low income housing tax credits have been advanced. Of the following, the three signed on to by a wide range of organizations are the five-year carryback, changes to passive loss rules to allow owners of pass-through entities and closely held corporations to offset revenue with tax credit investments, and the extension of the Exchange program through 2010 and its application to four percent credits.

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- **The most efficient way to bring the mid-2000s investor base back to the market is to shorten the investment horizon and restore the value of the credit to firms without tax liabilities in any given year.** There are three principal ways to accomplish this while maintaining long-term recapture and affordability restrictions on tax credit properties: (1) make LIHTCs refundable, (2) extend the carryback of the credit from one to five years or more, and (3) allow Fannie Mae and Freddie Mac and TARP recipients to use their credits to offset dividend payments owed to the Treasury. The most powerful option would be to make the LIHTC refundable so that owners of LIHTCs could submit for a dollar for dollar tax refund even if they do not have tax liability in that year. Failing that, extending the carryback to five years would help revive a substantial share of demand, although the measure would probably not be enough to bring Fannie Mae and Freddie Mac back to the market given the efficiency of their tax planning in prior years. Supplementing the carryback extension by granting Fannie Mae, Freddie Mac, and TARP recipients the ability to use LIHTCs to repay dividends owed to the Treasury would be sufficient for these companies to make use of the tax credits they already own and more. Extending the carryback would accelerate when tax credits are taken and therefore cost the federal government more upfront. The same would apply if Fannie Mae and Freddie Mac were permitted to accelerate the use of their tax credits to offset dividend payments or if the Treasury purchased tax credits directly. Because the federal budget process typically assumes that almost all tax credits will eventually be used and does not discount future expenditures, these proposals would have a far lower net cost to the government over a 10-year period.
 - **Broadening the investor base would provide another way to revive demand.** Making the tax credit refundable or extending the carryback would shorten the tax planning horizon and likely bring new investors to the market. Short of these measures, there are two ways way to broaden the investor base: 1) selectively relax passive loss rules and 2) expand the coverage of CRA. Because these two proposals would affect the distribution rather than the volume of tax credit expenditure, they would have minimal federal budget impact. The key proposal circulating now with respect to easing passive loss limitations would allow partnerships, Limited Liability Corporations, S corporations (pass-through entities) and closely held corporations of a particular scale to offset revenue with tax credit investment

before passing through income and losses to their individual owners. This approach has been advanced as a way to attract investment to rural areas where equity capital is less available. Syndicating projects to smaller corporations, however, would likely entail marginally higher syndication fees, reducing the net proceeds to tax credit properties. Another way to broaden the investor base would be to expand the Community Reinvestment Act to cover financial institutions other than banks so that they, too, have a reason to invest—and perhaps at high prices like CRA banks. Another possibility is to allow CRA credit for loans and investments in underserved areas outside banks’ assessment areas. In any of these cases, absent a shortening of the period over which a tax credit is taken, pricing is likely to be much lower than if the period were shortened. In addition, the question of whether or not to expand CRA is part of a much wider debate that is already playing out in Congress, and the impact of CRA on the LIHTC program is a small part of that wider debate.

- **Creating a viable secondary market could shorten the investment horizon for the LIHTC and expand demand without legislative action.** A liquid secondary market would allow investors to offset as little as one year’s worth of tax liabilities by selling the tax credit investment at the end of a year. Because tax credits are at risk of recapture if a property falls out of compliance, a secondary market would be facilitated if the financial institutions that originally underwrote the investment provided some form of guarantee against recapture. For example, some firms with capital at risk and the ability to make good on a guarantee could assure investors that they would receive a predetermined yield if a property becomes noncompliant. In addition, a trading platform and standardization of documents, financial structures, and underwriting would likely be required. In the short run, trading of existing tax credits might suppress demand for new allocations, though it could also increase demand for them by removing tax liability risk.
- **Extending the current stopgap measures could help to address funding shortfalls, but doing so would neither improve pricing nor bring back demand.** To help clear the pipeline of stalled projects and provide funding at 85 cents or another amount on the dollar for some portion of 2010 and/or 2011 allocations, the Exchange and/or the TCAP programs could be extended for a year or two. Now that they are up and running,

the programs should operate much more efficiently. These two measures, however, do not address the underlying issue of low tax credit demand and poor pricing. In fact, the Exchange program may even add to the problem by imposing an artificially high price on tax credits in many markets. Of the two measures, the Exchange is far more likely to be extended because it is reportedly nearly budget neutral, with current funding replacing future tax credit expenditure. TCAP is a supplemental appropriation that is not offset by a future reduction in LIHTC expenditure.

- **Expanding the Exchange program to include four percent tax credits could help recapitalize expiring use subsidized housing.** The Exchange program applies only to nine percent tax credits, which support new construction and the rehabilitation of affordable housing without the aid of other federal subsidies. The program excludes four percent tax credits, granted noncompetitively if a property uses tax-exempt bond financing. As a result, preservation activity using this source of funds has ground to a near halt. In instances where allocating agencies have elected to support preservation projects, they have had to draw heavily on nine percent credits and limited TCAP or local sources of funds. A quick way to provide more funds to recapitalize expiring use subsidized housing would be to expand the Exchange program to include all four percent tax credit projects in 2010 or unused tax credits from 2008 and 2009. The program cost would be capped because private activity bonds are capped. Though this would increase the size of the Exchange program, whether the change was seen as an additional cost to the government would depend on how the proposal was scored in the budget process. In all likelihood, it would also be seen as nearly budget neutral.
- **With special access to the LIHTC program, the Public-Private Investment Program (PPIP) could be used to transfer ownership of distressed market-rate housing to mission-motivated entities.** Although markets for both tax credits and real estate assets remain roiled, there are important opportunities to purchase good-quality housing at discounted prices to expand the affordable supply. One way to seize the moment would be for some investment funds to apply for the PPIP program and for Congress to dedicate a stream of nine percent tax credits or Exchange funds for approved projects. Since the PPIP entails underwriting on the equity side by the Treasury and on the

debt issuance side by the FDIC, taxpayers would have an added layer of protection against failure. This proposal would, however, entail significant administrative and rule changes in the LIHTC program, neither of which could be accomplished quickly, especially given the complexity of the tax credit program.

THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM: CAUSES, CONSEQUENCES, RESPONSES, AND PROPOSED CORRECTIVES

The Low-Income Housing Tax Credit (LIHTC) program is widely regarded as the most successful affordable housing production and preservation program in the nation's history. Since its inception in 1986, the program has provided financing for more than 1.7 million affordable rental units, and in recent years it has generated about 120,000 affordable units annually.¹

The LIHTC program gained broad bipartisan support because every state has successfully used the tax credits to produce and preserve affordable rental housing. As a federal program with funding awarded on a per capita basis, it enjoys Congressional support among those representing both the nation's most and least expensive housing markets. At the national level, the standardization of tax credits allows for efficiency in syndication and investment. The LIHTC program has successfully harnessed the discipline and incentives of private markets for public purposes and has served as an engine for decentralized and locally responsive policymaking. State tax credit allocation agencies ensure that public policy objectives are met, while investors in tax credits screen projects based on economic criteria. Even in rare cases when projects fail, the US Treasury recaptures significant amounts of tax credits, so taxpayers do not pay for affordable housing services promised but not delivered. In fact, the threat of recapture motivates limited partner investors to force changes in an affordable rental property's financial structure and operations to restore compliance, up to and including the replacement of the general partner/project sponsor.

While some lament the tendency for market-based pricing to result in less than one dollar's worth of tax credit directly supporting projects, most see the sale of tax credits at a discount as worthwhile because it buys a level of market discipline, oversight, and accountability. The long record of low default rates is seen as evidence of the value of this method of delivering affordable rental housing. According to a survey by Ernst & Young, the annual foreclosure rate for tax credit properties from 2000 to 2005 was under 0.1 percent, well below the rate for other

¹ HUD Low-Income Housing Tax Credit database, www.huduser.org.

real estate asset classes.² The principal complaint against the design of the LIHTC program is that it is not deeply targeted enough, failing to make rental housing affordable to those with the greatest need—extremely low-income households earning 30 percent or less of area medians. States are required to target the lowest income households in their allocation plans, but additional subsidies are usually required for LIHTC properties to remain financially viable while serving the neediest households. Some counter that the best way to serve this population is either through rental vouchers or a separate and more tailored production and preservation program.

The principal findings of this report are:

- 1.** The LIHTC program is widely regarded as the most successful federal program for the production and preservation of rental housing affordable to low income households. The keys to its success are seen as: (a) the devolution of the allocation and administration of the credits to state and a few local agencies; (b) the commitment of private capital with a stake in the success of the properties and the wherewithal to manage assets across periods of temporary economic stress; and (c) the fact that taxpayers, as a result of recapture provisions imposed on private capital, do not pay for failure. The current problem attracting investors—both because they need to be comfortable with long-term real estate investments and have some certainty around future tax liability at this time of economic stress—must not be confused with the success of the program in terms of its low default rates and “pay-for-success-only” design.
- 2.** The TCAP and Exchange programs were critical stopgaps that, while taking time to get up and running, will likely succeed in funding a substantial portion of the backlog. Even though the two programs should be sufficient to deal with 2007 and 2008 pipeline projects and 2009 allocations in certain areas (mostly large metropolitan areas with large banks assessed for community investment performance where demand did not fall as much), they may not be enough to fund the backlog and new 2009 projects in other areas.
- 3.** TCAP and Exchange were *not* aimed at restoring investor demand for the tax credit. Instead, they were conceived as stopgap measures until demand for the LIHTC could be restored.

² Ernst & Young LLP, “Understanding the Dynamics IV: Housing Tax Credit Investment Performance,” June 2007.

Additional actions will be necessary to restore demand now that the traditional sources cannot use the tax credits they have and all investors are sensitized to the risk of not having sufficient tax liability to use the LIHTC over its long 10-year use period.

4. Absent a legislative change or a private market solution which has yet to emerge, investor demand for the LIHTC is unlikely to catch up with supply. To both revive demand and reduce its volatility in the future, the 10-year use period must effectively be shortened and/or limitations on the deduction of passive losses must be relaxed. Otherwise, low income housing tax credits will not be competitive with other investments including business tax credits with shorter use and recapture provisions. Without addressing this problem, the investor base will remain a narrow, undiversified group of large financial institutions, unless it is served by these institutions through secondary market resale.

5. Because the large financial institutions that now make up the largest share of the investor base will not be able to utilize the tax credits they have for several years, some combination of three consensus proposals that have emerged will likely be needed to sustain the nation's primary program for the production and preservation of affordable rental housing. These three proposals are extending the carryback of low-income housing tax credits from one to five years, relaxing passive loss restrictions to allow certain existing corporations to pass through losses to individual taxpayers, and extending the Exchange program. In the long term, the idea of creating a robust secondary market for LIHTCs anchored by strong underwriter/guarantors reserved against losses could have promise but has not been sufficiently studied. Several technical issues need solving before such a secondary market could take root.

The Nature of the Problem

Until recently, pricing for the tax credit increased over time as a progressively higher share of winning bids came from large financial institutions with the economies of scale to underwrite and manage investments in such a complex program and with regulatory reasons to accept lower returns. When these investors—primarily Fannie Mae and Freddie Mac, along with large

national banks—found themselves without taxable income to offset in 2008 and 2009, however, demand for new tax credits fell sharply.

Many projects that received allocations in 2007 and 2008 were predicated on receiving a higher price for their tax credits than they were able to get by the time they tried to sell them to investors. This effectively stranded thousands of housing projects with allocations because they either could not sell their tax credits at all or could do so only at depressed prices that left large financing gaps. To make matters worse, lenders began to tighten underwriting standards and raise interest rates, adding to the subsidy gaps.

Faced with the prospect that construction or rehabilitation of more than 100,000 affordable rentals with 2007 and 2008 allocations would not proceed as planned, and with demand for 2009 tax credits well below supply, the federal government enacted two stopgap measures in February 2009 as part of the fiscal stimulus bill. The Tax Credit Assistance Program (TCAP), created to provide gap financing for projects, was a special appropriation of \$2.25 billion using HOME formulas to apportion the funds to state and local housing agencies. The Department of Housing and Urban Development (HUD) was authorized to issue guidance on how the funds could be used to support the completion of projects that had received tax credit allocations.

The second initiative, the Tax Credit Exchange Program (Exchange), was designed to help offset the drop in tax credit demand and the gaps in financing. Structured as a tax expenditure, the program authorized LIHTC allocating agencies to exchange up to 100 percent of unused 2007 and 2008 allocations and 40 percent of 2009 allocations for 85 cents on the dollar.³ The Treasury Department was authorized to issue guidance on how these funds could be used. Exchange-funded properties were subject to the same rent and income limits as LIHTC properties, and, as with the LIHTC program, states had wide latitude in deciding how to award Exchange funds to developers.

While the jury is still out on how well these programs will deal with projects stranded in the pipeline and the weak demand for 2009 tax credits, it is clear that they have taken several months

³ It is important to note that only allocated tax credits were eligible for exchange. Four percent tax credits awarded noncompetitively to tax-exempt bond financed projects could not be exchanged.

to get up and running. As a consequence, many projects that received allocations in 2007 and 2008 remained stalled late in 2009. In cases where project sponsors arranged debt financing to cover predevelopment or acquisition costs of stranded projects, those sponsors and their lenders, to the extent they specialized in tax credit projects, are under significant stress. It also appears the demand for tax credits in 2010 will again fall short of supply without further legislative action. Moreover, there is widespread concern that one or more large investors plan to sell their tax credits, potentially further disrupting the market.

To shed light on the problems facing the LIHTC program and current proposals for reform, the Joint Center for Housing Studies reviewed current analyses of the crisis; interviewed more than two dozen leaders in the low-income housing production, preservation, syndication, and investment communities; and conducted a follow-up focus session with many of these same industry experts. This research was intended to:

1. Provide context around and explanation for the turmoil in the LIHTC market.
2. Assess whether the TCAP and Exchange programs have been effective and sufficient.
3. Summarize the pros and cons of current proposals to boost tax credit demand and improve pricing.

Operation and Salient Features of the LIHTC Program

In return for capping rents at levels affordable to low-income households, state or local housing agencies allocate tax credits to developers (project sponsors). Typically, agencies award credits to about one in five competitive projects. Projects financed with tax-exempt bonds are eligible for credits outside states' allocation ceilings, subject to separate limits on private activity bonds. Annual state competitive allocation ceilings are indexed to inflation and determined by population.⁴

Tax credits for substantial rehabilitation and new construction of rental housing are worth nine percent of the eligible basis of the property annually for ten years, while those for acquisition and moderate rehabilitation of existing housing are set at roughly four percent. In the case of projects

⁴ The Housing and Economic Recovery Act of 2008 temporarily increased the state per capita allocation volume cap to \$2.20 in 2009, with a small state minimum of \$2.6 million.

that also receive tax-exempt bond financing, four percent credits are awarded to both new construction and acquisition.⁵

Since 1989, project sponsors have had to commit to keeping rents affordable for 30 years. States are prohibited from holding more than a de minimus equity position, and at the end of the affordability period, sponsors retain control of the property. Tax credit properties can be sold to new sponsors and are often recapitalized with additional tax credits, thus extending the rent restriction period. Because of the complexity of the program, developers and other parties are usually LIHTC specialists.

The LIHTC Program Relies on Private Capital

Like several business tax credits, LIHTCs are syndicated and sold to investors. Syndicators typically purchase and resell tax credit investments, charging higher upfront fees and lower ongoing asset management fees. LIHTCs are unlike many other business tax credits that offset business income without a sale to investors, however. The Low-Income Housing Tax Credit works by raising capital to reduce the amount of debt a property requires. By lowering debt service costs, the property is able to support lower rents.

Pricing for credits is set by the market and depends on both the demand for the credit relative to supply and on the return expectations of investors. Though ownership arrangements vary, typically the limited partner investors calculate their investment yield based only the value of the tax credit stream and their share of property losses, particularly depreciation. The sponsor, who maintains a minimal ownership stake, is responsible for ensuring the property generates enough cash flow for ongoing debt repayment and remains in compliance with income and rent restrictions.

Until the sharp falloff in demand, average tax credit prices (net of syndication and other fees) hovered in the high 80-cent to mid 90-cent range. According to a survey of large investors fielded by Ernst & Young, average pricing then dropped to 74 cents in 2008.⁶ In phone interviews conducted for this study, however, many respondents estimated that the volume of

⁵ For a thorough discussion of the mechanics of the LIHTC program, see Jason Korb, “The Low-Income Housing Tax Credit: HERA, ARRA and Beyond,” MIT Master’s Thesis, September 2009.

⁶ Ernst & Young LLP, “Low-Income Housing Tax Credit Survey,” October 2009.

demand for LIHTCs had fallen 40 percent from its peak by the fall of 2009 and that some projects were receiving bids in the high 50-cent to low 60-cent range or no bids at all. They noted strong geographic variability, with coastal metros receiving higher pricing than Midwestern and rural areas. Prices dropped both because of the falloff in demand and because of higher expectations of return in exchange for increased risk, as rental market conditions softened and the certainty of having taxable income diminished.

Passive Loss Rules Discourage Individual Investors

In the wake of tax shelter abuses during the 1970s and early 1980s, the Tax Reform Act of 1986 included a rule limiting individual investors from claiming losses from passive investments (including real estate) in excess of income from such activities. The passive loss rules apply to housing credit investments, with an exception that permits investors to take annual credits against income that are equivalent to \$25,000 in deductions.⁷ The prohibition also applies to pass-through entities—partnerships and S- corporations—which pass their incomes and expenses through to individual owners, and to closely held C corporations. While this does not preclude individual taxpayers and closely held corporations from investing in LIHTCs, it does mean they will have less of an appetite for the credits than widely held corporations that can make full use of the credits against their tax liability.

The Investor Base Has Narrowed to Institutions Willing to Accept Low Returns

Over its 23-year history, the LIHTC investor base has migrated from individuals purchasing tax credits for under 70 cents on the dollar, to many corporations purchasing tax credits for 75–80 cents on the dollar, and finally to large financial institutions willing to pay more than 90 cents on the dollar. In the case of banks, tax credits help institutions achieve higher grades on Community Reinvestment Act (CRA) examinations. In the case of Fannie Mae and Freddie Mac, broad pressure to meet their public goals led them to invest heavily in LIHTCs in recent years. Also, Fannie and Freddie face strict charter limitations on the businesses in which they can engage. Investing in tax credits was one of only a few avenues open to them to grow their revenues and

⁷ At a 35% tax rate the \$25,000 in loss equivalents translates into \$8,750 of eligible tax savings for the top bracket.

earnings. At pricing between 90 cents and a dollar, these investors were essentially accepting four to six percent returns for investments with considerable risk.⁸

The migration to a narrow investor base that accepted low yields not only produced the maximum amount of dollars for production and preservation of affordable rental housing from the LIHTC program, but it also put the credits in the hands of institutions best able to underwrite them and manage the capital invested. It also, however, left the program vulnerable to a sudden drop in tax credit demand from a relatively small number of financial institutions. Many estimate that Fannie Mae and Freddie Mac held about 40 percent of all funds invested in tax credits from allocation rounds earlier in this decade. This is important to grasp because moving forward it raises an important policy question, Should the federal government aim to maximize the price of the tax credit by creating regulatory requirements on a broad enough set of financial institutions to push up prices, or try to broaden the base beyond financial institutions with real estate investing and regulatory motivations to invest? Either way, the risk of being unable to use a purchased tax credit due to reported tax losses must be addressed, as is discussed in the next finding.

Tax Credits Are Subject to Long-term Recapture Provisions

Housing credit allocations entitle investors to take the credits on their tax returns in each of 10 years from the date a property is placed in service. Like other business tax credits, LIHTCs can be carried back for one year or forward for 20 years if an investor does not have enough tax liability to use the credit in a given year. To receive the full present value benefit of the credit, however, investors must have enough taxable income over the subsequent decade to use the credits on schedule.

Moreover, if investors experience net operating losses, they must use up those losses before carrying forward credits. Similarly, large corporations with foreign tax liability must use their foreign tax credits before business tax credits. Finally, financial institutions are strictly limited in the amount of deferred tax assets they can count as part of their regulatory capital. Holders of credits without current tax liability are thus likely to lose their appetite for new tax credit investment for some time into the future even after returning to profitability, and they may be

⁸ Ernst & Young, 2007.

willing to sell their existing credits at a substantial discount. The need, made manifest during the financial crisis, to project tax liability 10 years into the future thus puts downward pressure on prices and limits the pool of potential investors.

Adding to the long time horizon required for tax planning, tax credit investors are subject to recapture if the property falls out of compliance at any point over a 15-year period. Recapture events include foreclosure and failure to maintain compliance with rent restrictions and tenant income limits. After the 15 year initial compliance period, state requirements dictate that LIHTC properties must be maintained as affordable housing for a minimum of another 15-year term. Tax credit investors, therefore, must have specialized knowledge of real estate risk and confidence in the ability of project sponsors and syndicators to maintain compliance.

Private Investors Are Responsible for Asset Management

Without exception, interviewees considered the role of large private investors and large syndicators as important to achieving the program's impressively low default rates. According to a survey that covered approximately a third of tax credit investment, between 1991 and 2005 only 49 of nearly 14,000 properties were foreclosed, for an annual rate of .035 percent. In comparison, overall foreclosure rates for apartments as reported by the American Council of Life Insurers (ACLI) were about 10 times higher—and ACLI has one of the lowest loss rates of all indicators of multifamily losses.⁹ Syndicators' business models depend on attracting a steady stream of investors. As a result, both investors and syndicators have a strong interest in ensuring continued compliance. This interest creates a level of oversight and market discipline that enables state agencies to focus on allocating tax credits rather than managing them as assets.

Several Ernst & Young studies have shown that, while tax credit properties are not immune from real estate risk, project sponsors, investors, and syndicators have been able to manage that risk by stepping in when net operating income turns negative. Several interviewees expressed concerns that investors and syndicators may be less inclined to take similar actions as rental markets come under additional stress in the next year or two and more properties reach the end of their initial 15-year compliance periods. Others noted that the LIHTC program benefited until recently from

⁹ Ernst & Young, 2007.

a long period of economic expansion with rising asset values and falling interest rates, providing a financial buffer between pro forma modeling and closing that no longer exists. The history of the program, however, spans elevated rental vacancy rates in the late 1980s, a period of real rent deflation in the early 1990s, and rising rental vacancy rates and soft rents following the 2001 recession and so-called jobless recovery period. In addition, most of the people we interviewed believed that, while investment demand has faltered because of a lack of capital in the market, the financial and operational performance of affordable housing with tax credit investment is likely to continue to be excellent.

Tax Credit Allocations Are Usually Made Late in the Financing Process

One of the hallmarks of the LIHTC program is that the application for tax credits under the competitively allocated cap is usually made well after project sponsors have lined up other sources of capital.¹⁰ This is a result of the statutory requirement to consider other funding sources and only allocate the necessary amount of tax credit. While many project sponsors attempt to gain control of a site or property through an option arrangement, some procure debt financing to do so long before receiving a tax credit allocation and securing other forms of subsidy (usually soft debt). In either case, capital is committed upfront and the project is predicated on securing (a) some amount of private capital by winning a tax credit award and (b) a certain price for the credit in the case of competitive allocations or noncompetitive four percent tax credits for projects receiving tax-exempt bond financing.

If the selling price of tax credits is lower than the price anticipated in the pro forma analysis, a funding gap results. The gap is not easily filled, and often the other forms of financing already secured must be drawn down on a preset schedule. If the gap goes unfilled long enough, project sponsors must reapply or renegotiate their other capital sources, which can lead to an even larger funding gap. This aspect of the program is the reason so many properties in the pipeline with allocations found themselves with gaping holes in their financial structures when tax credit pricing plummeted.

¹⁰ This LIHTC “value chain” is well described in David Smith and Ethan Handelman, “Rethinking and Re-engineering the LIHTC Value Chain,” *Recap Update* 74, April 2009.

Multiple Agencies Allocate and Administer the Tax Credits

While the U.S. Treasury Department issues guidance on the use of the program, state agencies (and a few local agencies) allocate, administer, and monitor compliance with the tax credits.

Among other responsibilities, allocating agencies are required to issue a Qualified Allocation Plan each year that presents the criteria and the process they intend to use to make allocation decisions.

The process is competitive, and sponsors that submit proposals that earn more points have a greater chance of receiving tax credit allocations. Over time, project sponsors have learned how to work within these plans, the broader Treasury-determined rules issued by the IRS, and the interpretations of rules by specific allocating agencies. The program had reached a high degree of efficiency before investment demand plummeted and forced the creation of short-term new programs to deal with the situation. Creating two programs with new rules requiring individual state-level interpretation to deal with the current LIHTC crisis disrupted this efficiency.

Operation and Effectiveness of the Stopgap Programs

It is too early to know how well the Tax Credit Assistance and the Tax Credit Exchange Programs are operating and how many projects they will effectively serve. It is clear, however, that the process of renegotiating tax credit pricing and sorting out the best funding option for stranded pipeline projects, as well as for projects funded in whole or in part with new 2009 allocations, has added to the delay and cost of closing projects. Nevertheless, investors and project sponsors reported that the measures were starting to get projects in the pipeline “unstuck” and expressed cautious optimism that the programs will ultimately serve their intended purposes.

Many of the delays and uncertainty during the startup of TCAP and Exchange related not just to the bureaucratic cost of starting two new federal programs but to legal difficulties involved in replacing private capital in projects with grants or loans. Delays reflected the necessary care allocating agencies took to ensure they were in compliance with sometimes vague rules and guidance, which took time to get issued and were then updated or amended by the Treasury and HUD in response to issues that emerged. This process was set against strict requirements about how fast funds had to be allocated and then in turn used by project sponsors to remain in compliance.

The following findings are based on interviewees' impressions and comments by reviewers of an initial draft of this paper on how the TCAP and Exchange programs are working and problems they have encountered.

Both Programs Were Slow to Start

The TCAP and Exchange programs, enacted in February 2009, had ambitious goals to commit and deploy funds quickly. By all accounts, however, funds did not start to flow in a material way until mid-summer and not in heavy volume until the fall. HUD and the Treasury issued initial guidance for both programs in May. Not only did HUD and the Treasury have to promulgate rules for the new programs, but state allocating agencies also had to seek clarifications and additional guidance to ensure compliance before setting up their own processes. For the TCAP program, states also had to wait for HUD to approve implementation plans.

The slow start was perhaps predictable given the essential features of the LIHTC program, including its inherent complexity and its allocation and administration by multiple agencies. Even once the programs were underway, some investors and developers expressed frustration at the heterogeneous implementation across states, but they acknowledged that it was too soon for best practices to exist.

The TCAP Program Raises More Compliance Issues than the Exchange Program

The TCAP and Exchange programs are administered by different federal agencies and entail different requirements. Allocating agencies, syndicators, and project sponsors clearly felt frustrated with the rules issued under both programs and the delays in resolving problems raised by the allocating agencies and the industry. In addition, states varied in how quickly and efficiently they got the programs up and running and in the additional conditions they imposed. In some cases timing problems meant allocating agencies designed their TCAP and Exchange programs while trying to deal with legal problems and complexities which HUD and the Treasury later resolved.

Because it is an appropriation rather than a tax program, TCAP is encumbered by many additional rules. Project sponsors must comply with multiple federal requirements including the Age

Discrimination Act, Section 504 of the Rehabilitation Act, the National Environmental Policy Act, lead-based paint laws, Davis-Bacon prevailing wage laws, anti-lobbying restrictions, the Drug Free Work Place Act, and certain Office of Management and Budget circulars and regulations.

HUD required that each allocating agency submit information on the intent to accept funds, a description of the competitive selection criteria, plans to meet the tight expenditure deadlines for the use of TCAP funds, and a transparency plan. States are also required to develop affirmative fair housing marketing plans and ensure that owners follow them, as well as perform or contract for asset management functions. In some cases, the requirement that states perform environmental reviews of any project receiving TCAP funds brought construction to a halt. A further complication is that projects receiving TCAP funds must have at least a nominal amount of tax credit investment. This is not a statutory requirement but HUD has mandated it and states have been uncertain how to define “nominal.”

It is no surprise, therefore, that the TCAP program took longer to get up and running than the Exchange program. Exchange funds began to flow to the states in June 2009. Under this program, some allocating agencies requested developers applying for funds return unused 2007 and 2008 allocations without providing any guarantee they would receive any funds for each dollar of tax credit returned. In other cases states made the return of credits conditional on whether sufficient funds for a particular project could be generated. While the Exchange program cleaves more closely to existing LIHTC rules, the Treasury had to issue guidance on how to treat the funds and how to handle recapture in the event of noncompliance. Compared with the TCAP program, though, the guidelines and extra requirements for Exchange are modest.

Allocating Agencies Faced New Risks and Responsibilities

Under various terms of the two programs, allocating agencies could face additional financial risks in the case of project failure. This is a concern because state housing finance agencies have limited capital that is pledged mainly to bondholders. For example, the strong LIHTC recapture mechanism, enforced by the federal tax system, was replaced with an administrative recapture mechanism for the new sources of funds. The administrative recapture needed to be legally enforceable without displacing the rights of permanent debtholders, and the responsibility for

implementing and enforcing this administrative recapture mechanism fell primarily on the allocating agencies.

Originally the Treasury stated that all Exchange funds were to be issued as grants to project sponsors, but without the ability to place a mortgage lien, states had weaker control over Exchange-funded properties and poorer ability to intervene with troubled properties. Moreover, issuing Exchange funds as grants in some states, particularly California, triggered additional state labor and environmental review requirements. The Treasury eventually clarified that Exchange funds could be issued as forgivable loans payable in the event of a recapture event.

In the case of TCAP, allocating agencies were concerned because according to HUD rules they were liable for construction period risk, even if developers provided a guarantee. In addition, allocating agencies had the responsibility for monitoring compliance with federal assistance requirements, including conducting environmental reviews.

Tighter Credit Terms Have Added to Project Costs

While largely attributed to the drop in tax credit pricing, today's financing gaps also reflect changes in loan underwriting terms and, in the case of four percent credits, the difficulty of finding buyers for tax-exempt bonds. Permanent lenders reportedly have raised their interest rates, have been more conservative in appraising the value of properties, have widened their debt coverage ratios, and most importantly, have reduced the maximum loan-to-value ratio. Reducing the amount of debt a project can carry increases the amount of private investment capital that must be raised. The TCAP and Exchange programs, however, were sized to cover only what (at the time) was thought to be the shortfall in available tax credit investment capital due to gaps created by the dip in tax credit prices.

The Four Percent Tax Credit Market Has Been Particularly Hard Hit

Several of the people interviewed for this study noted that placing and pricing four percent tax credits have historically been more challenging than selling nine percent tax credits because the investment generates more of its return in the form of deductions (losses) rather than credits, adversely affecting reported earnings. Four percent credit deals are ineligible for the Exchange

program, however. This lack of eligibility is a major public policy concern because these credits are used to preserve subsidized housing at the end of the initial use period and other affordable units at risk of loss. For example, four percent credits were used to preserve 42,500 units in 35 states in 2007, according to a survey by the National Housing Trust.

With their large presence in affordable housing preservation, nonprofits are hit especially hard by the difficulty of attracting investors to four percent tax credits. To beat out better capitalized for-profit developers who can option properties, nonprofits are more likely to acquire site control before tax credits are sold—exposing themselves and their lenders to considerable capital risk.

Exchange Pricing May Distort Markets Where Tax Credit Demand Is Weak

Some interviewees believed that in markets not benefiting from intense competition among CRA-regulated banks, the presence of the 85-cent Exchange program for LIHTCs has kept private capital from returning. In some cases, allocating agencies have reportedly exchanged all credits in some projects, rather than accepting a far lower market price which would force them to use more of their limited TCAP resources to close financing gaps. On one hand, this impedes a rebound in the tax credit market since it is costly to underwrite investments in tax credit projects prior to bidding. (If their bids are turned down because of an artificially high Exchange price, investors will start to withdraw from the market.) On the other hand, it is a decision made by allocating agencies only after developers have made a good faith effort to attract private capital, and reflects an effort to produce and preserve as much rental housing as possible with the resources that are available.

Funds May be Insufficient to Meet Needs in States with the Lowest Demand

The repricing of tax credits and renegotiation of debt terms in places with the weakest demand for tax credits and the thinnest markets for permanent debt financing can result in large financing gaps. In certain areas, even the combination of the TCAP and Exchange programs may be insufficient to fund the pipeline. Respondents colorfully described the areas where tax credit demand fell furthest as “tax credit deserts” and “cold and coastless” states. Several interviewees thought that many of the projects in second-tier metros, rural areas, and the Midwest would not be funded despite TCAP and Exchange. At the same time, one respondent said that some

projects in higher cost markets—where tax credit pricing reached the high 90-cent range and still could not cover construction costs without a great deal of soft debt—also faced serious financing gaps when pricing dropped below 85 cents and credit terms tightened.

Some Aided Projects May Have Little or No Limited Partner Capital

While it is difficult to judge how widespread this attempt may be, some states apparently are finding that they must use some of their TCAP and Exchange funds to supplant limited partner capital. Although states are required to make efforts to maintain private investment, there are a number of circumstances under which execution without private capital is desirable and in compliance with the law. For example, if no bids are made or bids are so low that a large amount of scarce TCAP resources would be required to close the gap, allocating agencies may opt to use 100 or near-100 percent Exchange funding instead of private investor capital. The primary market constraint on this approach is whether lenders will be willing to extend permanent financing to projects with minimal or no limited partner capital.

While allocating agencies may provide or contract for asset management services, the cost of this asset management—asset management that would otherwise be performed by private investors—would be a fee charged by the states and would have to be generated through the financing structure of projects. Some respondents were concerned that third-party asset managers, while as attentive as private investors with “skin in the game,” would not have the resources to support temporary operating shortfalls in the way a private investor risking tax credit recapture would. Indeed, several expressed concern that allocating agencies will be less effective asset managers than limited partners, not only because they lack experience and expertise, but because they have less flexibility than private investors to use outside resources to keep troubled properties afloat until market conditions improve. A number of interviewees expressed concern about the possibility of a cohort of properties funded with grants rather than private capital that would experience ongoing performance problems due to the lack of private market oversight.

Impacts of the Disruption on Tax Credit Demand and Pricing

By any measure, the Low-Income Housing Tax Credit market is nowhere near peak investment levels. Pricing varies by geography and is deeply depressed in many areas. It is important to note, however, that tax credit prices remain in the high 70- to mid 80-cent range in markets where large national lenders continue to compete. The large banks appear to be staying in the market primarily for regulatory reasons and in the hope that the government will take further action to mend the markets. Should these initiatives fail to materialize, tax credit demand even in these places may fall.

There are several reasons why demand remains anemic and may continue to be so for an extended period of time.

Fannie Mae and Freddie Mac Are Unlikely to Return to the Market

Given the magnitude of losses they have suffered, the GSEs have no appetite for new tax credits. Indeed, they cannot use the tax credits they already own. It was widely reported during the fall of 2009 that both GSEs were actively seeking a sale of credits, but the Treasury failed to approve a proposed sales contract for \$2.6 billion announced by Fannie Mae in November. The Treasury stated that the loss of tax revenue to the government would be greater than the gain from the sale. This decision seems to indicate that the two GSEs, which have been under federal conservatorship since November of 2008, will not be allowed to resell their existing credits anytime soon.

Investors Are Avoiding Areas with Weak Rental Demand

Many interviewees said that without Fannie and Freddie in the LIHTC market it was difficult for them to envision a scenario where tax credit demand would revive outside large coastal metros. Some pointed out that, given the severe recession, because the LIHTC program provides a fairly shallow rent subsidy, housing investments in economically depressed areas where market rents are at or near LIHTC rents are currently seen as having significant real estate risk. Others believed that the lack of demand in rural areas, second-tier metros, and the Midwest related more to the lack of large CRA-motivated banks in those areas. The latter seemed to be the more widely held view. Several people also said there might therefore need to be a long-term alternative to

LIHTC to support affordable housing production in those areas—even though this could jeopardize political support for the LIHTC program, which depends in part on its ability to deliver benefits nationally.

Some CRA-Motivated Banks May Also Withdraw

Investors that do not expect to benefit from their tax credits for years to come have a powerful motivation to sell. Once banks return to profitability, they can use their net operating losses from previous years to offset taxes. It can be a number of years after that point before the credits have value again. While it is unclear why large banks unable to use their tax credits for the foreseeable future remain in the market, interviewees suggested these banks do so to achieve outstanding CRA scores. If this is the case, even the lower levels of existing demand for tax credits may not be sustainable.

The Duration of the Credits Discourages Potential Investors

Several interviewees reported that they were unsuccessful in persuading large nonfinancial firms to invest in housing tax credits. Respondents indicated that the chief financial officers of the large corporations they approached would not consider investments in any tax credits that extend beyond three years. While this could change if yields remain high, the duration of the tax credit is reportedly a major obstacle for investors. Indeed, the 10 year period for using the tax credits was cited as the major obstacle to attracting a larger and more diverse set of corporate investors. Many corporations reportedly will not consider investing in LIHTCs unless this obstacle is in some way resolved, either by a legislative change or a market solution.

Investors Will Demand Higher Risk Premiums

If the market disruption has driven home any one point, it is that investing in a 10-year tax credit with a 15-year recapture period entails a great deal of tax liability risk. Tax liability risk is the risk that a firm will not have enough income at some point over the 10–12 year period (not all tax credits start to flow the year an investment commitment is made) to derive value from the tax credits. Investors will almost certainly demand a much higher tax liability risk premium than they did before the financial crisis.

Even if yields rise, the difficulty of assessing recapture risk over a 15-year term creates a barrier to entry for new investors who might otherwise be attracted into the market. Recapture risk is the risk that a property will default or fall out of compliance. Though the industry as a whole has a very good record of avoiding recapture events, for those not intimately involved in the real estate business it is hard to measure recapture risk for an individual investment. Inexperienced investors must rely on third parties to measure recapture risk for them, which increases costs, and these investors are likely to demand higher returns. Moreover, all investments in real estate will likely be viewed with a jaundiced eye in the immediate future.

Other Options Are Available to Offset Taxes

Syndicated business tax credits established since the LIHTC have much shorter use and recapture periods. For example, the Wind Energy Production Tax Credit established in 1992 has a credit period of 10 years, but no provision for recapture, simplifying the resale of credits. In 2007, the market volume for this investable credit was an estimated \$5 billion. The Solar Energy Investment Tax Credit and the Historic Rehabilitation Tax Credit are one-year credits with a five-year recapture provision, while the New Markets Tax Credit program has a seven-year credit and recapture period. Together, these three credits had a market volume of \$2.5 billion in 2007.

Though these credits are currently smaller in market size than the LIHTC, and renewable energy credits have similar information-based barriers to entry, their shorter tax planning horizon makes them attractive to investors.¹¹ In addition, there are a number of tax credits that businesses can claim on their internal operations, including credits for increasing research activities and providing work opportunities for welfare recipients. The research credit is roughly equal in size to the housing tax credit, according to 2008 tax expenditure estimates by the Congressional Joint Tax Committee.¹²

¹¹ Ernst & Young, 2009.

¹² Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012," October 2008.

Impacts of the Disruption on the Low-Income Housing Industry

Most respondents said they were personally aware of individual firms that were struggling, on the brink of failure, failed, or looking to sell uncompleted projects to better capitalized players. While this kind of shakeout in the market is unsurprising, its extent and its medium- and long-term implications are still unclear.

Delays Have Resulted in Higher Costs Across the Board

The crisis and disequilibrium in the tax credit market, followed by delays in getting the TCAP and Exchange programs up and running, have been costly by all accounts. Most project sponsors and syndicators plan a certain level of activity and timeline for completion of projects, and they rely on a steady stream of fees to run their businesses. With activity down and planned activity delayed, nearly all developers and syndicators have seen revenues fall, threatening their own viability and their ability to use fee income to support deals and backstop troubled properties.

Program delays have also added to the costs of closing deals. Developers with existing allocations have had to navigate a new application process with housing agencies and in most cases renegotiate loans with the first-lien lender. Other subsidy and soft debt providers are often involved as well. In addition, project sponsors have been unable to pull invested capital out on schedule, thus hampering pursuit of other opportunities. For many, the slow start to the TCAP and Exchange programs has meant making payments for longer than expected on lines of credit or on loans for acquisition, development, and construction.

Project Sponsors Focused on Special Needs Populations Are Pressed for Capital

In a world where the supply of tax credit investment has dropped from perhaps the \$8–9 billion range to \$4–5 billion, investors are cherry-picking deals. Project sponsors focused on deep targeting, social service provision, and special needs populations may lose private capital funding or see very large drops in pricing because their deals are the most complicated and costly. Some respondents, however, pointed out that at least some allocating agencies are focused on trying to fund these projects directly with TCAP and Exchange. Nevertheless, several people interviewed for this study knew of formerly strong and viable nonprofit developers that

are now in trouble. Some respondents had been approached by nonprofits looking to sell their pipeline projects or proposing joint ventures.

Lenders Specializing in ADC Loans Are Struggling

Related to the challenges of the long delays and late staging of tax credit allocations, lenders that specialize in acquisition, development, and construction loans are at significant risk. Community Development Financial Institutions may be particularly stressed.

The Tax Credit Market Contraction Has Forced Layoffs of Specialized Staff

Most interviewees expressed concern over the damage done to the human capital invested in developing a specialized delivery system for LIHTC properties, as many in the LIHTC industry have been laid off and further layoffs hang in the balance. A few interviewees suggested that it will take several years to build back staffs with the expertise to work on tax credit transactions. Many respondents fear that this will affect the quality and quantity of tax credit developments during the recovery and undermine the nation's efforts to preserve and produce affordable rental housing.

Proposals for Longer-Term Corrective Action

There are two principal means to revive tax credit demand: (1) increase the capacity of current investors to make new investments given their tax situation, and (2) broaden the base of potential investors. A wide range of constituencies has come together in support of two consensus proposals to achieve these ends.¹³ One proposal addresses the 10-year credit period by extending the ability to carry back tax credits to offset prior income taxes from one year to five years, without changing the 15-year recapture and 30-year affordability restriction periods. The second proposal addresses the barriers to entry posed by passive losses by relaxing them for certain pass-through entities and closely held C corporations with the hope of attracting new investors, especially in rural and smaller metropolitan areas where equity capital is scarcer.

¹³ These two proposals and a third calling for extension and expansion of the Exchange program as a short-term corrective action are the product of a broad coalition of stakeholders under the banner of the Rental Housing ACTION group. The proposal to carry back tax credits for up to five years was introduced in Congress as HR 4109 in November 2009, while the other consensus proposals were still under discussion at that time.

Make LIHTCs Refundable

Perhaps the most efficient—albeit least politically popular—way to revive demand for low-income housing tax credits is to make them refundable. In this scenario, both current and future owners could exchange the tax credits, dollar for dollar, for cash from the Internal Revenue Service. This approach would make tax credits, both existing credits and new investments, instantly valuable again to the narrow class of investors that dominate the program.

It would, however, involve significant changes to the program. To maintain outside private investment in projects, project sponsors that apply for refundable tax credits would need to be restricted from using them directly. For budget scoring purposes, making the tax credit refundable would likely be neutral. From the point of view of the federal government, however, making housing tax credits refundable could move the cost of the LIHTC program from the tax expenditure category to a direct expense category similar to other government entitlements.

Refundability would arguably result in the highest prices for the tax credit, which would in turn maximize the amount of taxpayer dollars invested into affordable rental properties. It would also leave investment in the hands of the financial institutions with the greatest depth of experience in underwriting and managing residential rental assets. Moreover, it would avert the risk of current LIHTC owners selling their credits and flooding the market.

This method is politically unpopular because refundable tax credits for businesses are rare (the authors of this paper could only identify one example) and they would likely be used by many of the large financial institutions faulted for precipitating the financial crisis in the first place.

Extend the Carryback to Five Years

Under the consensus proposal, existing investors could carry back for up to five years unused low-income housing tax credits on their 2009, 2010, and 2011 income tax returns from projects that first generated credits in 2008 or before. These carrybacks would be allowed only to the extent that the investors made new LIHTC investments. Purchasers of tax credits originating after 2008 would also be able to carry the credits back for up to five years at any point during the 10-year credit stream. The permanent carryback for new credits would apply to all investors but

not require reinvestment. The proposal also calls for allowing carried back credits to offset Alternative Minimum Tax liability.

Extending the carryback from one to five years would immediately monetize existing credits, absorbing some of the current oversupply with only limited long-term budget impact. A five-year carryback for new investments would also shorten the timespan for which investors need to predict future tax liabilities, making the tax credit more attractive.

When surveyed, even some of the largest banks with the worst losses calculated that a five-year carryback would double their demand for tax credits in the near term.¹⁴ A shorter carryback—for example, three years—could have some benefit but would not deliver a lift to tax credit demand as powerful or immediate as the five-year carryback. Like a refundable credit, a five-year carryback restores the value of existing tax credits without necessitating a sale between investors who currently cannot use them and investors who can. It would thus prevent the market from being flooding with existing tax credits up for resale, which could potentially suppress the demand and pricing of unused and unallocated tax credits. This measure would also maintain demand among the investors with a proven willingness to pay the most for the credits.

As with refundable credits, the five-year carryback proposal would likely have a low cost to the federal government over a 10-year period, even though it would involve large initial refunds to investors. In the past, the federal government reportedly assumed all tax credits would eventually be used when evaluating the cost of the LIHTC program. Moreover, the government does not discount future expenses relative to current ones in its budget scoring process. The government may, therefore, score many LIHTC proposals that involve changing the time when credits are used as nearly budget neutral. How proposals will actually be scored is uncertain and depends on whether the full-use assumption is continued and on the effect of a given proposal on other revenues such as the alternative minimum tax.

¹⁴ Ernst & Young, 2009.

Accelerate the Tax Credit

Accelerating the tax credit is another way to allow investors to realize value within a shorter time period.¹⁵ Accelerating the credit would give investors more confidence in their estimates of future tax liability when arriving at a bid price. Such a solution would not be as effective in repairing the tax credit market as other proposals because it would still leave current owners with tax credits they cannot use. It would, however, likely draw more investors to the market over the longer term and encourage higher bids. At the same time, though, accelerating the tax credit would result in larger short-term tax expenditures because a portion of the credits would be taken sooner (though not as large a portion as in the case of the five-year carryback).

Improve Tax Treatment for Selected Investors

Modifying passive loss rules to encourage certain subchapter S corporations and closely held C corporations to invest in tax credits is another proposed option for jumpstarting demand—particularly outside of major metropolitan areas. Advocates believe this proposal might improve investor demand for complex projects that combine housing and supportive services. By one estimate, as many as 2,000 community banks in the United States are subchapter S corporations. Because these banks pass their income and expenses through to their individual owners, they cannot currently claim passive investment losses or credits against active income.

To maintain investor oversight and engagement, the current consensus proposal would be limited to businesses with at least \$10 million in gross annual receipts. Moreover, businesses could not be formed primarily to invest in affordable housing to minimize federal income tax, and reasonable asset management would be required.

Allow GSEs and TARP Recipients to Use Tax Credits to Offset Dividend Payments

Since the government stepped in to back Fannie Mae and Freddie Mac at the beginning of the financial crisis, the two GSEs have received substantial support from the U.S. Treasury, and the Treasury is accruing dividends on the amounts outstanding. In the meantime, the two GSEs are under pressure to write off or sell billions of dollars of deferred tax credits they cannot use. The same holds true for several large banks that received TARP funds.

¹⁵ There are a number of ways this could be structured. The most common proposal calls for allowing tax credit investors to use 20 percent of tax credits each year for three years and 10 percent each year for the next four years.

To remedy this situation, the Treasury could agree to allow the GSEs and TARP recipients to use their tax credits to pay dividends to the government. As the tax credits are already scored as used, the long-term budget impact would be limited. This would, however, make the tax credits useful to the GSEs as they repay the Treasury. Given that the Treasury apparently decided not to allow the GSEs to sell their existing credits, and they are not in a position to make new investments, this action might have limited impact on the LIHTC market. If TARP recipients are allowed to use tax credits to pay dividends to the government in exchange for making new LIHTC investments, it could help spur demand, though doing so would eliminate private investors as asset managers in properties where all tax credits were returned.

Broaden CRA Coverage to Nonbank Financial Institutions

The Community Reinvestment Act (CRA) is a primary driver of tax credit investment demand and yields. Even in today's struggling market, tax credits from projects in the CRA assessment areas of large banks are still selling at prices close to the historical average. In second-tier metros and states without CRA-motivated banks, however, equity capital is scarce since the exit of Fannie and Freddie.

Increasing CRA coverage would expand the number of potential investors who have the motivation to pay premium prices and accept low yields for investing in tax credits. There have already been calls to reform the CRA and create a more level playing field for banks, mortgage and insurance companies, and the shadow banking system. Greater demand for low-income housing tax credits would be a beneficial side effect of this reform but is not likely to drive the debate over it.

Give Full CRA Credit for Investment in Regional LIHTC Funds

Another suggestion that might serve to support investment demand in underserved areas is to change how banks receive CRA credit for investments in multi-investor LIHTC funds. One of the papers delivered at a Federal Reserve conference in November 2009 on innovative ways to revitalize the LIHTC market made three policy proposals concerning how CRA credit is

calculated for these funds.¹⁶ First, it suggests that, as long as a bank maintains a satisfactory CRA rating, it should receive full CRA credit for LIHTC investments made through regional funds that include any of the bank's assessment areas where it has deposit-taking branches. Second, it suggests reversing the current practice of discounting CRA credit for investments benefiting a large regional area. Lastly, it suggests clarifying that an eligible region can be as large as a quadrant of the country.

Taken together, these changes might help replace some of the investment demand that vanished when Fannie and Freddie exited the market. In particular, they would make LIHTC investments more attractive to local and regional banks with relatively small assessment areas. Unlike large national banks that have been moving toward investing directly in properties or through proprietary private label funds, local and regional banks would benefit from the risk diversification and centralized underwriting and asset management provided by multi-investor funds, as long as they were able to claim CRA credit for such investments.

Create a Fluid Secondary Market for LIHTCs

Many respondents believe that the future of the LIHTC program depends on creating a secondary market for the tax credits. Such a market could broaden the appeal of housing tax credits by reducing the need for investors to predict their tax liabilities so far into the future. Instead, they could buy in or out of the market at will. Creating a liquid secondary market with credible intermediaries and standardization might also broaden the investor pool to include large profitable corporations outside the financial services industry.

Underwriting and monitoring tax credit properties, however, demands real estate expertise and recapture liability extends for 15 years. A secondary market would therefore likely need to structure tax credit tranches to be accompanied by a credit-enhancing guarantee or put option from a sophisticated counterparty.¹⁷ Given the weak management of counterparty risk that

¹⁶ Buzz Roberts, "Modifying CRA to Attract LIHTC Investments," in *Innovative Ideas for Revitalizing the LIHTC Market*, Federal Reserve Bank of St. Louis, 2009.

¹⁷ Shekar Narasimhan, "LIHTC: The Dilemma and a Secondary Market Solution," in *Innovative Ideas for Revitalizing the LIHTC Market*, 2009.

contributed to the financial crisis, it is likely that such a guarantee would also need to have real credibility in the market.

Fannie Mae and Freddie Mac are among the organizations in a logical position to fulfill this underwriting and guarantor role. They have the right scale and skills, and could structure the investment in such a way that investors have confidence in the guarantee. However, with their future uncertain and dependent on government decisions, it is unclear whether they will be able to play such a role any time soon.

Another possible type of counterparty would be a foundation's social investment fund. For example, the MacArthur Foundation has described a financial mechanism that would divide a LIHTC investment fund into senior and subordinated tranches. Senior investors would receive all benefits in the initial years and would be able to leave the fund once they achieved a predetermined yield, probably two to three years before the end of the 10-year use period. Subordinate investors would receive all returns for the remainder of the 10-year use period. A foundation guarantee against construction and stabilization risk, recapture risk, and the continuity of federal Section 8 funding would supplement this two-tiered capital structure.¹⁸

Assuming a strong guarantor exists, a truly liquid secondary market would demand many additional features that would take time to develop. Tax credits are fairly opaque investments, which is a barrier to the formation of a liquid secondary market, especially without strong guarantors but potentially even with them. Tax credits also lack a trading platform. Finally, issues with the accounting of a guarantee for bank regulatory capital purposes would need to be resolved.

While a secondary market might bolster demand for LIHTCs in the long run, any increase in current liquidity could push prices even lower given the current softness of the primary market. An increase in liquidity might jeopardize new tax credit construction in the short run as investors sought out shorter tax credit streams from established and seasoned properties. It is also possible

¹⁸ Debra D. Schwartz, "Enhancing LIHTC Investment in Preservation Projects," in *Innovative Ideas for Revitalizing the LIHTC Market*, 2009.

that, by resolving the tax liability risk issue, a liquid secondary market could increase demand even in the short run.

Proposed Short-Term Corrective Actions

Short of making more lasting changes that would also tackle the short-term challenges, there are a number of stopgap measures that could address the depressed state of Low-Income Housing Tax Credit demand as well as the cost and availability of permanent debt for tax credit projects. One of the following emerged as a consensus proposal from the broad set of stakeholders who have rallied behind the two consensus proposals previously discussed: extending the Exchange program through 2010 and expanding it to cover four percent allocations.

Extend the Exchange Program for 2010 and Expand It to Cover Four Percent Credits

Under this proposal, the Exchange program would extend on the same terms through the end of 2010. Though not specified in the proposal, respondents expected the extension would allow states to exchange up to 40 percent of 2010 tax credits at 85 cents on the dollar. Given that investor demand for tax credits is unlikely to recover during the coming year, this extension would allow states to continue to support the construction pipeline with direct funding. If they chose, states could set a lower nominal tax credit “price” for developers applying for Exchange funding. According to the proposal, all funds would need to be disbursed by 2013.

The low cost of extending the Exchange program for another year makes this an attractive option. Unlike TCAP, the Exchange program is nearly budget-neutral, with lower future tax credit claims offsetting current expenditures. While there is some criticism that Exchange might be crowding out private investors who are willing to purchase tax credits (albeit at a lower price), the program provides an economically efficient way to replace some of the affordable housing capital that disappeared when the tax credit market collapsed.

If the program is extended, a decision must be made either to continue exchanging state credit allocations for 85 cents on the dollar or to set a lower amount. In theory, keeping the 85-cent rate would provide enough capital to fill gaps for a substantial share of pipeline projects. At the same

time, though, setting the price near the current average market price would make private capital investment more attractive to state agencies and developers, except in areas with very low demand and low pricing. This could be helpful in making the transition from direct funding back to a private capital investment model.

The proposal also requests extending the Exchange program to include four percent tax credits. These credits are allocated to affordable housing projects that apply for and are awarded state tax-exempt bond financing, and they are a primary tool for the acquisition and preservation of existing affordable housing. The proposal suggests that developers indicate in their applications for four percent credits whether they will be able to sell those credits or would prefer to exchange them for direct funding. In the event that developers with tax-exempt financing are unable to sell either credits or bonds, according to the proposal they would still be awarded credits or cash, the bonds would count against the state's volume cap, and developers could seek taxable financing elsewhere.

Four percent credits are a useful tool for acquiring and preserving affordable housing for two reasons. First, whether awarded competitively or outside the competitive allocation process for tax exempt bond financed properties, acquisition tax credits are limited to 30 percent of present value, or roughly four percent per year. New construction and substantial rehabilitation is funded at 70 percent of present value, or nine percent per year. Since only one in five competitive applications for credits is typically funded, organizations seeking to acquire and preserve affordable housing often prefer to use automatically allocated four percent credits. Moreover, four percent credits are available throughout the year instead of in one or two application rounds, reducing the delay in acquiring expiring use properties.

Have the Treasury Co-Invest in Tax Credit Properties

Another proposal suggests the Treasury use TARP, stimulus money, or other resources to invest in tax credit properties alongside pre-approved private investors. Under this proposal, the government would purchase LIHTCs in properties in the same amounts and on exactly the same terms as private investors, and to the extent that the purchases were made at a discount, could actually make money by buying tax credits back at a discount upfront rather than being taken in equal increments

at par over ten years. This proposal would maintain private market discipline in the selection and management of LIHTC properties while providing additional capital for affordable housing in the near term and improving the balance of the supply and demand for tax credits.¹⁹

Transfer Ownership of Troubled Properties to Mission-motivated Entities

Several people interviewed for this paper believe that the housing market crisis offers a unique opportunity to use LIHTCs or other subsidies to add good quality, market-rate units to the affordable stock. As noted above, however, the four percent tax credit market is the most severely disrupted. In addition, a nine percent credit might be necessary to gain control over market-rate properties, but it cannot be used for acquisition. A few interviewees think policymakers should consider allowing four percent tax credit exchanges and the use of nine percent credits for acquisition under limited circumstances.

Another approach would be to use the Treasury's Public Private Investment Partnership (PPIP) program to create a fund for acquiring properties. It is possible that one or more for-profit or nonprofit agencies would try to form a PPIP for this purpose. The attractiveness—and effectiveness—of doing so could be enhanced by providing special access to Exchange or TCAP funding, as well as more flexible use of nine percent tax credits. The advantages of this program would be that the Treasury would underwrite the partners in the PPIP and the FDIC would determine the amount of government-insured debt they could issue. The PPIP has been slow to get off the ground, however, and it is not clear that it is a viable option or that one or more entities will commit the capital and time to test its feasibility. Modifying tax credit rules to work with the PPIP program would be a daunting undertaking, and could be viewed skeptically by the government if it diverted funding from the preservation of existing assisted properties.

Expand the Exchange Program to Include Disaster Area Credits

When initially enacted, neither TCAP nor Exchange applied to regional tax credits awarded after the Gulf Coast hurricanes and Midwestern floods. HUD then expanded TCAP to include these Gulf Opportunity Zone and disaster area credits. To extend the Exchange program in a similar way, however, requires legislative action. A bill currently pending in Congress proposes

¹⁹ Joseph Flatley, "Federal Co-Investment in LIHTC Properties," in *Innovative Ideas for Revitalizing the LIHTC Market*, 2009.

expanding Exchange to cover these regional credits. This expansion would provide additional reconstruction capital and economic stimulus for these hard-hit areas.

Provide Extra CRA Points for Permanent Debt Financing of Tax Credit Properties

Another problem interviewees mentioned repeatedly is that permanent debt financing for tax credit properties is becoming harder to come by and with tighter terms. One way to address this situation would be for federal banking regulators to provide extra credit on CRA exams, at least in the short-run, for extending permanent debt financing to tax credit properties. While this approach still would not fully address the needs of places outside the presence of large banks, it could have some benefit for these markets.

Conclusions

Recent experience has underscored the challenge of maintaining demand for a 10-year tax credit system with a 15-year compliance and recapture period tied to a risky asset like real estate. The costs of performing due diligence on the initial investment in a tax credit project are high. Sale of tax credits to another investor involves similar due diligence costs unless the original investor provides a guaranteed return and the buyer values that guarantee. In addition, the lack of standardized underwriting and reporting impedes the formation of a secondary market in low income housing tax credits.

Under these conditions, firms must feel confident in their tax forecasting ability over a 10-year period and in the ability of the project and its sponsor to remain in compliance for 15 years. The financial market meltdown shook that confidence to its core. Investors will inevitably factor a larger discount into the price they are willing to pay for a low-income housing tax credit, and many others will not participate at all because they can use other shorter-term credits to manage tax liabilities.

Dealing with these issues requires legislative changes that reduce or eliminate tax liability risk or a liquid secondary market solution that allows firms lacking tax liability in a given year to sell their tax credits to other investors that can use them.. Making the LIHTC refundable would

eliminate tax liability risk and extending the carryback to five years would go a long way towards reducing that risk. A liquid secondary market could also reduce tax liability risk, but it would take time to develop and many issues would need to be resolved before a fully functioning market could emerge.

Pricing of tax credits over the long run will depend, from a market perspective, on the yield expected to offset tax liability risk and the yield expected to offset recapture risk, as well as on the supply and demand for tax credits. The demand for credits could be increased by relaxing passive loss rules that favor widely held C corporations. The best pricing has been achieved to date, however, by placing regulatory pressures for community investment on large financial institutions through CRA and on Fannie Mae and Freddie Mac through their charter and supervision. Even if tax liability risk was reduced to zero, prices would not reach the levels they did in the mid 2000s without maintaining regulatory pressure.

Meanwhile, the principal goal of the TCAP and Exchange programs—to get shovel-ready projects underway quickly—has been difficult to achieve. This was perhaps inevitable given the complexities of creating two new programs that require the issuance of new guidelines, a new process for allocation, and the interpretation of new rules by more than 50 allocating agencies. While funds are now flowing and there is cautious optimism that much delayed production will occur in 2010, these funding sources are probably insufficient to rescue all the affordable rental properties in the pipeline.

The shortfall is likely to be greatest in the states, small metropolitan areas, and rural areas where tax credit pricing is the most depressed. In some cases, this shortfall may reflect deteriorating rental market conditions, but most individuals interviewed for this study believe it is largely due to decreased investment in tax credits as well as the focus of the remaining large bank investors on areas where they are assessed for CRA. Furthermore, demand for tax credits does not appear to be reviving, making 2010 look much like 2009, when the Exchange program was crucial to keeping production moving in many states where large national banks had no significant presence.

The damage to the LIHTC delivery system from delays in getting the stopgap programs up and running is not yet known. Many respondents believe the impacts on certain industry players may be considerable. In particular, undercapitalized project sponsors and community lenders specializing in LIHTC acquisition, development, and construction lending may not survive. Syndicators that found themselves with tax credits they could only sell at a steep discount are under significant stress, have been sold, or are in the process of reorganizing. While this may mean that stronger players will gain share in the LIHTC market, especially in places without the presence of large national banks, it could also have lasting negative effects on the infrastructure of the Low-Income Housing Tax Credit program.