

# *Social Policy and the U.S. Tax Code: The Curious Case of the Low-Income Housing Tax Credit\**

***Abstract** - The Low-Income Housing Tax Credit (LIHTC) is the federal government's largest subsidy program for the production of affordable rental housing. The LIHTC is allocated in fixed amounts each year by state agencies, and provides an investment tax incentive for the production of rental housing with rents limited to percentages of HUD-specified Income Limits based on HUD-estimated area median family income. One inherent difficulty in the LIHTC not present in direct rental housing subsidy programs is that the subsidy amount is determined before the housing project begins operation, and there is no mechanism for ex-post adjustment to reflect, e.g., increasing operating cost, increasing tenant utility allowances (which reduce rent revenue) when energy costs spike relative to income, or declining area median income. Direct subsidy programs for rental housing, such as HUD's Public Housing and Section 8 Housing Choice Voucher programs, adjust subsidy to changes in operating cost and tenant income either directly or indirectly (through connection to actual operating expenses or market rents). HUD uses a hold-harmless policy in setting its Income Limits for subsidy programs to accommodate this problem with the LIHTC, even though this tends to inflate the population eligible for HUD programs. Recent changes to HUD's Income Limits methodology, however, show that the hold-harmless policy may not be enough to keep LIHTC projects operating. We discuss legislative policy options for ensuring LIHTC projects can continue to operate in these situations while maintaining affordability.*

## INTRODUCTION

Much of the federal tax code, particularly the numerous carve-outs of credits and deductions from the personal income tax, was created to support various social policy goals. Currently, the tax code provides favorable treatment toward energy efficiency, education, and homeownership, to name just a few. The federal government clearly understands the power of using fiscal inducements to achieve its social policy goals and often favors this approach over direct subsidies. The use of these fiscal inducements works to achieve social goals in one of two ways—either by directly altering the

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behavior of a target group or by re-aligning the economic allocation of resources. At its disposal, the federal government has two fiscal policy tools: taxation and expenditure. Taxation is an effective tool to induce either of these effects, while the spending of government revenues is mostly effective only for re-aligning resources between uses, unless designed as a negative tax, which could also serve to induce behavioral changes. This approach of using tax policy to achieve social goals was the motivation behind the creation of the Low-Income Housing Tax Credit (LIHTC) in the Tax Reform act of 1986. Its intention was to induce private resources toward the development of affordable rental housing, differing from the direct subsidy programs on which the federal government had previously relied.

The Low-Income Housing Tax Credit (LIHTC, 26 U.S.C. 42) is the federal government's largest program for subsidizing the production of affordable rental housing for low-income tenants. Within the Tax Reform Act of 1986, Congress eliminated a variety of tax provisions that had favored rental housing and replaced them with a program of tax credits. Under the LIHTC Program, 58 state and local agencies are authorized, subject to an annual per capita limit, to issue federal tax credits for the acquisition, rehabilitation, or construction of affordable rental housing. The credits can be used by property owners to reduce federal income taxes and are generally taken by outside investors who contributed initial development funds for a project.

Arguably, the LIHTC program has been successful in fulfilling its purpose. Since its inception, over 27,000 projects containing over 1.5 million units, mostly low-income,

have been placed-in-service. Many of these leverage other U.S. Department of Housing and Urban Development (HUD) grant programs, such as HOME, CDBG and HOPE VI.<sup>1</sup> Further, the per-unit subsidy cost of properties financed by tax credits is quite low compared to other subsidy programs.<sup>2</sup> However, the LIHTC program, suffers from an inherent flaw not present in direct rental housing subsidy programs. The LIHTC subsidy amount is determined before the housing project begins operation, and depends on forecasts of projected costs and rental income for the entire 15-year compliance period, with no mechanism for ex-post adjustment in the subsidy to reflect unforeseen changes. To accommodate this problem, HUD instituted a hold-harmless policy in setting its Income Limits for subsidy programs, ensuring rental income, which is tied to the Very Low Income Limit (VLIL), does not decline. Recent changes to HUD's Income Limits methodology, however, show that the hold-harmless policy may not be enough to keep LIHTC projects operating. This paper outlines the problems facing the LIHTC program and discusses legislative policy options for ensuring LIHTC projects can continue to operate in these situations while maintaining affordability.

## BACKGROUND AND MECHANICS OF THE LIHTC PROGRAM

Although the concept of effectively subsidizing low-income housing through the tax code originated prior to the Economic Recovery Tax Act of 1981 (ERTA), the vastly expanded allowances for accelerated depreciation in rental housing contained in

<sup>1</sup> The HOME Investment Partner grants and Community Development Block Grants (CDBG) provide state and local governments funds for community development purposes including housing construction and rehabilitation. The HOPE VI program provides housing authorities funds to rehabilitate or redevelop distressed public housing.

<sup>2</sup> GAO (1997) estimated the present value of the average tax credit cost per unit for units placed-in-service between 1992 and 1994 to be \$27,310. However, this does not include other federal subsidies, which many tax credit properties rely on.

this legislation caused the concept to take off. Specifically, the depreciation period for low-income real estate was shortened from 40 years to 15 years. The allowance of accelerated depreciation greatly increased the use of low-income tax shelters and produced a boom in the production of rental housing.<sup>3</sup> In the spirit of the current tax credit program, developers financed their projects by selling limited-partner equity interests to syndicators, who not only received the excess depreciation deductions, but also received tax benefits on any capital gains realized. Because maximizing the value of the tax benefits was achieved by minimizing net operating income, these projects tended to operate at rents affordable to low-income households.

Despite the boom in rental housing, the control of important policy variables remained out of the control of the federal government, particularly maximum rent levels and tenant income limits. This prevented the federal government from ensuring that the rental housing produced with this tax subsidy was initially, and remained, affordable and served a low-income population. The budgetary impact also could not be controlled or limited as any project built would be eligible for the depreciation deductions.

The Tax Reform Act of 1986 ended much of the favorable treatment toward real estate investment. Tax shelters lost their value as capital gains were now treated as ordinary income<sup>4</sup> and the depreciation period increased to 27.5 years, lowering the value of the depreciation deductions. In order to prevent a complete halt to

the production of low-income housing, Congress established the Low-Income Housing Tax Credit (LIHTC) program. The provisions of this program provided a lucrative incentive to developers of low-income housing, in return for restricting rent and tenant income levels. Further, per-capita limits on the number of credits that could be allocated ensured that the budgetary impact was well-defined.<sup>5</sup>

Following guidelines set by the IRS, authorized state and local housing agencies administer the program and allocate the credits to developers. Developers of LIHTC projects, about one-third of whom are non-profit sponsors, raise equity to finance the projects by selling their allocated tax credits to investors with tax liabilities. This equity, which effectively serves as an indirect federal grant, provides the primary source of funds used to finance the low-income units.

In return for the tax credits, developers must set aside a specific proportion of its units for lower income households, with the rents on these units limited to a maximum of 30 percent of qualifying income. Owners may elect to set aside at least 20 percent of the units for households at or below 50 percent of area median income (AMI) or at least 40 percent of the units for households with incomes below 60 percent of AMI. Annual rents in the low-income units are limited to a maximum of 30 percent of the elected 50 or 60 percent of AMI.

The allocated tax credits are provided for a period of ten years, although the affordability requirements must be maintained for a minimum of 15 years.<sup>6</sup> At the

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<sup>3</sup> The full effect was not realized until 1983, when the effects of the 1981–82 recession diminished. Total multi-family starts in 1983 increased 63 percent from 394,000 to 641,000, and remained at that level through 1987 (Case, 1990).

<sup>4</sup> Previously, capital gains were taxed at 40 percent of the rate applicable for ordinary income.

<sup>5</sup> Although there is a limit on the number of competitive tax credits awarded, there is no limit on bond-financed tax credit projects. Ultimately, these are limited by state caps on private purpose bond authority.

<sup>6</sup> As part of the Revenue Reconciliation Act of 1989, Congress added an extended use requirement of an additional 15 years, increasing the total affordability period to 30 years for projects placed in service after 1989. However, owners are still able to opt out of the program after 15 years and many buildings need additional investment after the initial 15-year compliance period. Thus, the effect of this change in keeping units financed by tax credits affordable over a longer period is uncertain and an important question for future research.

end of the 15-year compliance period, owners may choose to opt out of the program and convert the units to market rate. With the program in its third decade, the early projects are reaching the end of their compliance period and face the decision to remain affordable or opt out of the program. When an owner chooses to opt out, the state housing agency can attempt to find a purchaser who agrees to maintain the income and rent restrictions. If the housing agency is unable to do so, the owner may convert the units to market rate, thereby ending the social benefits the program was intended to create.

Let us review these mechanics with a focus on the difficulties they introduce.

- The amount of LIHTC associated with a rental housing project is a function of: the depreciable basis of the project and the percentage reserved for low-income tenants (the eligible basis); a present-value credit percentage based on the activity undertaken, other financing and subsidies involved, and certain differences depending on project location (between 30 percent and 91 percent of eligible basis); and an after-federal-tax discount rate (for computing present value) based on the market rate for comparable-maturity Treasury bonds. All of this is determined before a project begins operating.
- The LIHTC provides a fixed ten-year stream of payments in the form of forgiven taxes. In addition to project compliance risk (credits may be denied or recaptured up to year 15 if the project fails to comply with income and rent restrictions and other rules), this stream of payments is subject to interest rate risk

(its value falls if interest rates rise), and tax liability risk (if taxes owed are less than credits due, or the taxpayer is subject to the Alternative Minimum Tax, realization of the return for investing in LIHTC must be deferred, reducing its value). Tax liability risk in particular tends to decrease the amount of money investors are willing to put into low-income housing backed by the LIHTC relative to what they would pay for a bond connected to project rule compliance and paying tax-exempt interest at the same discount rate. It also contributes to the difficulties caused when project revenues and expenses fail to match forecasts.

- In addition, business investors<sup>7</sup> in LIHTC projects may also claim the projects' depreciation deductions against other income. While this tends to increase the amount paid for LIHTC investments, it also reinforces the need to operate LIHTC projects as close to zero net cash flow as possible. Positive net cash flow above what cannot be put into reserve accounts reduces the value of depreciation deductions. Actual profits eat into the value of the LIHTC investments.

Profits are, of course, not undesirable, so divining the theoretical reason to explain the observed behavior that LIHTC projects act to zero-out net cash flow is difficult. If the LIHTC project has positive cash flow, it reduces the value of the depreciation deduction, but after-tax profits increase anyway because the tax rate is less than one. We postulate that the departments of corporations that invest in LIHTC

<sup>7</sup> While in theory individual investors could also take depreciation losses as deductions against their taxes, these are subject to the same passive loss limitation that limits the amount of LIHTC individual investors may claim.

projects focus solely on maximizing tax offsets per dollar invested (i.e., the tax departments are assigned specific goals for tax liability reduction return-on-investment and do not consider the potential total after-tax return on LIHTC investments). This compartmentalization of management means that LIHTC investors are effectively engaging in a second-best solution to the after-tax profit maximization problem over their entire portfolios. In response to the demand for such products, suppliers of LIHTC investments design the financing of projects to avoid positive net cash flow.

- Another difficulty caused by the availability of depreciation deductions is that demand for LIHTC may be skewed toward business where profits and tax liability are more volatile and cyclical. This means the prices paid for LIHTC are dependent on the profitability of the major investors.

#### LIHTC PROGRAM'S INHERENT FLAW

While the means of converting a stream of tax credits into upfront financing for low-income housing and this system's inherent difficulties are interesting, they are not the subject of this paper. Neither are the difficulties of writing the compliance rules to achieve objectives like preventing the LIHTC from being used as a source of financing for university student housing *without* excluding Temporary Assistance for Needy Families (TANF)-assisted mothers enrolled in school or job training programs and their elementary-school-aged children as "households made up of entirely of full-time students." The scope of this

paper is limited to examining the inherent problem of the LIHTC program that the subsidy level is determined prior to a project being placed into service, with no mechanism to adjust the subsidy in response to unforeseen conditions.

At the time of application, LIHTC developers must submit financial statements containing, among other things, projected rent and expense levels over the 15-year compliance (or 30-year or longer extended use) period. Further, the LIHTC statute requires the allocating agencies to award only the minimum number of tax credits to make the project financially viable, again based on these very long projections. This, plus the incentives to run projects on a zero-net-cash-flow basis described above, means that incorrect revenue and expense (net revenue) forecasts in either direction are bad for LIHTC investments. If net revenue is lower than forecast, the project may be induced to drop out of compliance and revert to market rate prior to the end of the compliance period. If net revenue is higher than forecast, the value of the LIHTC investment is reduced.<sup>8</sup>

LIHTC tenant income limitations and maximum project rent revenues are based on HUD's estimates of area median family income (AMI), specifically the Very Low Income Limits (VLILs) derived from them. VLILs are based on 50 percent of AMI adjusted for family size and the incidence of particularly high or low housing costs (market rents) relative to AMI. IRS establishes a formula for converting VLILs based on household size into LIHTC unit rents by number of bedrooms in the unit. HUD's AMI estimates are based on a combination of 2000 Census data for individual area median family incomes and update factors including data on average wages from the Bureau of Labor statistics and state-level median income estimates

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<sup>8</sup> The higher-than-forecast net revenue situation, however, is easily remedied by reducing rents below the statutory maximum.

from the Current Population survey and the American Community Survey (ACS). In the FY 2007 AMI estimates, HUD introduced local ACS data for metropolitan areas and counties with populations above 65,000 from the first full-implementation year of the ACS (2005).<sup>9</sup>

One way in which the 15-year LIHTC revenue forecasts can go wrong is through the failure of AMIs, and the income limits and rents derived from them, to rise as predicted. A number of factors have the potential to cause at least some area median income estimates to decline in real, or even nominal, terms including:

- a general environment of low inflation where median income growth must arise from very broad-based real income growth;
- the availability of more frequent and accurate measures of local incomes such as the Census Bureau’s new American Community Survey (ACS); and
- the potential for national or regional recessions causing declines in nominal income measures.

HUD has always recognized the potential for disruption to the LIHTC program that could be caused by falling income limits and addresses it using a “hold harmless” policy where income limits are not reduced when statistical evidence

indicates they should be. The hold harmless policy has been in place since the LIHTC’s inception in the late-1980s and until recently it has been effective in limiting the impact on LIHTC projects of the few AMI decreases actually experienced. Recent changes to HUD’s AMI estimation methodology, however, show that the hold-harmless policy may not be enough to keep LIHTC projects operating within the constraints of the program. Specifically, two recent methodological changes have brought this issue to light.

First, beginning with the FY2006 income limits, HUD relied on, for the first time, OMB’s revised metropolitan area definitions, which were based on revised definitional standards and data from the 2000 Census.<sup>10</sup> The new metropolitan area definitions, which HUD slightly modifies when calculating its income limits, had the effect of decreasing the number of non-metro counties by 257, and reconfiguring the geography of many metropolitan areas. More importantly, shown in Table 1, the change in metropolitan area definitions greatly increased in number of non-metro counties and metropolitan areas held harmless under HUD’s income limits program (i.e., where the new definitions would have otherwise caused a decrease in the VLIL because the applicable AMI was lower).

In FY2005, only seven percent of non-metro counties and 14 percent of

**TABLE 1**  
NUMBER OF AREAS HELD HARMLESS IN HUD’S INCOME LIMITS PROGRAM

	Non-Metro Areas			Metro Areas			Areas at least 10% Above Statistical Limit
	Counties Held Harmless	Total Number of Counties	Percent Held Harmless	Areas Held Harmless	Total Number of Counties	Percent Held Harmless	
FY 2005	161	2,302	7%	51	356	14%	30%
FY 2006	249	2,045	12%	155	523	30%	47%
FY 2007	1,629	2,045	80%	367	530	69%	71%
FY 2008	637	2,043	31%	190	532	36%	34%

<sup>9</sup> Prior to the FY 2007 AMI estimates, HUD used state-level income data from the smaller experimental versions of the ACS conducted from 2000 to 2004 as state-level controls on increases in metro-area and county-based AMI estimates.

<sup>10</sup> See Office of Management and Budget (2003, 2005).

metropolitan areas were held harmless. Applying the new metropolitan area definitions in FY2006 increased those percentages to 12 percent and 30 percent, respectively. Further, the number of areas, both metropolitan and non-metropolitan, held more than ten percent above their statistical limit increased from 30 in FY2005 to 47 in FY 2006. The “distance” between the hold-harmless and statistical income limit is important because it reflects how long LIHTC projects operating at maximum rents in a hold-harmless income limit area are likely to go before seeing increases in rents. At a typical income growth rate of three percent per year, it would take projects in areas with statistical income limits of ten percent or more below their hold-harmless income limits in excess of three years before seeing increases in rents.

Second, beginning with the FY2007 income limits, HUD began using data from the ACS, which replaced the long-form of the decennial Census, as the basis for area median income in areas where it was available and statistically reliable. Due to an artifact arising from the slightly different ways in which income data were collected in the 2000 Census and the ACS, when state and local median family income estimates from the two sources are trended toward one another using common trending factors, the decennial census estimates average about one percent higher than the ACS estimates.

Table 1 shows the large increase in the number of areas held harmless due to the introduction of the ACS. From FY2006 to FY2007, the percent of non-metro counties held harmless dramatically increased from 12 percent to 80 percent and the percent of metropolitan areas increased from 30 percent to 69 percent. The number of metro and non-metro areas where actual data would put their income limits more

than ten percent below their hold-harmless values also increased from 47 to 71. While the number of held-harmless areas decreased in FY2008, and should continue to decrease, overall it is clear how program administrative changes coupled with underlying local conditions, can create a widespread problem forcing maximum rent levels to remain flat for years.

In addition to administrative changes, future legislation may have unintended negative consequences for the tax credit program. For example, the Section 8 Voucher Reform Act (SEVRA)<sup>11</sup> currently being considered in Congress would alter the way Fair Markets Rents (FMRs) are determined. FMRs are currently based on metropolitan statistical area definitions developed by the Office of Management and Budget (OMB) with a limited number of modifications that primarily affect outlying counties of large metropolitan areas. Because income limits must be adjusted for high or low market rents under HUD’s statutes, HUD estimates AMIs and computes VLILs for the same areas as it sets FMRs. If passed, this bill would alter HUD’s computation of FMRs by requiring the establishment of many smaller FMR areas, including separate areas for large central cities and each county in the country. Consequently, income limits for many central cities, or counties containing them, would decrease, substantially in some cases. Even with the hold-harmless policy, LIHTC projects in these areas would be subject to even longer periods of flat rents, causing at least some projects to become financially infeasible. At best, many of these projects would be expected to opt out after their initial compliance period. In the worst case scenario, many projects would go into default.

Clearly, the “hold harmless” policy is necessary to ensure sufficient operating income is received by project owners

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<sup>11</sup> SEVRA passed the House as H.R. 1851, and was introduced in a somewhat different form in the Senate as S.2684.

to cover debt service and maintenance costs. The absence of such a policy would undoubtedly force some projects to revert to market rate units and prevent others from even applying for tax credits. Unfortunately, while this policy may not be sufficient to ensure continued operation of LIHTC projects in the worst cases of disconnect between hold-harmless and statistical income limits, it also has the unintended consequence of widening the focus of eligibility standards, and fails to direct resources in accordance with measured incomes.

Other sources of reductions in LIHTC project net income include changes in operating expenses, and increases in tenant-paid utilities and the associated "utility allowance" reduction in rents granted to tenants who pay major utility bills for their units. Operating expenses tend to grow fairly relentlessly with local wages and the age of the project. Failure of rents to rise as fast as predicted in the project financing documents, or expenses rising faster than predicted, squeezes revenues. Similarly, when tenant-paid utility bills rise, projects must increase the mandated utility allowance deduction from maximum rent. If rents are not rising as fast as utility allowances, project revenues suffer.

Whatever the source of LIHTC project's revenue or expense difficulties, the subsidy provided by the LIHTC cannot be adjusted in order to ensure continued operation of the project at rents affordable to low-income households. This contrasts with various HUD programs. In HUD rental subsidy programs, HUD generally pays the difference between the cost of providing housing and 30 percent of the tenant household's income. When tenant incomes fall, HUD's subsidy payment increases.

Specifically, HUD's Housing Choice Voucher program pays rents derived from HUD's estimate of area Fair Market Rent. If rental housing expenses increase

in a way that is reflected in market rents, voucher payment levels increase. HUD's project-based subsidy contracts are adjusted each year by either "Annual Adjustment Factors" (AAFs) derived from Consumer Price Index data on rents and utility prices, or by "Operating Cost Adjustment Factors" (OCAFs) derived from data on housing project operating expenses. In all of these programs, HUD's AMI estimates and Income Limits serve only as tenant eligibility standards. They have no bearing on rents received by housing providers, rents paid by tenants, or subsidies paid by HUD.

The subsidy levels provided by the LIHTC are determined before the first renter moves into a unit. As HUD's AMIs and Income Limits rise, so do LIHTC tenants' rents. If income limits do not rise as fast as assumed in project underwriting, or expenses rise faster, the LIHTC project is in a financial bind. Under "normal" circumstances, the numbers usually worked out fairly well, but unanticipated changes, like market area redefinitions or AMI data re-benchmarking, throw these carefully balanced assumptions off track. In the future, as HUD has access to more accurate ACS data on local median incomes and will be relying less on trending factors in estimating AMI and setting Income Limits, the assumption of steady revenue growth in LIHTC projects will cease to bear out. Policy changes may be needed. Three potential alternatives are discussed below.

## POLICY OPTIONS

This section presents three policy options Congress could consider for the tax credit program to try to ensure LIHTC projects remain open and affordable in situations when HUD's Income Limits do not grow as forecast. All of the options concern adjustments to project-specific income limits and rents. They all would lead to at least some increases in rents col-

lected from tenants relative to the current policy. The advantages and disadvantages of each are discussed.

### *Operating Expense Increase Option*

Under this option, Congress would allow projects in areas where the HUD Income Limit does not increase from the previous year to increase their income limits and rents by the increase in operating expenses experienced in the previous year. LIHTC projects would continue to operate at these higher rents and tenant income levels, and implement increases based on the same calculation method, until HUD-based income limits and rent levels surpassed these individual project limits and levels.

The advantage of this method is that it would ensure that project rents kept pace with expenses when rents would otherwise not increase. The disadvantages include the fact that tenant rents would be increasing in a manner unrelated to area income growth, making affected units less affordable relative to the incomes of potential tenants, and that once a project's rent schedule deviates from the HUD income limits, it is unlikely that the HUD Income Limits would ever again "catch up" with expenses. Such a program would also be administratively difficult as individual project rents and income limits would be computed from individual project records rather than a set area-based formula.

### *Adjust Income Limits and Rent Levels using CPI*

A second option to ensure income limits and rents do not remain flat would be to annually adjust initially determined income limits and rents using a commonly accepted price index, such as the CPI. Under this option, the Very Low Income Limits (VLILs) would continue to be set annually by HUD as they are

now, but would only be applicable to new placed-in-service projects. Existing projects placed in service in prior years would have their income limits and affordable rent levels adjusted using the CPI, rather than the increase in the VLIL, which in many areas would continue to remain flat (or could actually decrease as the need for the hold-harmless policy would be eliminated).

While this would prevent delayed rent increases that would occur under the current policy, it would produce a different distributional effect: projects built in different years in an area would have different income limits and maximum rent levels. Thus, existing projects could become increasingly unaffordable over time to the target population and different vintages of LIHTC housing in particular areas would in general have different rents and income limits. Rent computation, however, would be administratively less complicated than the first option since it would be based on the income limit of the placed-in-service year and change in CPI since then.

### *Compromise Approach*

In order to address the original problem without creating new distortions, a third option would apply an "income increase factor" derived from the change in area median income estimates to the income limitations of projects where HUD's current area income limits (without a hold-harmless policy) would be lower than the income limits that applied to the project in the previous year.

The income increase factor would be used to adjust income limits for previously existing LIHTC, bond-financed, and other program rental projects where maximum rent and tenant income levels are, under current law, set according to current HUD income limits. In cases where the income limits for these projects that applied in the previous period are higher than HUD's

published income limits in the current period, the previous period's income limitations would be multiplied by an income increase factor to determine the project-specific income limitation for the current year. The income increase factor would be equal to the greater of 100 percent or 100 percent plus one-half the percent change in area median income from the previous period to the current period. For example, if this year's area median income estimate is 104 percent of last year's area median income estimate (an increase of four percent), the income increase factor would be 102 percent. If this year's area median income estimate is 97 percent of last year's area median income estimate (a decrease of three percent), the income increase factor would be 100 percent.

Use of the income increase factor would, thus, follow a modified "hold harmless" policy that would hold income limits at the previous year's level if the area median incomes are lower than the previous year, but would allow project-specific income limits to increase by half of any percentage increase in the area median income over the previous year if the increase in the area income limit is insufficient to raise it above the project's previous year's income limitation level.

An illustrative example is helpful in understanding this option. Suppose between year one and year two, HUD's VLIL for an area containing an LIHTC project, computed without the hold-harmless policy, falls by ten percent. From year two to year three, the AMI and VLIL for the area increase by four percent. In year two, the LIHTC project's *individual* income limits and maximum rents would be held harmless at the year-one levels. In year three, these would be increased by one-half the change in the AMI, or two percent. As AMIs and VLILs in the area grow over time, eventually the LIHTC project's income limits and rents would converge

with the HUD-derived income limits and rents, which would continue to apply to new LIHTC projects placed in service.

Under such a policy, HUD could then revise its income limit computation methodology to no longer use the "hold harmless" income limit policy, which does not allow income limits to decline despite statistical evidence that they should. HUD's income limits would, therefore, be much more closely tied to area median incomes (or market rents in the case of high or low housing cost areas) than the current HUD income limits and better target housing subsidy resources (e.g., in HUD's designation of Difficult Development Areas under section 42(d)(5)(C)).

## CONCLUSION

In creating the Low-Income Housing Tax Credit (LIHTC) program, Congress chose to address affordable housing problems using fiscal incentives, rather than direct subsidies, which had been the norm. Although this serves to move the expenditures "off-budget" and induces private investment into low-income housing, the design of the program, whereby developers receive credits prior to construction or renovation with no opportunity for adjustments in response to unforeseen circumstances, creates the possibility where long stretches of flat or declining income and rent levels could cause projects to revert to market rate before the end of the compliance period.

Methodological changes in HUD's AMI estimates and Income Limit determinations have highlighted the need to address this problem. Tax credit projects in many areas across the country face flat rents for years, while maintenance costs continue to rise. Meaningful change is clearly needed to the tax credit program, not only to avoid current owners of tax credit properties

opting out of the program, but also to avoid decreased interest from potential developers.

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