# Q. What is the Low-Income Housing Tax Credit and how does it work?

## A. The Low-Income Housing Tax Credit provides a tax incentive to construct or rehabilitate affordable rental housing for low-income households.

The Low-Income Housing Tax Credit (LIHTC) subsidizes the acquisition, construction, and rehabilitation of affordable rental housing for low- and moderate-income tenants. The LIHTC was enacted as part of the 1986 Tax Reform Act and has been modified numerous times. Since the mid-1990s, the LIHTC program has supported the construction or rehabilitation of about 110,000 affordable rental units each year (though there was a steep drop-off after the Great Recession of 2008–09)—over 2 million units in all since its inception.

The federal government issues tax credits to state and territorial governments. State housing agencies then award the credits to private developers of affordable rental housing projects through a competitive process. Developers generally sell the credits to private investors to obtain funding. Once the housing project is placed in service (essentially, made available to tenants), investors can claim the LIHTC over a 10-year period.

### QUALIFYING FOR THE CREDIT

Many types of rental properties are LIHTC eligible, including apartment buildings, single-family dwellings, townhouses, and duplexes.

Owners or developers of projects receiving the LIHTC agree to meet an income test for tenants and a gross rent test. There are three ways to meet the income test:

1. At least 20 percent of the project's units are occupied by tenants with an income of 50 percent or less of area median income adjusted for family size (AMI).
2. At least 40 percent of the units are occupied by tenants with an income of 60 percent or less of AMI.
3. At least 40 percent of the units are occupied by tenants with income averaging no more than 60 percent of AMI, and no units are occupied by tenants with income greater than 80 percent of AMI.

The gross rent test requires that rents do not exceed 30 percent of either 50 or 60 percent of AMI, depending upon the share of tax credit rental units in the project. All LIHTC projects must comply with the income and rent tests for 15 years or credits are recaptured. In addition, an extended compliance period (30 years in total) is generally imposed.

## COMPUTING THE CREDIT

The annual credit claimed by a taxpayer equals a credit percentage multiplied by the project's qualified basis. The percentage is larger for new construction or substantial rehabilitation (roughly 9 percent but specified in the law as a 70 percent present value credit) than for properties acquired for rehabilitation or for projects funded using tax-exempt bonds (roughly 4 percent but specified as a 30 percent present value credit). The qualified basis equals the fraction of the cost of the housing project rented to tenants meeting the income tests. For many LIHTC projects, the owners or developers aim to rent 100 percent of the units to qualifying tenants. State housing finance agencies may allocate enhanced tax credits to qualified projects in areas where the need is greatest for affordable rental housing.

The LIHTC statute originally specified that the IRS would periodically reset the specified credit percentages to maintain the present value of the 10-year stream of tax credits at 70 percent or 30 percent of the qualified basis. However, since 2008, Congress has specified that the minimum credit rate for the 70 percent present value credit should be at least 9 percent, regardless of prevailing interest rates. Thus, in a low interest rate environment, the present value of the credits claimed over 10 years will exceed 70 percent of the qualified basis.

## ALLOCATING THE CREDIT

Congress sets a limit on the amount of LIHTC that can be allocated in any year. For 2018, each state was originally allocated $2.765 million or $2.40 per capita, whichever was larger. But Congress provided a 12.5 percent boost for 2018 through 2021, so these figures were increased to $3.1 million and $2.70, respectively for 2018. Both dollar amounts are adjusted for inflation.

This structure guarantees that states with low populations get a somewhat larger award when calculated on a per capita basis. States then allocate these credits (generally through state housing finance agencies) to developers, based on state-created qualified allocation plans. These plans are required to give priority to projects that serve very low income households and that provide affordable housing for longer time periods.

Projects financed by private activity tax-exempt bonds do not need to obtain a separate credit allocation from the state housing finance authority. The state, however, must approve the use of these bonds, which acts as a check on developers' ability to access 30 percent present value LIHTCs.

Developers generally sell the tax credits to investors, who may be better able to use the tax credits and other tax benefits of the housing project (e.g., depreciation, interest paid, net operating losses). Investors also contribute equity, often through a syndication or a partnership. The investors or limited partners usually play a passive role, receiving the tax benefits associated with the project but not participating in day-to-day management and oversight.

Most investors in LIHTC projects are corporations that have sufficient income tax liability to fully use nonrefundable tax credits. Financial institutions traditionally have been major investors, because they have substantial income tax liabilities, have a long planning horizon, and often receive Community Reinvestment Act credit from their regulators for such investments. Taxpaying investors cannot claim credits until the project is placed into service.

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## CALCULATING COSTS AND BENEFITS

The LIHTC is estimated to cost around $9.5 billion per year. It is by far the largest federal program encouraging the creation of affordable rental housing for low-income households. Supporters see it as an effective program that has substantially increased the affordable housing stock for more than 30 years. LIHTC addresses a major market failure—the lack of quality affordable housing in low-income communities. Efficiencies arise from harnessing private-sector business incentives to develop, manage, and maintain affordable housing for lower-income tenants.

Critics of the LIHTC argue that the federal subsidy per unit of new construction is higher than it needs to be because of the various intermediaries involved in its financing—organizers, syndicators, general partners, managers, and investors—each of whom are compensated for their efforts. As a result, a significant part of the federal tax subsidy does not go directly into the creation of new rental housing stock. Critics also identify the complexity of the statute and regulations as another potential shortcoming. Another downside is that some state housing finance authorities tend to approve LIHTC projects in ways that concentrate low-income communities where they have historically been segregated and where economic opportunities may be limited. Finally, while the LIHTC may help construct new affordable housing, maintaining that affordability is challenging once the required compliance periods are over.

*Updated May 2020*

### Further Reading

Joint Committee on Taxation. 2017. "Present Law and Data Relating to Tax Incentives for Rental Housing." JCX-40-17. Washington, DC: Joint Committee on Taxation.

Keightley, Mark P. 2019. "An Introduction to the Low-Income Housing Tax Credit." RS22389 (updated February 27, 2019). Washington DC: Congressional Research Service.

Scally, Corianne Payton, Amanda Gold, and Nicole DuBois, 2018. "The Low-Income Housing Tax Credit: How It Works and Who It Serves." Washington, DC: Urban Institute.