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Business in Society: Doing Well by Doing Good?
Final Paper

The Low Income Housing Tax Credit: Aligning the interests of private investors and affordable housing developers

The Low Income Housing Tax Credit (LIHTC) is widely hailed as one of the most successful federal programs in history for enabling the development of affordable housing in the US. This Credit, which was first offered by the IRS in 1986, allocates approximately $4.1B in tax credits each year to developers of affordable housing across the United States[1]. Since then, this funding has contributed to the development of 60,000-80,000 new affordable apartments across the US each year.[2]

This essay is an investigation of how this tax credit works and why it has been so successful. First, I will provide some context for affordable housing development, and for the importance of fair lending legislation in the US. Second, I will present the lifecycle of the LIHTC, from the IRS, through the developer then the syndicator, to the private investor. Lastly, I will discuss the interesting ways that this credit has aligned the interests of government, affordable housing developers, and business sectors, and I will introduce some of the arguments against this tax credit.

Context: Affordable Housing

For many low income Americans, the path out of poverty begins with finding a safe, affordable place to live. As real estate prices surge in popular cities like New York, low-income people are forced out of their neighborhoods, out of town, or out of housing altogether. On May 3rd 2005, there were 34,448 homeless people living in shelters and on street corners in New York City alone.[3] There are countless organizations, in every sector, working in creative ways to tackle homelessness and to provide housing solutions to low-income people. And they still have their work cut out for them. However, there does exist a large number of government subsidy programs—like the LIHTC—that provide financial incentives to make construction of affordable housing affordable, and sometimes even desirable.

According to the US Department of Housing and Urban Development (HUD), housing is affordable if “the rent does not exceed 30 percent of the annual income of a family”. Additionally, the family must have a low income, “60% percent of the average median income for the area.”[4]

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[1] http://www.mhc.gov/papers/lihtc.doc
[2] http://www.mhc.gov/papers/lihtc.doc
[3] http://www.nyc.gov/html/dhs/html/home/home.shtml
[4] http://www.hud.gov/offices/cpd/affordablehousing/programs/home/limits/rent/index.cfm

The Community Reinvestment Act

In 1977, the Congress enacted the CRA to encourage banks and thrifts to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods, consistent with safe and sound lending practices.[5] The law aimed to reverse decades of discriminatory lending practices that prevented residents of many low-income neighborhoods from accessing affordable credit and basic banking services.

The CRA was motivated by the need to reverse redlining and disinvestment practices that had become widespread in mainstream financial institutions. Redlining refers to a lender's process of outlining certain poor neighborhoods on a map, in order to indicate areas considered "too high" a risk for lending. Disinvestment is the practice of taking deposits from an inner city community and investing them elsewhere, where risks are perceived to be lower, and where financial institutions feel more comfortable doing business. This practice strips capital from low-income neighborhoods and acts to reinforce income inequalities. For many poor Americans, the combination of redlining and disinvestments meant inadequate access to credit and reliance on highly priced, less carefully regulated sources, including rent-to-own programs, consumer credit companies and even loan sharking. This cycle is self-perpetuating because recipients of these "expensive loans" will have difficulty with repayment and may default more often.

The letter of the law

In brief, all publicly chartered financial institutions are required to comply with the CRA, by providing financial services in each community where they accept deposits. Their CRA compliance obligations are based on the number of deposit dollars they hold from each community. CRA examinations are administered by the four financial supervisory agencies: the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS). The quotation below describes today's examination criteria in more detail.

> Under the CRA, large institutions, those with more than $250 in assets or under a holding company of more than $1 billion in assets, are examined under three tests – the Lending Test, the Service Test, and the Investment Test…pursuant to the following criteria:
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> (1) The dollar amount of qualified investments;
> (2) The innovativeness or complexity of qualified investments;
> (3) The responsiveness of qualified investments to credit and community development needs; and
> (4) The degree to which the qualified investments are not routinely provided by private investors.[6]

Banks may meet their CRA requirements by providing debt or equity financing to businesses in low-income areas. CRA exams are administered annually, and banks are

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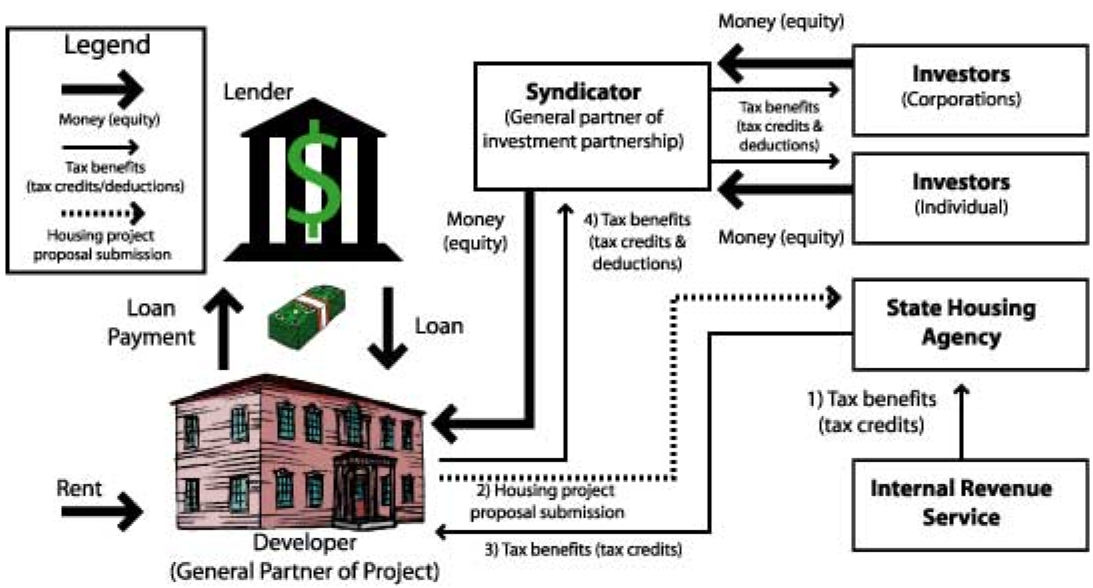
[5] US Dept of the Treasury, community Reinvestment Act Regulations, Thursday, May 4, 1995

[6] http://www.frbsf.org/community/resources/QIfinal.pdf

scored on a scale from unsatisfactory to outstanding. Scores are publicly disclosed and banks are facing increased scrutiny of CRA performance. As a result, banks are in constant search of profitable investment opportunities that can allow them to fulfill their CRA requirements, while delivering financial returns to their shareholders simultaneously. The LIHTC is one of many Federal programs that banks seek out to align community needs and financial returns.

How the LIHTC works

The graphic below, originally published by The Danter Company, provides a useful visual aide for understanding the flow of tax credits from their origin in the IRS to their ultimate destinations with private investors. En route, they pass through the hands of real estate developers and syndicators.[7]



Each party plays an important role in the flow of the tax credit. I will briefly describe each step of the process.

Tax Credits originate in the IRS (labeled 1, above). They are then distributed to designated agencies in each state, often called the Housing Finance Agency or "HFA". The value of each state's allocation of tax credits is a function of its population—typically, allocations are close to $1.75 per capita.[8]

Next, through a very competitive process, developers submit proposals for tax credit allocations (step 2). State housing agencies screen housing project proposal submissions

[7] http://www.danter.com/TAXCREDIT/lihtccht.htm
[8] http://www.enterprisefoundation.org/esic/taxcredits/101/section-b.asp

and award the Tax Credits to a handful of lucky developers.[9] (step 3). In cases where housing developments are not 100% affordable, credits are only available for the portion of the development that will be rented to low-income tenants. There are many additional restrictions on the appropriate uses of tax credits, and projects are audited periodically to make sure they are performing as planned; if they fail to meet the appropriate terms, they risk losing their credits.

In step 4—by far the most complex and interesting step-- the syndicator buys the tax credits from the developer, in exchange for an equity share in the development. To understand the significance of this, we must understand the mechanics of the tax credit cash flows, and details about the role of the syndicator.

Syndication changes the timing of the tax credit allocation. Allocations of tax credits have dollar values, which are delivered from the HFA to the developer in small increments over 10 or 15-year time spans. However, developers (who often face a financing gap) are often short on funds and want to speed up the inflow of their financing. As one syndicating company described it, "…the developer needs the money immediately to pay for development costs, not 10 percent annually for 10 years. Accordingly, the developer typically syndicates the credits - i.e., sells the rights to the future credits in exchange for up-front cash." [10] The syndicator will make the funding available now, and will collect the tax credits as they trickle in over time. Of course, there is a cost for this service: syndicators purchase tax credits at a discount and earn a profit by pocketing the spread between each dollar of tax credit and their investment to the developer. This "syndication fee" can range between 5% and 15% of the total tax credit value.

Syndication brings a secondary market of private investors into the financing loop. Typically, a syndicator will provide equity financing for a portfolio of real estate developments. It will pool them, repackage them, and offer private investors (top right of the diagram) the chance to invest in the pooled fund. Private investors receive equity in the development, and a proportion of the tax credits. In this way, syndicators are intermediaries between private investors (who are seeking tax credits) and real estate developers (who hold tax credits, but are seeking equity financing). The syndicators are the keystone in the process, providing industry knowledge and mitigating investment risks in several ways.

The critical role of the syndicator

It is important to note that not all tax credits are "syndicatable" and that syndication provides numerous advantages. For one, syndication allows division of labor: it allows developers to focus on developing, and investors to focus on investing. As full time intermediaries, tax credit syndicators build relationships with both groups. They expedite the processes that both groups would normally undertake independently. In contrast, in markets where credits cannot be syndicated, developers must solicit equity investors on

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[9] http://www.danter.com/TAXCREDIT/lihtccht.htm

[10] http://www.hud.gov/offices/cpd/affordablehousing/training/lihtc/basics/syndication.cfm

their own. Most developers have neither the time nor the expertise to develop these relationships.

Secondly, by pooling streams of tax credits, syndicators diversify away some of the idiosyncratic risk associated with an individual investment. Without this pooling effect, investors would be more vulnerable to fluctuations in returns on their equity. Although they would still benefit from the cost savings caused by the tax credits, they would miss out on the potential equity returns.

Thirdly, syndicators put the tax credits where they are most needed. In cases where developers of affordable housing are small, or have profits too low to take advantage of the tax credits, or when the developers are not for profit and are exempt from property taxes altogether, this syndication process provides a valuable incentive for highly profitable investors.

It is also important to understand the legal structure of a typical deal; typically, each affordable housing development is structured as a partnership between the developer and the other equity investors. "As the general partner, the developer has a very small ownership percentage [typically only 1% of the business] but maintains the authority to build and run the project on a day-to-day basis. The investor, as limited partner, has a large ownership percentage [approximately 99%] with an otherwise passive role."[11] In our scenario, the investor is the syndicator. This deal structure is significant because it protects the interests of the developer, while allowing for a big inflow of capital through additional equity investors. It also underscores the importance of thorough underwriting by the investors; they are becoming partial owners of the development and they must try to uncover every potential risk that may arise. Syndicators are well positioned to conduct this due diligence and mitigate some of the investment risks.

We now have an understanding of the path that equity financing follows from the IRS to the private investors. Furthermore, we have an understanding of the critical role of each player in the process, and the synergies enabled by the syndicator. Next, I would like to discuss the implications of this model, within the framework of our course. In many ways, this process exemplifies successful collaboration and alignment of interests between the government, business and non-profit sectors.

There are numerous accounts of the LIHTC motivating collaboration across sectors. "Under the leadership of the National Housing Conference, a coalition of 9 major housing organizations, representing private business as well as state government and nonprofit organizations, has called on Congress and the Administration to implement a number of immediate and long-term steps to address the nation's affordable housing crisis."[12] Thus, we see an example of one NGO—the National Housing Alliance—assembling a team from all three sectors to bring the affordable housing agenda to Washington. I propose that this collaboration is facilitated by the financing structure,

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[11] http://www.enterprisefoundation.org/esic/taxcredits/101/section-c.asp
[12] http://www.endhomelessness.org/pub/onlinenews/021403.htm

which aligns the social mission of the affordable housing developers with the profit maximizing mission of the businesses.

There are also examples of activism within this financing system. In an article called "Doing Well by Doing Good", the president of ESIC, a for-profit tax credit syndicator, described his role as an advocate for green design in affordable housing. "ESIC's intention," said Donahue, is "to mainstream the use of environmentally friendly construction methods and to encourage green building not only among developers, but also to push the adoption of green building programs among government agencies at the local and state levels […to get HFAs] to dedicate a significant portion of their federal housing tax credits to healthy, energy-efficient affordable housing sites located near public transportation."[13] If this works, it will be a remarkable example of blended social and financial missions. I assume that as an intermediary in this financing system, Donahue is well positioned to advocate for innovation. He likely carries support from multiple stakeholder groups, including real estate developers, financial institutions and government HFAs.

It is important to note that despite the impact that the LIHTC has made in increasing equity financing for affordable housing development, it has numerous critics as well. Some feel that when they buy credits at a discount, the syndicators rob the affordable housing developers of critical funding that would otherwise have gone to the public good. Others feel that CRA generally lacks the teeth to repair damages from unfair lending. Another group of critics characterizes the LIHTC as a corporate welfare program which has managed to deceive many in the social service community.

Conclusion

In conclusion, the LIHTC has funneled a tremendous amount of federal funding to development of affordable housing across the US. It has enabled developers to provide safe, secure housing for hundreds of thousands of families over the last 20 years. Beyond the mere existence of the tax credit, the syndication system is the lynchpin in the whole financing operation. Syndication enables private investors to easily access sound investments, while rewarding them with tax credits, equity investments and CRA credits. What's more, investors can achieve all this while managing to avoid direct contact with the real estate developers.

It is important to recognize that there is a healthy debate about this topic; the LIHTC has vocal critics who will continue to advocate in Washington and in academic writing for changes away from corporate tax shields and towards more service delivery. It is true that affordable housing developers would be even better off if the government invested directly in their projects, and avoided the cut that the syndicators take. However, to the extent that social change can be market driven, and businesses can truly align doing well and doing good, it seems that this tax credit is a prime example.

[13] http://www.knowledgeplex.org/news/67518.html