Policy Brief
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LAO

California's Low-Income Housing Tax Credit

Better Targeting Could Improve Effectiveness

The low-income housing tax credit is one of the state's major housing programs. Currently, there is legislation pending which would make significant changes in the credit. This brief evaluates the credit and offers recommendations for improving its effectiveness.

In 1989 the Legislature enacted legislation (SB 726, L. Greene) to continue the state low-income housing tax credit program as long as a related federal program exists. That legislation also requires the Legislative Analyst's Office to evaluate the effectiveness of this program. This policy brief provides the evaluation, and makes recommendations for changes to improve the program's effectiveness.

Background

The state's low-income housing tax credit is intended to increase the number of affordable rental housing units available to low-income households in California. It does this by providing developers and investors with a financial incentive--in the form of a credit against their state tax liability--to produce such units. The credit is based on the amount of investment in a qualified low-income housing project.

The program complements a federal tax credit program which also works to promote the development of low-income housing. Both programs are administered by the state's Mortgage Bond and Tax Credit Allocation Committee (the Committee). The Committee allocates the state and federal tax credits to projects that meet certain established criteria.

How Does the Low-Income Housing Tax Credit Program Work?

Chapter 1138/87 (AB 53, Klehs) authorizes the Committee to allocate the lesser of either $35 million or $1.25 per capita in state tax credits for each year the program continues. The Committee allocates these credits to developers of qualified projects, who generally sell the credits to investors in order to raise capital for these projects.

Figure 1

State Low-Income Housing Tax Credit Project Requirements and Priorities

1987 through 1989

Project Requirements	Project Priorities
• The buildings must be located in California.	• Government-assisted projects likely to convert to market rate units.
• Either the project has been allocated a federal credit or is more than 50% bond-financed.	• Projects committed to low-income use longer than 30 years.
• The developer agrees to provide (1) 20 percent of the units at rents that are affordable to persons at or below 50 percent of area median income, or (2) 40 percent of the units at rents that are affordable to persons at or below 60 percent of area median income.	• Projects providing more subsidized units than required (more than 20% or 40%). • Projects charging lower rent than required (less than 15% or 18% of area median income) • Projects that expect a cash return on investment less than 8% annually.
• The taxpayer may not receive more than 8% annual cash return on investment.	• Projects providing housing to groups with special needs (the disabled, farmworkers etc.).
• Projects must provide low-income rents for 30 years (the federal credit only required 15 years).	

The average total credit given under the program has been about $61,000 per unit.

Through 1989, the amount of the federal tax credit was generally equal to 70 percent and the state tax credit was equal to 30 percent of a project's "qualified basis." Smaller federal credits (30 percent) were allowed for acquisitions of existing buildings and federally subsidized projects. Qualified basis generally consists of acquisition, construction and/or rehabilitation costs of the units designated to rent to low-income tenants. The basis, however, does *not* include the cost of the land.

Figure 1 lists the requirements projects had to satisfy to qualify for credits through 1989, and the priorities the Committee used in allocating the credits among qualified applicants (applied in the order listed). Through the middle of 1989, the Committee awarded credits on a first-come, first-served basis so that project proposals received early in the year did not need to compete with projects whose applications were received later in the year.

How Has the Program Performed Since 1987?

Figure 2 highlights the activity of the state tax credit program since its inception in 1987.

As Figure 2 illustrates, from 1987 through 1989, the allocation of $104 million in state tax credits resulted in the subsidization of 6,180 low-income housing units. The average state credit award was $16,900 per unit of low-income housing. For a typical project this subsidy was *in addition to* approximately $44,000 per unit in federal tax credits, making the average *total* credit award approximately $61,000 per unit. By the end of 1988, only $2.5 million of these credits had been used to offset tax liabilities. This is primarily due to the long lead times required for housing projects to be placed in service, which must occur before these tax credits may be claimed.

Figure 2

State Low-Income Housing Tax Credit Program Performance

1987 through 1989

Year	Credit Ceiling	Credit Awarded	Credit Claimed	Units Subsidized
1987	$34,578,625	$6,818,086	$245,000	674
1988	34,578,625	32,987,856	2,300,000	1,645
1989	35,000,000	64,351,308[a]	n/a	3,861
Totals	$104,157,250	$104,157,250	$2,545,000	6,180

[a] Includes unallocated credits from 1987 and 1988.

How Effective Has the Program Been?

This section evaluates the effectiveness of the tax credit program in providing additional affordable housing to low-income individuals. It first examines the impact of both federal and state credits together. In addition, however, it evaluates the impact of the state credit by itself in order to determine what the state credit is buying in terms of additional low-income housing.

Combined Credit Effective in Producing Low-Income Units. In order to determine the role of the *combined* federal and state tax credits in producing low-income units, we surveyed developers of 60 potential low-income housing projects which were denied *both* federal and state credits in 1989. These projects were equally qualified as those which received credits, but were denied credits due to the timing of their applications. Because this group was sufficiently similar to the entire group of applicants (successful as well as unsuccessful) its behavior is most likely representative of the behavior of the applicants in the absence of a tax credit allocation. The main finding of our survey was that only four of the developers surveyed were still planning to rent units at "low-income" rates. These four projects were committed to renting at reduced rates because of other public financing they had received (such as mortgage revenue bonds). The developers of the 56 projects that were not "locked in" to providing low-income rents were planning either to sell their projects or to rent the units at market rates.

It seems clear from the survey results that the *combined federal and state* tax credits are effective in producing low-income housing units *for projects not bound by contractual obligations arising from other forms of public financing.* Thus, it is probably reasonable to attribute most of the 6,180 new housing units in Figure 2 to the tax credit program.

State Credit Effective in Extending Low-Income Use. The Committee made no attempt to assess the extent of a project's need prior to awarding either federal or state tax credits. It granted maximum credit awards to all qualifying projects on a first-come, first-served basis. Consequently, we are unable to determine how important--if at all--the state credits were in developers' decisions to make units available to low-income persons. For instance, the Committee may have subsidized units which would have been built without any state or federal credit awards (projects receiving other forms of subsidized financing, for example). For other projects, the federal credit alone may have been sufficient incentive for production. Finally, for those projects which did need additional incentive, a smaller state credit may have been sufficient.

The state credit did, however, play a role in extending the useful life of low-income projects. Those projects which received state credit awards in addition to federal credits are committed to providing low-income rents for 30 years rather than the 15-year commitment required by the federal program. In this way, the state credit was an effective "piggyback" program producing an additional 15 years of low-income rents from projects. Again, however, there is no way of knowing whether this additional commitment could have been achieved with smaller awards.

Reorientation of State Tax Credit Program Needed

In 1989, the operation of the federal tax credit program was extended until September 30, 1990 and significantly modified. The major federal changes were: (1) extension of the mandatory low-income use period from 15 to 30 years, (2) allowance of one-year carryover of unused credit authority, (3) restriction of credits for acquisitions of existing buildings only to those projects which include plans for rehabilitation, and (4) limitation of credit allocations to the amount necessary to ensure project feasibility.

This modification of the federal program necessitates a reorientation of the state's program for two reasons. First, the federal limitation of credit allocations based on financial need will require the Committee to perform a much more sophisticated analysis of projects than in the past. In addition, the change in compliance period from 15 to 30 years for those projects receiving federal credits dramatically alters the role of the state tax credit program. Whereas, in the past, the state credit was used to "buy" an additional 15 years of low-income rents, it will no longer perform that function. Consequently, the Legislature needs to reassess the need for the state credit. Given legislative interest in extending operation of the state credit, we provide several recommendations that would help target the allocation of state credits toward obtaining additional units.

Legislation is currently pending to bring the program into compliance with new federal requirements and make other improvements in its operation. Figure 3 summarizes our recommendations for legislation that would (1) increase the number of low-income units which could be produced with a given level of tax credits; and (2) increase the extent to which projects receiving tax credits meet legislative objectives for low-income rental housing in the state.

Limit State Tax Credit Awards to the Amount Needed for Financial Feasibility. Recent federal legislation requires that federal credits be limited to the amount needed for financial feasibility. State credits also should be awarded only to those projects which, having received the maximum federal amount, need additional funds for financial feasibility. Limiting the state award in this way could result in smaller per-unit subsidies to each project. Smaller per-unit

The primary impact of the state credit appears to have been increasing the developers' commitment to maintain low-income rents for an additional 15 years.

Figure 3

Summary of LAO Recommendations

- ☑ Limit tax credit awards to the amount needed for financial feasibility.
- ☑ Provide incentives for smaller subsidy requests.
- ☑ Allow the committee more flexibility in awarding state credits.
- ☑ Eliminate the priority for projects with high concentrations of low-income units.
- ☑ Modify the rural set-aside provision.
- ☑ Require project managers to report annually on project use.

subsidies would, in turn, *increase* the number of low-income units the credit can provide.

Provide Incentives for Smaller Subsidy Requests. Determining the amount of credit a project needs for financial feasibility is a difficult task. The Committee is developing an allocation plan that addresses this issue. Because this is such a difficult task, however, any allocation plan would be enhanced by providing an incentive for applicants to limit their requests to only that amount needed for financial feasibility. This could be achieved if the Committee considered the amount of credit needed per low-income unit when allocating tax credits to projects. Awarding tax credits first to those projects with the least amount of credit needed per unit (adjusted for differences in area development costs in order to avoid a bias against projects in high-cost areas), would provide an incentive to applicants to limit their requests to that amount needed for financial feasibility. In addition, this allocation method would tend to reduce the size of individual awards, so that the Committee could increase the number of projects subsidized.

Allow the Committee More Flexibility in Awarding State Credits. We recommend that the Legislature eliminate the requirements that: (1) state credits be awarded only to projects receiving federal credits, and (2) state credit awards made independent of federal awards be limited to 30 percent of a project's qualified basis. These restrictions on the use of state credits apparently were implemented with the intention of using the state awards to extend the useful life of low-income projects to 30 years. Since the federal government now requires the 30-year low-income use commitment, the state credit could be used to obtain *additional* units through new construction or rehabilitation. Eliminating the above restrictions could help achieve this end. For instance, as noted above, it may be that significantly less than 30 percent or no state credit is needed in the case of many projects. In that case, the state should allow itself the flexibility to provide awards to projects which do *not* receive federal assistance. For "state-only" projects, however, the state may need to provide credits of more than 30 percent in order to make a project financially feasible. Allocating these credits using the lowest cost per unit criteria discussed above would help to ensure that the maximum number of additional low-income housing units are obtained.

Eliminate the Priority for Projects With High Concentrations of Low-Income Units. Current law provides an allocation priority for projects with greater than the required number of low-income units. In fact, most projects receiving tax credits in 1989 provided 100 percent low-income units. Encouraging the concentration of subsidized units, however, appears to be contrary to the Legislature's stated intent. For example, with respect to the California Housing Finance Agency (which administers other programs that subsidize affordable rental housing), the Legislature has sought the "... avoidance of concentration of very-low-income households that may lead to deterioration of a development" (Health and Safety Code Section 5092).

Modify the Rural "Set-Aside" Provision. State law requires that 20 percent of both federal and state tax credit authority be provided to rural projects. This strict set-aside provision, however, runs the risk that projects will go unfunded while available tax credit money remains unallocated. For example, the dollar amount of federal credits allocated to rural projects in 1989 was less than 20 percent of the total because there were insufficient qualified rural applicants. Consequently, the state lost $155,000 in federal credit authority, in spite of the fact that the Committee had a long waiting list of urban projects seeking those federal tax credits. While recent federal and state changes (that is, the one-year carryover provision) make it unlikely that future credits will be lost, the set-aside requirement may still result in the state being unable to fund high priority urban projects despite the availability of unallocated credit authority.

Require Project Managers to Report Annually on Project Use. Most other state housing programs require that either those who receive the subsidies or agencies granting the subsidies report annually on the extent to which projects are meeting state housing goals. This information enables the Legislature to monitor and evaluate the program and increases its ability to plan for future program improvements. ❖

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