United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on HUD/Mod Rehab Investigation, Committee on Banking, Housing and Urban Affairs, U.S. Senate

August 1990

RENTAL HOUSING

Observations on the Low-Income Housing Tax Credit Program

142018

GAO/RCED-90-203

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-236205

August 14, 1990

The Honorable Bob Graham
Chairman, Subcommittee on HUD/Mod
Rehab Investigation
Committee on Banking, Housing and Urban
Affairs
United States Senate

Dear Mr. Chairman:

Following our April 27, 1990, testimony on the Low-Income Housing Tax Credit Program before your Subcommittee, you requested additional information on (1) the estimated cost to the Treasury of low-income housing tax credits awarded during 1987-89, (2) whether the awarded tax credits have resulted in reduced rents paid by tenants in credit-assisted units, (3) whether such tenants have been selected from waiting lists maintained by public housing authorities, (4) the adequacy of existing compliance monitoring requirements, (5) the adequacy of current statutory provisions designed to prevent noncompliance, and (6) alternative tax credit allocation formulas. We briefed your office on most of these matters in early November 1989 as part of the Subcommittee's interest in issues pertinent to national housing legislation being considered in the Congress. This report, per your request, updates information previously provided. Additionally, you requested our views on programmatic or legislative changes that could improve the tax credit program.

The Low-Income Housing Tax Credit Program was authorized in the Tax Reform Act of 1986 as a 3-year program to provide an incentive for investors to construct or rehabilitate low-income housing. The program, administered by the U.S. Treasury Department and state housing agencies, provides a 10-year tax credit to property owners for each unit set aside for low-income use. The tax credits may be used, within specified limits, on a dollar-for-dollar basis, to reduce income tax liability. They are, therefore, financial assets sought by prospective investors. When investors purchase interests in tax credit projects, they also are entitled to use tax credits and other related project benefits, such as depreciation, as allowed by law. The capital raised is available to help finance projects or to contribute to the developer's profits. Since the credit was established, it has emerged as the primary tax incentive for stimulating low-income housing production and rehabilitation.

Results in Brief

- For tax credit awards made during 1987-89, we estimate the total projected tax expenditure[1] at about $5.7 billion, unadjusted for traditional revenue estimating requirements.[2] We estimate that the tax expenditure will be used between 1987 and 2000. The expenditure extends to the year 2000 because of provisions of the program that allow the start of the 10-year credit period to be deferred.
- In the time available, we were unable to determine the extent to which tax credits alone, without any other form of subsidy, have been used to reduce total unit rents to no more than the legally required 30 percent of the tenants' adjusted incomes. However, on the basis of our limited information, it does not appear that the credits have typically been used to achieve this purpose. Rather, it seems that the amount collected from tenants is frequently supplemented with either federal or nonfederal subsidies as authorized by statute. Currently, there is no statutory or regulatory requirement to use tax credits solely to reduce rents to an amount that eliminates the need for additional subsidies. Our work indicates that if such requirements were in place, they might adversely affect the financial viability of proposed projects, or substantially reduce project owners' profits, and could likely result in discouraging the development of low-income housing.
- Currently, there is no legal requirement to select tenants for credit-assisted housing from waiting lists maintained by public housing agencies (PHAS) except when the credit-assisted housing also receives Department of Housing and Urban Development-sponsored assistance in the form of project-based section 8 rental subsidies. Waiting lists maintained by PHAS are, however, sometimes used to fill vacancies in credit-assisted housing. And, according to National Council of State Housing Agency officials, state credit awarding agencies are required to give evaluation preferences to project proposals that plan to use waiting lists as a source of tenant referrals. We were unable to determine, however, to what extent credit-assisted projects were actually rented to tenants from PHAS' waiting lists.
- In our view, the program's existing compliance monitoring requirements are not adequate by themselves to ensure compliance with program requirements. Currently, state credit awarding agencies are required to report to the Internal Revenue Service (IRS) any instance of noncompliance of which they become aware. However, after the initial award, no specific federal, state, or local agency is required to monitor assisted

[1] Tax expenditure is the term used to describe the revenue foregone through the various tax benefits authorized in the Internal Revenue Code.

[2] Traditional revenue estimates would include adjustments such as the interest costs the government would have to pay on funds it borrowed to replace tax revenues foregone.

projects for continuing compliance with the tenant eligibility and housing quality requirements of the program. As a result, it is uncertain whether the existing compliance provisions will effectively detect noncompliance. Accordingly, billions of dollars in federal subsidies are apparently being dispensed almost solely on the basis of self-certification by the recipient taxpayers. This condition could allow instances of noncompliance with program requirements to go undetected for long periods of time. Expanding the current role of the states in administering the program to include compliance monitoring of assisted projects could help to ensure compliance with program requirements. Further, the state role of reporting noncompliance to the IRS for enforcement action, including civil and criminal penalties where appropriate, would not change.

- On the basis of our limited work, it appears that the current statutory program provision related to noncompliance—recapture of a portion of the awarded credit—may not effectively discourage noncompliance with program requirements by credit recipients. This is especially true in situations where it is economically beneficial to convert low-income housing to other uses. First, the potential financial impact of recapture is relatively small, amounting at most to one-third of the award. Second, recent amendments to the statute added an extra 15-year low-income-use period to the original 15-year compliance period. However, there is apparently no recapture adjustment in the program for an owner's failure to comply with program provisions during the second 15 years.
- Because of the limited time available to respond to your request and the resulting constraints on our work, we lack the data necessary to endorse any alternatives to the existing per capita allocation formula used to authorize tax credit allocation amounts for each state. However, there are numerous options potentially available for allocating states' respective shares of the credits. For example, a formula could be established on the basis of need so that those states or areas within states with the greatest need would receive a larger allocation. An example of need could be the lack of vacant, suitable rental housing already in existence in the state. Data required to develop a needs-driven allocation formula is not currently available on a state-by-state basis. However, according to Census Bureau officials, it would be possible to modify the American Housing Survey to provide the required data.

With regard to our views on possible programmatic or legislative changes to improve the tax credit program, we believe a clearer statement of the primary focus of the program would be useful. Ostensibly, the Low-Income Tax Credit Program is designed to stimulate private investment and increase the supply of low-income housing. However, decisions about how the credits are used can significantly affect the results obtained. For example, credits can be used to provide the amount of financing needed to fill the gap between the financing already secured and the total amount required, and awarded as sparingly as possible in combination with other kinds of financial assistance. Alternatively, they can be viewed as deep subsidies to provide the greatest possible assistance to the lowest income families. A clearer statement of the primary focus of the program could enhance its effectiveness by allowing the various mechanisms for financial and in-kind housing assistance, including tax credits, to be structured to complement each other.

In addition, the 1989 amendments to the law directed states to award the minimum amount of credit necessary to ensure the financial viability of an assisted project. If states take this as an injunction to spread credits among projects as sparingly as possible, it could impair project owners' ability to establish rents at the 30-percent level because the tax credits are often used in amounts needed in combination with other subsidies to achieve the mandated rent levels and ensure the financial viability of the projects. The 1989 amendments also require that states plan to award credits to projects serving the lowest income tenants over the longest period of time. Again, it may be difficult to spread credits as thinly as possible while concurrently assisting the lowest income tenants. To achieve these objectives, the program allows state awarding agencies to make determinations about which projects receive credits and in what amounts.

The foregoing demonstrates that stimulating private investment, producing large numbers of assisted units, and reducing rents to reach the lowest income tenants may be somewhat inconsistent objectives. It is doubtful that tax credits alone can accomplish all of them. Accordingly, we believe that in the reauthorization process it will be important to decide what the primary focus of the tax credit program should be. An advantage of stating a clear goal for the program is that it could then better form part of a comprehensive, coordinated low-income housing strategy.

Scope and Methodology

Our work was performed between October 1989 and June 1990. To develop our estimate of the cost to the Treasury of credits awarded to projects by states from 1987 to 1989, we consulted with staff of the Joint Committee on Taxation. To ascertain how some PHAs were using waiting lists for credit-assisted projects and using tax credits to set rent levels, we conducted a limited review of PHA practices and interviewed

PHA officials in Prince Georges and Montgomery Counties, Maryland. To assess the adequacy of compliance monitoring requirements and the adequacy of noncompliance sanctions, we interviewed officials of the Treasury, Internal Revenue Service, the National Council of State Housing Agencies, and the Executive Director of the Florida Housing Finance Agency. As requested, we did not obtain official comments on our draft report from the parties involved in these matters. However, we discussed our observations on these issues with them and incorporated their comments where appropriate. The officials we contacted generally agreed with our assessments and observations.

As agreed with your office, the observations in this report are conditional because of the limited scope of our work. Copies of this report will be sent to the Director of the PHAs in Prince Georges and Montgomery Counties, Maryland, and the Maryland and Florida tax credit allocation agencies. Should you require additional information on these issues, please contact me at (202) 275-5525. Major contributors to this report are listed in appendix IX.

Sincerely yours,

John M. Ols, Jr.
Director, Housing and
Community Development Issues

Contents

Abbreviations

GAO	General Accounting Office
HUD	Department of Housing and Urban Development
IRS	Internal Revenue Service
PHA	Public Housing Agency
SRO	Single Room Occupancy

The Low-Income Housing Tax Credit Program

The Low-Income Housing Tax Credit Program was authorized in the Tax Reform Act of 1986 as a 3-year program to provide an incentive for investors to construct or rehabilitate low-income housing. In December 1989 the program was revised and extended through December 31, 1990. Before 1986 the Internal Revenue Code allowed other tax incentives for low-income housing, such as accelerated cost recovery deductions and special treatment of construction-period interest and taxes, among others. With passage of the 1986 act, those incentives were replaced with low-income housing tax credits. Since the credit was established, it has emerged as the primary tax incentive for stimulating low-income housing production and rehabilitation.

The program is administered by the U.S. Treasury Department and state housing agencies. Subject to eligibility criteria, it provides a 10-year tax credit to property owners for each unit set aside for at least 15 years for low-income use.

Three different categories and two different levels of low-income housing tax credits are available. For new construction and rehabilitation expenses, the credit is designed to return to the taxpayer over 10 years up to a maximum of the present value of 70 percent of the allowable cost or the qualified basis (i.e., the low-income units) in the project. For acquisition costs (except land acquisition), the credit can return the present value of 30 percent of qualified basis over 10 years. Federally subsidized projects are eligible for credit only at the 30-percent level. For the tax credit program, federal subsidies include any tax-exempt financing or below-market federal financing. Rent supplements provided through section 8 existing certificates or housing vouchers do not count as federal subsidies and do not reduce the amount of credit a project may receive.

The low-income housing tax credit program includes a state allocation system. A project must qualify for the credit on the basis of requirements in the Internal Revenue Code, but in addition the owner must apply to the state in which the project is located. The state tax credit allocation agency has the authority to grant all or part of the allowable tax credits requested, up to the limit of the state's total tax credit allocation.

The state allocation is made pursuant to a state limit, or cap, of 93.75 cents (formerly $1.25) per resident. For example, a state with about 4 million residents would have about $3.75 million ($0.9375 x 4 million) worth of credit authority per year. Accordingly, that state could allocate credits for projects where all credits taken in a year by all owners who applied totaled \$3.75 million. When multiplied by the 10-year credit period, the actual total of tax credits that could be used in that state originating from that year would be about \$37.5 million.

Individuals, corporations, partnerships, and nonprofit entities are eligible to be awarded low-income housing tax credits. However, passive activity rules limit the amount of taxes that can be offset by the credits for certain groups of taxpayers. The maximum low-income housing tax credit that an individual can use in any year is \$8,250. On the other hand, most corporations can use the tax credit without being subject to the \$8,250 limit. Corporations are also exempt from passive activity limitations on depreciation deductions that apply to individuals.

Nonprofit entities that have no tax liability can also benefit from the credits by selling an interest in the project to investors who can use the credit. In fact, because of the limitations on using the credits directly, and because the credits provide dollar-for-dollar reductions in tax liability, interests in tax credit projects are commonly sold by all types of owners to investors through syndicators. In this way, the developer converts future tax credits into cash, usually received within 3 to 4 years of project inception. When investors purchase interests in tax credit projects, the capital raised is available to help finance projects or may contribute indirectly to the developer's profits.

Estimated Cost of Tax Credits, 1987-89

Question : With respect to the tax credits that have been allocated during the years 1987-89, what is the estimated cost to the Treasury of the allocated credits over the 10-year credit period? In addressing this question, GAO may assume that there will be no adjustment in the amount of the credits that have been allocated to projects, unless you learn that credits have not been or will not be used. The Subcommittee is interested in an absolute number rather than a relative number that takes into account alternative strategies available to taxpayers to avoid or minimize taxation. In providing this estimate, identify any material assumptions made.

Response: Table 2.1 shows that for tax credit awards made during the 3-year period, the total federal projected tax expenditure is estimated at about $5.7 billion to be used over the period from 1987 through 2000.

As we reported during the April 1990 hearing, since the Low-Income Housing Tax Credit Program began in 1987, award and use of the credits has steadily increased from about 20 percent of the allocation to states in 1987 to about 98 percent of the allocation in 1989. By the end of 1989, about $565 million worth of initial-year credits had been awarded in connection with the development of approximately 236,000 low-income housing units.

In consultation with the Joint Committee on Taxation, we developed our estimated cost of foregone revenues for tax credit awards made during 1987-89. As you requested, this estimate does not assume adjustments to the initial-year awards, such as recapture events, and does not reflect other considerations, such as interest costs the government would have to pay on funds it borrowed to replace the tax revenues foregone. This estimate is also based on data from the National Council of State Housing Agencies regarding the respective portion of credit awards that are not used in the initial year. In accordance with the methodology used by the Joint Committee on Taxation, these figures are presented in current dollars, and no attempt has been made to discount the amounts to a base period.

Table 2.1: Estimated Costs of Tax Credits Awarded, 1987 to 1989

Year of tax credit award	Amount of annual tax credit awarded	(1) 1987	(2) 1988	(3) 1989	(4) 1990	(5) 1991	(6) 1992
1987	$62,885,954	$62,885,954	$62,885,954	$62,885,954	$62,885,954	$62,885,954	$62,885,954
1988	202,227,453	0	105,158,276	163,804,237	202,227,453	202,227,453	202,227,453
1989	307,320,726	0	0	162,879,985	252,002,995	307,320,726	307,320,726
Annual Costs		**$62,885,954**	**$168,044,230**	**$389,570,176**	**$517,116,402**	**$572,434,133**	**$572,434,133**

Years

(7) 1993	(8) 1994	(9) 1995	(10) 1996	(11) 1997	(12) 1998	(13) 1999	(14) 2000	Total costs
$62,885,954	$62,885,954	$62,885,954	$62,885,954	$0	$0	$0	$0	$628,859,540
202,227,453	202,227,453	202,227,453	202,227,453	202,227,453	97,069,177	38,423,216	0	2,022,274,530
307,320,726	307,320,726	307,320,726	307,320,726	307,320,726	307,320,726	144,440,741	55,317,731	3,073,207,260
$572,434,133	**$572,434,133**	**$572,434,133**	**$572,434,133**	**$509,548,179**	**$404,389,903**	**$182,863,957**	**$55,317,731**	**$5,724,341,330**

According to officials of the National Council of State Housing Agencies, only a portion of the cost of initial-year awards is incurred in the year that the awards are made. After credit award, project owners have until the end of the second calendar year after the year in which the award is made to complete projects and place them in service, provided that at least 10 percent of the total development cost is incurred in the year that the credits are initially awarded. Additionally, a project owner may elect to defer the start of the credit period for 1 year after the building is placed in service. In those instances, the 10-year credit period begins at a later time. Finally, the first year's credit is reduced to reflect the time during the year that any low-income units are unoccupied. The reduced credit is claimed in the 11th year. As a result, when calculating the cost of these awards, a portion of annual initial-year awards should be carried through to subsequent years. Accordingly, in some instances, the total project award amount (the initial-year award amount multiplied by 10) is actually used over a longer period. The maximum possible period from the credit award to final usage is 13 years and 11 months. For purposes of our calculations, however, we assumed 12 years as the longest credit use period.

Rent Reductions Resulting From Tax Credit Subsidies

Question: With respect to tax credit projects that have not received Section 8 Moderate Rehabilitation rent subsidies, does available empirical evidence indicate whether the tax credit subsidy has reduced the rents paid by tenants in credit-assisted units below the rents that such tenants would have paid for units not assisted by the credit?

Response: Rents for tax credit assisted units are statutorily set at 30 percent of the tenant's adjusted family income as determined by Department of Housing and Urban Development (HUD) standards.[1] In some instances, however, tenant rent is supplemented by federal or nonfederal subsidies. However, we do not know the extent to which tax credits have been used to maintain the statutory tenant rent without using any additional subsidy. The time available to respond to your request did not permit us to conduct an extensive review of this issue. However, we believe additional subsidies will generally be needed in combination with tax credits to adequately finance projects.

Currently, there is no statutory or regulatory requirement to use tax credits to set or maintain tenant rents at the statutory level without using any additional subsidy. An owner of a credit-assisted unit may not require tenants to pay rents of more than 30 percent of the family's adjusted income. In that sense, tenants in credit-assisted units should benefit from a reduced rent burden. The difference between the tenant's rent contribution and the actual rent, if any, would have to be subsidized in order for the owner to receive the full market rent for the unit.

In addition, we believe that in higher cost or lower income areas, the financial benefit derived from the capital generated solely through the use of tax credit subsidies would be insufficient to offset development and operating costs enough to permit substantial rent reductions below the level mandated by law. This is because of the statutory limits on the amount of project awards and the sizable portion of the credit award amount used in raising capital through project syndication. Therefore, a requirement to use credit proceeds solely for rent reductions without allowing other subsidies could discourage low-income housing development.

In order for the credits to enable a project owner to set the rents at a level that qualified tenants could pay without any other subsidies, credit awards would have to be large enough to absorb the effects of

[1]The tax credit program uses HUD's income eligibility regulations to determine adjusted family income. The regulations are at 24 CFR Part 813 (1989).

limited rents and still provide for a financially viable project and a reasonable profit to the owner. We have done limited prior work on the amount of net equity capital derived from low-income housing tax credits after syndication costs and investor yields have been taken into account. However, our work indicates that because of the cost associated with raising capital and the discounted cost of money, the tax credits usually provide substantially less than one dollar of equity capital potentially available for project development for every dollar of awarded tax credits. Credit proceeds could also leverage debt financing for the projects.

Accordingly, additional subsidies (federal, nonfederal, or both) are likely to continue to be needed in conjunction with tax credits to enable project owners to receive the full market rent charged for units and conform to the statutory requirement to provide units to tenants at rent levels no greater than 30 percent of tenants' adjusted family income. Required additional subsidies consist of financial assistance such as discount financing or in-kind contributions secured with the help of state or local governments, or federal rent supplements such as section 8 existing certificates or housing vouchers.

We discussed this matter with officials of two local public housing authorities (PHAS)—Prince Georges County, Maryland, and Montgomery County, Maryland. On the basis of our discussions, we found that each used tax credits differently in assisting eligible tenants.

Officials in Prince Georges County told us that the use of tax credit subsidies in their jurisdiction was determined solely by the state credit allocation agency in its decisions regarding which projects would be awarded credits. The officials noted that the state credit allocation agency consulted with county housing officials about whether a project proposal was consistent with county housing needs prior to making final project awards, but the PHA was not directly involved in which projects received credits or how the credits were used.

According to county housing officials, tenant needs and housing availability largely determined whether an eligible, low-income county resident resided in credit-assisted housing as opposed to housing that received another form of subsidy, such as HUD section 8 subsidies or public housing. In addition, the officials said that they did not know whether any rents had been reduced below the statutory maximum as a result of use of tax credits in credit-assisted projects in their jurisdiction.

Officials in Montgomery County, however, told us that the use of tax credit subsidies was an integral part of their local low-income housing strategy and that a primary objective of their use of the credits and other subsidies was to finance projects so that rents could be set at much lower levels than would be possible using debt financing. Since they started the program in 1987, they have developed about 125 units of credit-assisted housing.

Generally, Montgomery County has used the funds raised from credits to replace previous funding sources that are no longer available. The PHA has accomplished this by receiving tax credit awards from the state allocation agency and raising capital by forming limited partnerships with local and other private corporate investors such as banks, public utilities, and the Federal National Mortgage Corporation. The investors contribute equity capital to the partnerships, which the PHA, in turn, invests in low-income housing development that is owned by the partnership and operated by the PHA as the general partner. In exchange for their equity contribution, the private investors receive tax credits and related project tax benefits that are used to reduce their corporate tax liability.

Montgomery County PHA officials told us that the allowable amount of tax credits that can be awarded to a given project is usually not enough to enable rents for units that meet housing quality standards to be reduced to a level to serve the target population. Therefore, in addition to the credits, other forms of project subsidies are required to reduce rent levels sufficiently. Accordingly, the PHA has combined awarded tax credits with other nonfederal subsidies, such as local real estate tax abatement, donations of the land on which the housing has been developed, and state and local loans.

In addition to those measures, the PHA has acted as its own syndicator, so that the transaction costs associated with raising investor capital have been reduced greatly below the amounts usually incurred in these kinds of arrangements. PHA officials said that they were able to accomplish most of the necessary syndication requirements "in-house" because of their prior experience in underwriting real estate development projects.

According to PHA officials, the equity raised from the three tax credit partnerships in which they have participated has been targeted to tenants in the county with average incomes of 55, 35, and 40 percent of the area median income levels. The credit-assisted units have been filled with tenants at the target income levels, without using other federal subsidies, because of the way the housing was financed. Moreover, PHA officials told us that the PHA will retain control of the housing in perpetuity because the land on which the housing was developed is owned by the PHA and merely leased to the partnership.

According to PHA officials, as a result of their use of the credits combined with nonfederal subsidies, for the housing financed with tax credit-related capital, rents for tenants in the housing have been reduced below what they otherwise would have been, as shown in the following table.

Table 3.1: Estimated Rent Reductions for Tax Credit-Assisted Housing

	Actual rents using tax credits and nonfederal subsidies	Estimated rents[a] without tax credits and nonfederal subsidies
1-bedroom	$321	$510
2-bedroom	366	680
3-bedroom	433	860
4-bedroom	482	1,060

[a]Assumes 100 percent debt financing at 9.5 percent interest rate.

Source: Montgomery County Housing Opportunities Commission, Montgomery County, Maryland.

Montgomery County PHA officials told us that, although they had been successful in using tax credits and limited partnerships in developing affordable low-income housing that did not require other federal subsidies, they did not know how widely their approach could be used in other housing markets. They noted, for example, that the state had enacted laws to abate real estate taxes that otherwise would have to be paid and that local banks had invested substantial funds because they had used their low-income housing investments to satisfy Community Reinvestment Act requirements. In addition, they said that there was a lot of community support for the kinds of programs that they were sponsoring. It is not clear whether, or to what extent, these conditions may exist in other areas.

Use of Waiting Lists to Select Tenants for Credit-Assisted Housing

Question: To what extent have tenants of credit-assisted units in tax credit projects been selected from waiting lists maintained by local public housing authorities?

Response: Waiting lists maintained by PHAs are sometimes used to initially rent new units or fill vacancies in existing credit-assisted housing. In some states an owner's willingness to use waiting lists is a factor in evaluating the application for a credit award. However, we do not know the extent to which this practice is used, nor how effective it is in securing tenants for the projects.

The issue of using waiting lists to refer prospective tenants to credit-assisted housing was first raised at the Subcommittee's September 29, 1989, hearing. In our November 1989 briefing, we advised Committee staff that regulations for the HUD Moderate Rehabilitation Program required that for units that received project-based section 8 assistance along with the tax credits, vacancies be filled from the appropriate local waiting lists. Otherwise, we reported that the tax law contained no requirement to use waiting lists as a source of prospective tenants for tax credit units.

A requirement to use the waiting lists for tenant selection would not necessarily ensure priority placement for those who have waited longest or have the greatest need unless prospective tenants on waiting lists are also provided with additional rental assistance subsidies that would enable project owners to obtain their minimum cash flow requirements. A project owner who used the PHA waiting list as a source of tenant referrals would not necessarily choose to accept tenants in the priority order dictated by the waiting list. An owner would likely seek tenants whose adjusted incomes were as high as possible in order to receive the most allowable rent. This consideration might well override the waiting-list priority that eligible families otherwise obtain because of length of time on the list, homelessness, extremely low income, or other priority preference factors.

For the above reasons, we believe that the projects' debt service and owners' cash flow requirements would be more likely to dictate rental decisions than would placement priorities of the waiting lists. Accordingly, the use of the PHA waiting list would be of limited utility in ensuring that families with the greatest need were served first.

Absent a statutory requirement to use waiting lists, we believe the ability to legally obtain a higher total rent would likely encourage project owners to first try to secure tenants with rent subsidies. These tenants would not be found on the PHA waiting list because, with rare exceptions, the waiting list consists of families who do not have current subsidies.

We attempted to verify waiting list practices with officials in Prince Georges and Montgomery Counties. As was the case with using tax credits, each of the PHAS used its waiting list differently in assisting eligible tenants in its jurisdictions.

Officials in Prince Georges County noted that there is no requirement to establish special procedures or a special waiting list to refer eligible prospective tenants to credit-assisted housing. Their standard waiting lists—both for public and assisted housing—are maintained to refer prospective tenants to available, suitable housing for which they are qualified as each listee moved up the list for referral. The standard lists are used for all assisted housing in their jurisdiction, irrespective of the housing assistance program involved. No specific waiting list is maintained solely for the purpose of referring tenants to credit-assisted housing, nor are special procedures in place to use the standard assisted-housing waiting lists for that purpose. They said, therefore, that it would be coincidental if an eligible tenant from the waiting list was referred to a credit-assisted housing unit.

Officials in Montgomery County told us that, in initially renting new units and filling vacancies in existing units in their credit-assisted housing, they exclusively use their standard assisted-housing waiting list of eligible prospective tenants. They noted, however, that because of the target group of tenants they wish to assist, they often have to go further down the waiting list to find tenants with qualifying incomes (i.e., 35, 40, or 55 percent of area median income), but tenants are selected from the standard waiting list on the basis of listees' eligibility within the target tenant group. The officials noted, however, that all such selected tenants are high-priority placement listees.

The same waiting list is also used to refer prospective tenants to other types of assisted housing. However, because the prospective tenants for housing subsidized under other assistance programs often have lower qualifying incomes, the tenants usually require housing units that are subsidized with other federal assistance, such as section 8 rental subsidies.

Adequacy of Compliance Monitoring

Question: Are existing compliance monitoring requirements for the tax credit program adequate?

Response: The tax credit program currently reflects nearly $6 billion in present and future federal tax credit awards. If the program is authorized at the pre-1990 level of $1.25 in tax credits per capita, the total program commitment could be as much as $3 billion annually. This amount will increase for each year that the program is reauthorized. Because the credits represent a unique financial commitment to low-income housing, it is important that the program be monitored effectively to discourage and detect possible fraud or waste. In our view, notwithstanding the Internal Revenue Services's (IRS) other available criminal and civil noncompliance penalties, compliance monitoring requirements of the program do not provide reasonable assurances that the program will be used in accordance with requirements. That is because after initial project evaluation, no specific state or federal agency is required to monitor whether credit-assisted units are suitable and actually being used to house low-income families. An option to improve compliance monitoring could be to expand the states' current role in administering the program to include a requirement to have them monitor assisted projects for continuing compliance with program requirements. Through this expanded role, if states detected noncompliance, they could continue to report it to the IRS for enforcement action as is now required by the statute. In addition, effective compliance monitoring could be hampered because some occupancy requirement compliance criteria are unclear.

Representatives of the IRS testified at the April 27, 1990, hearing that current compliance monitoring for the Low-Income Housing Tax Credit Program consists primarily of a review of taxpayer certifications of the low-income use of the credit-assisted projects. Returns claiming the credit are screened to ensure that proper documents are attached. They also noted that a tracking system is being developed to match information on a project owner's tax return with information filed by the state and local housing authorities. However effective existing tax return reviews may be, we believe the review process would show only that correct paperwork existed to document the claimed credit. A review would not, for example, disclose whether the credit-assisted units meet minimum housing quality standards or whether the units were actually occupied by low-income tenants.

The December 1989 amendments require state housing credit awarding agencies to report to IRS any instance of noncompliance of which they become aware. However, there is no authority to require state agencies to verify continuing compliance once they make their original certification of a credit award. In fact, Treasury Regulation 1.42-1T (d)(8)(v), adopted before the 1989 amendments, expressly states that state housing credit agencies have no responsibility to monitor compliance. Neither do public housing agencies.

In our view, if no specific state, federal, or local agency is required to monitor on a continuing basis whether credit-assisted units are suitable and actually being used to house low-income families, billions of dollars in federal subsidies could be dispensed almost solely on the basis of self-certification. We believe the importance of the program warrants additional program controls. A knowledgeable, independent party, such as the state awarding agency, should be required annually to verify continuing compliance with program requirements and entitlement to the credit. The statute would have to be amended accordingly to require an independent party to verify credit-assisted projects' continuing low-income use.

It appears that state housing finance agencies are in a good position to monitor the program's requirements because of their role in initially awarding the credits and their expertise in housing matters. It would, however, undoubtedly be a financial and administrative burden for state agencies to verify annually that credit-assisted units are occupied by qualified tenants at the statutorily permitted rents, but states could rely, in part, on reports from local PHAs on occupancy by assisted tenants and information about placements from the waiting lists.

If this compliance monitoring option is adopted, the importance of the program and the amount of federal subsidy involved may warrant a modest grant to the states to fund all or part of the additional cost of compliance monitoring. If an additional inducement is necessary, states could be permitted to reallocate the dollar value of all credits recaptured as a result of detected noncompliance.

We discussed compliance monitoring provisions of the program with officials of the National Council of State Housing Agencies and the Executive Director of the Florida Housing Finance Agency. They agreed with our assessment of the existing compliance monitoring provisions. In addition, council officials said that they had recently established a task force to develop compliance monitoring procedures. They said the planned procedures should provide better assurances that credit-assisted projects continue to meet minimum housing quality standards and use requirements.

The Director of the Florida Housing Finance Agency also agreed with our assessment of the existing provisions and said that compliance monitoring grants to the states would be useful because otherwise the associated costs would probably be charged to credit awardees who would likely, in turn, include these charges in project development costs. He said that would, in effect, reduce the amount of the credit award potentially available for project development. He also said that he agreed that states could use existing reports from local PHAS in monitoring project compliance, and thought that reports from other entities, such as the Farmers Home Administration, would also be useful.

Problems in Determining Noncompliance

In addition to the issue of unspecified compliance monitoring responsibility, a related problem exists in determining what constitutes noncompliance with the occupancy requirements of the program. The tax credit provisions establish an occupancy requirement, but the requirement is not clear. Section 42(i) requires that, to be counted as a part of the qualified basis, low-income units must be both suitable for occupancy and actually occupied on a nontransient basis.[1]

Assuming a good faith intent to comply with the law's occupancy requirement, there is insufficient guidance as to how a vacant unit is to be treated. An inference can be drawn from the fact that a de minimis reduction in floor space reserved for low-income housing will not trigger a recapture: A short-term vacancy (i.e., a vacancy of less than the maximum 2 months allowed without loss of income in a typical Housing Assistance Program contract) should probably not affect the qualified basis at all. By the same token, a longer term vacancy should probably be treated as a de facto reduction in basis.

As a practical matter, however, the project "head count" for determining qualified basis is only required to be conducted annually at the end of the taxable year. Since the rules do not clearly require it, a project owner would probably not have an economic incentive to reduce his or her qualified basis by not counting a unit that had been vacant for less than a year where the vacancy did not extend through the end of the taxable year. Moreover, any vacancy of less than 3 months duration

[1]The December 1989 amendments authorized the award of tax credits on Single Room Occupancy (SRO) units and allowed month-to-month rentals of SROs to count as nontransient usage.

in progress at year's end would likely be considered de minimis by the owner and would not be removed either. That vacancy could then continue through the next 11 months without posing a recapture threat. Some adjustment seems to be needed here, and it could be handled effectively through regulations without amending the statute.

One possible approach is to establish a maximum permissible vacancy rate at the end of each taxable year. The vacancy rate could be the vacancy rate in the market area. Another approach would be to limit the number of months a unit can be held vacant without taking it out of qualified basis for the year, irrespective of its status at year-end. A third approach would be to use a monthly average vacancy rate.

Adequacy of Noncompliance Sanctions

Question: Are existing sanctions for noncompliance with program requirements adequate?

Response: The Internal Revenue Code authorizes the assessment of monetary penalties and interest against taxpayers who fraudulently or negligently understate their tax liability. Tax fraud can result in criminal prosecution as well. We do not question the efficacy of the Code's civil and criminal penalties. These sanctions would be as effective in preventing underreporting and fraud in the low-income housing tax credit area as they are in regard to other tax provisions. In addition to the sanctions, however, the low-income housing tax credit program includes a provision to adjust the tax credit in the event the low-income status of the credit-assisted units is endangered or changed. That adjustment is made by recapturing a portion of the awarded credit.

Either of two events may trigger recapture of the low-income housing tax credit. The first and most visible event occurs when the taxpayer disposes of the interest in the project without posting a bond to ensure its future low-income use. The other recapture event occurs when the qualified basis at year-end dips below the basis on which the credits were originally calculated.

In recapture, the accelerated portion of the credit for all prior taxable years on the noncomplying segment of the qualified basis is added to the taxpayer's tax liability for the current year along with nondeductible annual interest at the overpayment rate.[1] In the early years of the compliance period, the recapture amount would be less, but because only the accelerated portion of the credit is recaptured, recapture could never be more than one-third of the total credit allowed on a unit. Thus, the financial impact of recapture is relatively small.

Technically, recapture can occur at any time during the compliance period, even in years 11-15 after the credits have been fully parcelled out to the project owner. However, the December 1989 amendments to

[1]The amount of tax credit allocable to a building is computed and awarded on the building's "qualified basis." The qualified basis for recapture purposes is computed at the time the credits are awarded. "Qualified basis" is the lesser of two ratios—the number of low-income units compared to the total number of units, or the amount of floor space for low-income units compared to the total amount of floor space for all residential rental units in the building. (IRC Sec. 42(c).) The accelerated portion of the credit is created by the fact that credit is awarded annually for a 15-year compliance period, but it is actually taken over a 10-year period. The difference between the amount of credit that would have been allowed had the credit been used in 15 equal installments instead of 10 is the "accelerated portion of the credit." (IRC Sec. 42(j)(3).)

the statute added an extra 15-year "low-income-use period" to the original 15-year compliance period. Because there were no corresponding changes in the recapture provisions, there is apparently no program-specific financial sanction for failing to comply with the additional low-income-use period.

The occurrence of a recapture apparently does not terminate future entitlement to tax credits if compliance is resumed. Absent any indication to the contrary, it would also appear that the accelerated credit usage schedule would also be resumed in future taxable years.[2] We agree that it would probably be counterproductive to terminate the entitlement to future credits because that could eliminate any incentive to resume compliance.

If recapture is to be an effective tool to ensure maintenance of credit-assisted units in a low-income status, the financial impact should be substantial enough to provide a credible deterrent to making other use of the property. This means, for example, that the recapture liability should be high enough that converting the units to market rent or selling the property and paying the recapture due would not be financially beneficial to the owner.

There are many different ways in which the recapture provision could be revised. One possibility is that in addition to recapturing the accelerated portion of the credit on the noncomplying segment of the qualified basis, the recapture provision could include provisions for (1) disallowance of all of the current year's credit and (2) if no credits are being used in the current year, a penalty expressed as a percentage of accumulated past credits equal to the percentage of present noncompliance. Such a penalty could apply during years 11-15 of the compliance period or the additional low-income-use period.

We discussed noncompliance and sanctions with officials of the National Council of the State Housing Agencies and the Executive Director of the Florida Housing Finance Agency. They agreed with our assessment of the adequacy of the current recapture adjustment. In addition, they stressed that any change in the existing recapture provision should provide adequate time for detected noncompliance to be corrected prior to the imposition of the recapture. They said adequate time was important so that a probable loss of credit to the recapture provision would not

[2]The effect of resuming credit usage on the 15-year schedule would be to allow the taxpayer to regain some of the recaptured credit.

discourage owners' good faith efforts to correct problems and bring units back into compliance.

Alternatives to the Per Capita Allocation Formula

Question: What alternative, preferable allocation formulas could be used to allocate tax credits to states?

Response: The Congress made two changes in the allocation formula in the 1989 amendments to section 42. First, it reduced the allocation from $1.25 to $.9375 per capita for calendar year 1990 only. Second, it allowed the redistribution of expiring prior year tax credits from states that had not fully used their credits to states that had previously used all their available credits. Building on the latter change, a further refinement in targeting these redistributed credits could be to direct them to projects in high-cost, extreme poverty areas which, under the 1989 amendments, became eligible for bonus credits obtained on an enhanced (130 percent) basis. This would allow additional credits to be used for projects that cost more or would be located in very poor areas.

We are not in a position to endorse any alternatives to the flat allocation of tax credits on a state population basis because of the limited data we gathered in the time available. However, there are numerous options potentially available for allocating states' respective shares of the tax credit authorization. Under the current allocation method, states with equal populations receive equal tax credit allocations without regard to possible need-determined factors such as poverty levels, unemployment rates, or the availability of existing, affordable housing.

In our view, the program could be more effective if credit allocations to the states were based on relative need. In prior testimony and briefings for the Subcommittee, we have noted that tax credits have been used inefficiently to produce additional housing units in markets where significant numbers of suitable available rental housing units already exist. We also pointed out that in housing markets with an adequate supply of rental units, where the problem is one of affordability, the use of the existing housing supply with tenant-based section 8 existing housing certificates or vouchers becomes the less costly form of assistance. Accordingly, we believe an option would be to restrict the use of tax credits generally to areas where vacancy rates are low for suitable units renting at or below the area's fair market rents. It might also be feasible to require that any deviation from this policy by a state credit allocation agency be documented, justified, and subject to review by an authorized representative of the federal or state government.

Much of the data required to determine state-by-state low-income housing needs, however, is not currently available. We discussed this matter with officials in the Bureau of the Census. They said that the biannual American Housing Survey collects much of the data required to assess the quality and amount of housing in existence in selected areas of the country. In their opinion, the current survey could be expanded and conducted annually (as it was between 1973 and 1981) so that it could be used to assess low-income housing needs on a state-by-state basis. Required changes in the way that the survey is conducted would necessitate additional funding for the survey. Census officials said the additional cost would probably be relatively small in comparison to the amount of credits awarded annually, but time did not permit us to develop an estimate of the added cost.

Other Programmatic or Legislative Improvements That Could Be Considered

Question: What programmatic or legislative considerations should be considered to improve the program?

Response: We believe that it is important to clearly define the primary focus of the tax credit program as part of any reauthorization. The ostensible purpose of the program is to stimulate private investment and increase the supply of low-income housing. The program also compensated for the elimination of some tax benefits that had previously been available to investors in low-income housing.

Some program proponents may have expected that reduced debt service associated with generating capital through the use of tax credits would have enabled project owners to reduce rents to no more than 30 percent of adjusted income for tenants with incomes of less than 50 or 60 percent of the area median, without any additional federal subsidy being provided. However, current law does not require that any specific portion of the financial benefit derived from the tax credit be used for that purpose as long as certain minimum statutory requirements are met. In fact, if such a requirement were to adversely affect projects' financial viability or substantially reduce owners' profits, it could conceivably work against the goal of stimulating investment in low-income housing to produce more units.

What is needed is to carefully balance two potentially conflicting objectives: putting as much of the credit award as possible into the project to allow lower tenant rents, thereby assisting the lowest income tenants, versus providing project owners and investors with sufficient returns on their investment so that units continue to be produced. As previously noted, state awarding agencies are beginning to evaluate project proposals on the basis of how much credit subsidy is actually needed for the project. These evaluations are aimed at minimizing credit awards in view of other project funding sources.

That approach is consistent with our prior analyses of situations where tax credits and other rent subsidies, notably project-based section 8 assistance, have been combined. Our prior analyses showed that the tax credits are probably not needed at current allowable levels to ensure project financial viability where rental subsidies are available for all or most of the units in an assisted project.

The 1989 amendments directed states to allocate the minimum amount of credit necessary to ensure the financial viability of a project. However, if states take this as an injunction to spread the tax credits as sparingly as possible, it will likely, in many housing markets, impair project owners' ability to establish rents at the 30-percent level because the tax credits are often used in amounts needed in combination with other subsidies to achieve the mandated rent levels and ensure the financial viability of the projects. Moreover, the 1989 amendments contained another requirement that states should plan to allocate the credits to projects serving the lowest income tenants over the longest period of time. State awarding agencies would likely have to make the largest allowable project awards to achieve this objective. It may be difficult to achieve both goals at the same time.

These issues demonstrate that stimulating private investment, producing large numbers of low-income units, and reducing rents to reach the lowest income tenants may be somewhat inconsistent objectives. It is doubtful that tax credits can accomplish all of them. Accordingly, we believe that in the reauthorization process it will be important to decide what the primary focus of the tax credit program should be. An advantage of stating a clear goal for the program is that the various mechanisms for financial and in-kind housing assistance, including tax credits, can be structured to complement each other and provide a comprehensive, coordinated low-income housing strategy.

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