INSIGHT

The Low-Income Housing Tax Credit: Lowering the 50% Bond Threshold to 25%

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This Insight explains a proposal from the 117th Congress pertaining to the low-income housing tax credit (LIHTC) program that may be reintroduced in the 118th Congress: lowering the bond threshold on developments that combine LIHTCs with tax-exempt bond financing from 50% to 25%. This proposal was included in the Affordable Housing Credit Improvement Act of 2021 (S. 1136/H.R. 2573) and in various iterations of the Build Back Better Act (BBBA). The Insight first provides a brief overview of the program followed by a more detailed look at the bond threshold and selected policy considerations.

Brief Overview

The LIHTC program is the federal government's primary policy tool for encouraging the development and rehabilitation of affordable rental housing. Developers are awarded LIHTCs to offset the cost of producing affordable rental housing for low-income tenants by applying to their state (or in some cases local) housing finance agency (HFA). States are limited by a statutorily specified formula based on population that determines the amount of credits they may award in a year. In 2023, states are allowed to award LIHTCs in an amount equal to the greater of $2.75 times the state's population, or $3,185,000. The amounts determined by this formula are commonly referred to as a state's LIHTC "cap" or "limit."

HFAs evaluate developer applications for an award of LIHTCs according to federally required, but state-created, qualified allocation plans (QAPs). Each state quantifies its housing priorities via its QAP by awarding developers various levels of "points" for meeting certain criteria. For example, one state may give more points for housing intended for seniors or veterans, while another state may give more points for housing located near public transportation. There is competition among developers to put forth the most attractive (highest point) application because applications for credits typically exceed the amount of credits a state has to award.

There are two types of LIHTCs available to developers. The so-called 9% credit is typically reserved for new construction not utilizing additional federal subsidies, and the so-called 4% credit is typically used for rehabilitation projects utilizing federally tax-exempt bond financing. The 9% credit was originally intended to provide up to a 70% construction subsidy, whereas the 4% credit was originally intended to provide up to a 30% subsidy. Due to a number of legislative changes since the creation of the LIHTC

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program and the specifics of how each state administers the program, the actual subsidy rates may not be 70% or 30%.

Both types of credits are claimed in equal amounts over a 10-year period. However, developers need cash to break ground, so they will "sell" their 10-year stream of tax credits to an outside investor (e.g., large financial institution) in exchange for upfront construction financing. The capital raised by the sale of the tax credits is usually combined with other private and public funding sources in order to finance the development.

4% Credits, Tax-Exempt Bonds, and the Proposal

Developers are eligible for an *automatic* award of 4% credits (assuming they meet all other LIHTC eligibility requirements) if they finance at least 50% of a LIHTC project with qualified private activity bonds (PABs), a type of federally tax-exempt bond. That is, developers meeting the criteria for an automatic award of 4% credits do not need to compete with other developers in the application process run by the state HFAs. Thus, 4% credits, when combined with at least 50% in tax-exempt bond financing, are also referred to as "noncompetitive" credits. Awards of noncompetitive credits are not limited by, nor do they count against, a state's annual LIHTC cap. They are only limited by a state's authority to issue PABs, also called its "volume cap." In 2023, states have a PAB volume cap equal to the greater of $120 per person, or $358,845,000. In contrast, 9% credits are limited by a state's LIHTC cap and because there are typically more applications for 9% credits than there is cap space, 9% credits are also referred to as "competitive" credits. Finally, if the 50% threshold is met, the developer will receive 4% credits on all eligible LIHTC units in the building, not just on a fraction equal to the percentage of bond financing. The proposals introduced in the 117th Congress would have reduced the 50% threshold to 25%, either permanently or temporarily.

Selected Policy Considerations

Lowering the bond threshold may result in more LIHTC construction by allowing states to stretch their bond authority and by reducing competition for the limited 9% credits. States that more often exhaust their volume cap would benefit more from lowering the bond threshold than those that less frequently or rarely exhaust their volume cap (because they still have cap space left to finance LIHTC construction). In years that a state does exhaust its volume cap, the degree to which this may occur would depend partly on the state devoting the freed-up volume cap for affordable housing as opposed to directing it to other qualified private activities (e.g., certain infrastructure projects) that fall under the annual PAB volume cap. Any increase in LIHTC construction would also depend partly on developers' ability to secure other sources of financing to fill the gap left by the lower level of tax-exempt bond financing. To the extent that developers are unable to fill the gap, the increase in LIHTC construction would be smaller. Alternatively, if the gap is filled with financing previously reserved for other types of housing, the net increase in the housing stock would be smaller.

Lowering the bond threshold would have a revenue cost. The Joint Committee on Taxation estimated two slightly different proposals to lower the 50% threshold to 25% contained in various iterations of the Build Back Better Act: one that would lower the threshold for bonds issued in calendar years 2022 through 2026, and another that would lower the threshold for bonds issued in calendar years 2022 through 2028. The 10-year revenue costs associated with those proposals were $8.6 billion and $9.5 billion, respectively.

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