

## **F. Tax Credit for Developers of Affordable Single-Family Housing**

### **Present Law**

The low-income housing tax credit (the “LIHC”) may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures. The aggregate credit authority provided annually to each State is \$1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The \$1.75 per resident cap is indexed for inflation.

### **Description of Proposal**

The proposal would create a single-family housing tax credit. Eligible taxpayers generally would be the developer or investor partnership owning the qualified housing unit immediately prior to the date of sale to a qualified buyer. The maximum credit for each unit could not exceed the present value of 50-percent of the qualifying costs of that housing unit. This credit would be claimed over the five-year period beginning the later of the date of sale of the unit to a qualified buyer or the date a certificate of occupancy for that unit is issued. A qualified buyer would mean an individual with income of 80 percent (70 percent for families with less than three members) or less of area median income based initially on the 2000 census data. A qualified buyer would not have to be first-time homebuyer.

Similar to the present-law low-income rental housing tax credit, this credit would provide \$1.75 of tax credit authority annually to each State for every resident in the State beginning in calendar year 2003. The \$1.75 amount would be indexed for inflation beginning in calendar year 2004. Each State (or local government) would allocate its credit authority to the qualified developers or investor partnerships that own the housing unit immediately prior to the date of sale to a qualified buyer (or, if later, the date a certificate of occupancy was issued). Units in condominiums and cooperatives would be treated as single-family housing for purposes of the credit. Credits allocated to a housing unit would revert to the allocating agency unless expenditures equal to at least 10 percent of the total reasonably expected qualifying costs with respect to that housing unit were expended during the first six months after the allocation. Rules similar to the present-law LIHC rules would apply regarding plans on allocations, credit carryforwards, credit returns and a national pool of unused allocations.

The qualified developers or investor partnerships would claim the credit for the five years after the qualified property is sold to a qualified buyer. However, no credit would be allowed with respect to a housing unit unless that unit was sold within the one-year period beginning on the date a certificate of occupancy was issued with regard to that unit. Also, rules similar to the

present-law LIHC rules would apply to determination of eligible basis, present value calculations and reporting requirements.

A qualified homebuyer (not the developer or investor partnership) would be subject to recapture if the qualified homebuyer (or subsequent buyer) sells to a non-qualified buyer within three years of the initial sale of the qualified unit. The recapture tax would be the lesser of: (1) 80 percent of the gain upon resale, or (2) a recapture amount. The recapture amount would equal the value of the credits allocated to the housing unit being resold, reduced by  $1/36^{\text{th}}$  of that value for each month between the initial sale and the sale to the nonqualified buyer. If a housing unit for which any credit was claimed is converted to rental property within the initial five-year period then no deductions for depreciation or property taxes could be claimed with respect to such unit for the balance of that five-year period. The proposal does not provide how the qualified homebuyer (or subsequent buyer) would know what the recapture amount for their housing unit.

Effective date.--The proposal would be effective beginning in calendar year 2003.

### **Analysis of Complexity and Policy Issues**

#### **Complexity issues**

The proposal would add to complexity in the tax law by creating a new tax credit with numerous detailed rules and significant record keeping requirements for both the taxpayer claiming the credit and subsequent homebuyers. This new credit, like the low-income rental housing credit upon which it is based, would be inherently complex and detailed, and would require significant additional paperwork by taxpayers. The proposal would require the creation of additional tax forms and would require the Internal Revenue Service to devote resources to the administration and enforcement of the rules under the proposal. Also, a system to identify qualified buyers and advertise qualified properties for sale to such buyers would need to be developed. This proposal could give rise to an increase in the number of individual taxpayers requiring third-party assistance in preparing their tax returns. The factual inquiries necessitated by the annual State credit authority cap, the per-unit expenditure requirements, the certification of buyer income levels, the time limits on subsequent sales, and the recapture rules applicable to homebuyers, would tend to lead to additional disputes, including litigation, between the IRS and taxpayers. In addition, adding a new incentive to home ownership without repealing or consolidating with present-law incentives (such as the low-income housing credit), which have a similar policy goal but have somewhat different requirements, would cause a proliferation of similar provisions, adding to tax law complexity.

#### **Policy issues**

Families with incomes less than the median income family are less often homeowners than are families with incomes above the median income. While many factors determine a family's decision to rent rather than own their own home, the price of a home creates two important financial factors that, at least temporarily, persuade families with incomes less than the median income to choose to rent rather than buy. First, the greater the price of a home, the greater the required down payment, and families generally must accumulate funds for the down

payment. Second, the greater the price of a home, the greater the monthly mortgage payment, and both lenders and prudent buyers generally limit monthly housing expenses by reference to a percentage of current income. In summary, lower housing prices would make it easier for families with incomes less than the median income to accumulate funds for a down payment and to qualify for a mortgage based upon their current income.

The local housing market, supply and demand, determine the price of available homes. An important factor in determining the market price is the cost of developing new properties or renovating old properties. A developer's expenses in the provision of housing can be thought of as consisting of two components: (1) the cost of the land; and (2) the cost of construction. The proposal would provide a developer a credit against his income tax liability related to qualified construction expenses for housing sold to a qualified homebuyer whose family income is 80 percent or less of area median income (70 percent or less for families comprised of one, two, or three individuals). In a sale to a qualifying homebuyer, the credit has the effect of subsidizing construction costs. As a consequence, the developer may be able to offer housing for sale to a qualifying homebuyer at a lower price than the developer's costs, or the local housing market, might warrant. The tax credit may enable the developer to earn an after-tax rate of return comparable or greater to that the developer would have earned had the same housing been sold to a non-qualifying homebuyer or comparable or greater to that the developer would have earned had the developer built other housing to be sold to a non-qualifying homebuyer in the same local housing market.

The statutory incidence of the proposal provides that the taxpayer developing the qualifying property claims the tax benefit. However, in a market economy the economic incidence can differ from the statutory incidence. All of the benefit could accrue to a buyer of the property in the form of reduction in purchase price (compared to an otherwise comparable home offered by a developer who has not received an allocation of the proposed tax credits) equal to the full present value of the tax credits<sup>86</sup> the developer/seller may claim under the proposal. Alternatively, there may be no change in purchase price (compared to an otherwise comparable home offered by a developer who has not received an allocation of the proposed tax credits), in which case the entire economic benefit of the tax credits would accrue to the developer/seller claiming the credits under the proposal. Generally the more responsive purchasers are to changes in the market price, the greater will be the proportion of the economic incidence of a tax benefit that accrues to the seller. The more responsive sellers are to changes in the market price, the greater will be the proportion of the economic incidence of a tax benefit that

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<sup>86</sup> The proposal would determine the present value of the tax credits as provided under present-law Code section 42 (the low-income housing credit). The present value calculation prescribed in subsection 42(b) was based on a marginal income tax rate applicable to the highest income taxpayers of 28 percent. Subsequent changes in the marginal income tax rate structure, including changes enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, have established marginal income tax rates other than 28 percent to be applicable to the highest income taxpayers. Thus, the present value calculation of the proposal may not reflect the actual present value to the taxpayer.

accrues to the purchaser.<sup>87</sup> For example, if there are relatively few properties of a comparable type and it is difficult to obtain land or building permits to build more such properties, the more likely it will be that qualifying homebuyers bid against one another for a property. By bidding up the sales price of the property, more of the economic benefit of the tax credit accrues to the seller. Oppositely, if there are relatively few qualified buyers, but there are several potential developers who have credit allocations and can easily supply housing for sale, the developers may compete against each other to sell to a qualifying buyer by lowering the price they charge to such buyers. By lowering the price of the property under competitive pressure, more of the economic benefit of the tax credit accrues to the buyer.

Because of the diversity in market conditions of different local housing markets, it is not possible to predict whether buyers or sellers are likely to be the primary economic beneficiary of the proposed tax credit. The proposal requires that the credit may only be claimed for sales that occur within one year of the property being certified for occupancy. The time limit may exert pressure on developers to reduce the price of the property in order to sell it before the one-year period expires. On the other hand, the limit on the number of properties on which the credit may be claimed may impose a supply constraint. Potential qualifying buyers could bid against one another, keeping the sales price higher than it otherwise might be. Even if the economic beneficiary were to be the developer, the developer may only claim the credit if a family with an income of less than 80 percent of the area median income is the purchaser. Therefore, even if such a family did not receive a substantial price discount, if the developer sold to such a family, rather than a non-qualifying family, the goal of increasing home ownership by families with incomes less than 80 percent of the area median income may have been advanced.

The proposal defines qualifying buyers by reference to their annual income at the time of purchase. As noted above, a lower proportion of families with incomes less than area median income are homeowners than are families with incomes above the area median income. It is also the case that families headed by individuals 30 years old or younger are more likely to have incomes less than the area median income than are families headed by individuals over 30 years of age. This arises because most individuals' earning power increases with experience and job tenure. As the family's earners age, the family is more able to accumulate funds for a down payment and have sufficient monthly income to qualify for a mortgage on a home. Data on homeownership by age are consistent with this scenario. In 1999, the percentage of household owner-occupiers among households headed by an individual less than 35 years old was 39.7 percent. The percentage of household owner-occupiers among households headed by an individual 35 to 44 years old was 67.2 percent. The percentage of household owner-occupiers among households headed by an individual 65 years old or older was 80.1 percent.<sup>88</sup> By

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<sup>87</sup> Economists measure the responsiveness to demand and supply to price changes by reference to the "price elasticity of demand" and the "price elasticity of supply." The greater the price elasticity of demand relative to the price elasticity of supply, the greater the economic incidence falls to the benefit of purchasers. The greater the price elasticity of supply relative to the price elasticity of demand, the greater the economic incidence falls to the benefit of the seller.

<sup>88</sup> U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States 2000*.

targeting the credit based on annual income, the proposal may provide benefit to two distinct types of families. The proposal would provide benefit both to those families whose income, year-in, year-out falls below 80 percent of area median and who, consequently, may otherwise always find down payment and monthly mortgage servicing requirements a hurdle to homeownership. The proposal also would provide a benefit to families whose income growth would permit them to own a home without assistance as the family's income grows through time. For such families the proposal may only accelerate their ultimate status as a homeowner.

Some observers may find some unfairness in the proposal's definition of qualifying family. Under the proposal, the Smith family, whose income is less than 80 percent of the area median income, and the Jones family, whose income is above 80 percent of the area median income, could bid on the same property. If the Smith family offered \$95,000 for the property and the Jones family offered \$100,000, under the proposal, the Smith's offer could dominate the Jones's offer on an after-tax basis to the seller. The Smith and Jones families could have very similar incomes. A modest raise may have pushed the Jones family above the qualifying income threshold and thereby denied the Jones family the opportunity to acquire the home or it may require the Jones family to offer even more if they hope to acquire the home.

Some opponents of the proposal question the necessity of providing additional benefits to homeownership. They note that homeownership rates are above 60 percent<sup>89</sup> and homeownership receives preferential treatment under the present income tax as mortgage interest, home equity interest, and property tax payments are deductible expenses and that for many taxpayers any capital gain on the income from the sale of a principal residence is excluded from income. In addition, they note that, under present law, States may issue qualified mortgage bonds to lower the mortgage costs of middle and lower-middle income families who seek to acquire a home. That is, the qualified mortgage bond program generally targets the financial needs of the same population. Proponents of efforts to increase homeownership observe that homeownership helps support strong, vital communities and participatory democracy. In particular, they observe, the quality of life in distressed neighborhoods can be improved by increasing homeownership. In such neighborhoods the costs of renovation or new construction may exceed the current market value of housing in such neighborhoods and that a State allocation mechanism for the proposed credits may be able to direct qualifying investments to such areas where the social return to homeownership is particularly large.

### **Prior Action**

An identical proposal was included in the President's fiscal year 2002 budget proposal.

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<sup>89</sup> In 1999, of 104.9 million occupied housing units nationwide, 70.1 million were owner-occupied. U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States 2000*.