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Two Steps to Ensure Affordable Housing Production is not Lost

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Affordable rental housing survived the tax reform war of 2017, though not unscathed. Now it needs to stabilize and prepare to rebuild–and it took a first step to do so in March.

Tax credits and private activity bonds (PABs) were all under significant threat during 2017's yearlong battle over tax reform, which resulted in the passage of H.R. 1 in December 2017. The legislation preserved the low-income housing tax credit (LIHTC), PABs, the new markets tax credit (NMTC) and renewable energy investment tax credit (ITC) and production tax credit (PTC); while preserving but changing the historic tax credit (HTC). Considering that the House version of tax reform included the elimination of the tax-exemption of PABs, which help fund more than half of LIHTC developments every year, things could have been considerably worse.

However, merely preserving these incentives doesn't mean they escaped unharmed–particularly the LIHTC. The damage to affordable housing from the tax legislation is steep, primarily because the reduction of the top corporate tax rate from 35 percent to 21 percent.

That means the value of the tax losses that accompany LIHTC investments is reduced. A Novogradac & Company analysis found that the 14 percent lower corporate tax rate likely reduces the amount of LIHTC equity that can be raised by about 14 percent. In dollar value, that's roughly $1.7 billion each year.

Year after year after year.

Combined with another significant reform in tax law–the change in the annual inflation adjustment to the chained consumer price index (C-CPI) to increase the annual LIHTC and PAB allocations–Novogradac's analysis suggested the new tax rate would result in the loss of 219,200 to 232,300 affordable rental homes over a decade if no further changes were made.

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That would mean hundreds of thousands of people would be unable to access affordable housing because properties wouldn't be built, renovated or preserved during the next decade.

That is, unless other changes were made.

The first of those was made as part of the omnibus spending package approved by Congress and signed March 23 by President Trump. It featured affordable housing provisions that included a 12.5 percent increase in annual LIHTC allocations for the next four years, (as well as an income-averaging provision included in the Cantwell-Hatch, Curbelo-Neal tax bills). That's a start, although far from enough.

The Reason for Reduction

For LIHTC investors, there are two key financial elements: tax credits and tax losses.

This is simple math: The federal LIHTC benefit from tax losses equals the tax rate of the amount invested, since the LIHTC is a dollar-for-dollar tax credit. In other words, if an investor contributes $1 in equity for each dollar of tax credits, under prior tax law the taxpayer expected to receive federal tax loss savings of 35 cents per dollar over the 15-year compliance period. Under a 21 percent top corporate rate, such as is in place now, the value of the tax losses is 21 cents–a loss of 14 cents on the dollar compared to the higher rate.

In spite of this, there are legislative means to increase affordable housing preservation and production. The most obvious is passage of the Affordable Housing Credit Improvement Act, which was introduced in both houses of Congress and would greatly expand the allocation of LIHTCs (in the Senate bill, at least), while providing other improvements that would boost affordable housing production and enable more communities and population demographics to access affordable rental homes. (The 12.5 percent boost and another provision in the omnibus spending bill–income-averaging for LIHTC properties–were encouraged by this legislation.)

That said, there are also targeted ways to specifically address the loss of production and preservation resulting from the reduction in the corporate income tax rate. Here are some suggestions–specifically a two-step process that Congress could take to keep affordable housing production at the same rate as before the tax legislation.

Again, these aren't exclusive of the Affordable Housing Credit Improvement Act (AHCIA). They could be implemented to complement improvements suggested by that bill, and allow AHCIA to achieve its original goal of a 50 percent increase in affordable housing production and preservation. Two changes would assure that affordable housing production stays consistent with 2016 and 2017 levels in a world with a decreased tax rate and a chained CPI.

Step One: Increase Allocable LIHTCs

Congress could increase the amount of allocable LIHTCs each year–expanding and making permanent the 12.5 percent boost in the omnibus spending bill. Investors could simply be allowed a greater amount of tax credits–an amount equal to the difference after the 16-percent decrease in production because of the new corporate rate and shift to chained CPI.

The percentage obviously increases with the amount of the tax cut–although it stays relatively close to the amount of the tax reduction. Under this proposal, the federal LIHTC would receive a greater annual allocation to offset the drop in tax rate: And Novogradac's study shows the new 21 percent tax rate requires an increase of 16 percent in LIHTC allocations to keep production level, which isn't much higher than the 12.5 percent

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boost in the omnibus spending bill. The amount would need to be slightly higher to offset the loss of production due to the adoption of chained CPI.

Step Two: Credit Percentage Formula Update

The formula by which the annual LIHTC percentage is determined also needs to be reformed to ensure that developments that were financially feasible under a top corporate rate of 35 percent remain so under a rate of 21 percent.

The current LIHTC percentage formula is flawed because it doesn't capture the cost of capital for private investors in part because it's based on after-tax federal government borrowing rates.

Part of this problem was solved in December 2015 when Congress made the 9 percent LIHTC floor permanent. Unfortunately, part of this problem was not solved back for private activity bond financed developments, as the 4 percent floor was not enacted. The 9 percent floor is important in a low interest rate environment, but as interest rates finally begin rising after sitting at historic lows for several years, the problem with the formula will return. The LIHTC percentage doesn't adequately respond to increases in interest rates and other hurdles investors maintain investment and production.

That was already a problem and the lower corporate tax rate simply exacerbated the difficulty. To address both the rising interest rates and the lowered corporate tax rate, the formula should be modernized.

The current annual tax credit percentage formula is based on the average of the midterm and long-term applicable federal rates (AFRs), reduced by 28 percent and discounted on a present-value-basis over a 10-year period designed to cover either 70 percent or 30 percent of the depreciable cost (what we call the 9 percent and 4 percent LIHTC). Adding to the complication is the fact that the present-value calculation is made on the assumption that an investor receives the first-year's tax credit on the day their investment is made.

That rarely happens.

Novogradac's suggested formula would eliminate the 28 percent discount and simply add 150 basis points to the average of the midterm and long-term AFRs to approximate the difference between private investor's cost of capital and the federal government's cost of capital. In addition, the present-value discount should be delayed by two years–a switch that recognizes the fact that most private investors contribute a significant amount of capital well before they start claiming their LIHTCs, as well as the reality that the first-year LIHTCs claimed are usually less than a full year due to the lease-up rule.

After making those changes, the LIHTC rate should be adjusted based on the corporate tax rate changes. With the 14 percent cut in corporate tax rate, the LIHTC 9 percent rate would be boosted to 10.22 percent. The 4 percent rate would be 4.38 percent.

An important note: This proposal isn't at odds with the current-law minimum 9 percent rate or the bipartisan proposal to set a minimum 4 percent rate in the Affordable Housing Credit Improvement Act. The minimum rates and the new formula coexist quite nicely, as the floors serve as buffers against various combinations of future declines in interest rates and increases in corporate tax rates.

Why it Works

These proposals–to further and permanently increase the annual allocation amount and update the annual credit percentage formula –would help offset what is likely an unintended consequence of tax reform: a decrease in affordable rental housing investment and production.

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This two-step proposal would maintain current levels of LIHTC investment and production in a period of a dramatic (40 percent) reduction in the corporate tax rate. This plan would also ensure the financial feasibility of LIHTC developments under a lower corporate rate.

Affordable housing advocates are busy pushing for passage of the Affordable Housing Credit Improvement Act, a campaign worth all the energy and effort. These suggested changes work both independently of provisions in the bill and in conjunction with them.

The changes make sense.

Congress should consider going beyond the provisions of the omnibus spending bill by restoring LIHTCs based on the corporate tax rate decrease and upgrading the LIHTC percentage formula. ❖

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