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The Many Meanings of 'Mixed-Income' and How they Affect Policymakers

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Policymakers have been interested in creating mixed-income housing for decades. How the federal low-income housing tax credit (LIHTC)–the nation's primary affordable rental production program–promotes this objective is an important question. The first step in answering is to define the term.

One Term, Multiple Definitions

What can be surprising to some is that "mixed-income" can describe six different circumstances in the LIHTC context. Appreciating the existence of the distinctions below is itself an important step in considering what policies an allocating agency adopts.

1. Neighborhoods and larger vicinities containing households at a variety of incomes, including multiple prospects for meaningful interaction (e.g., parks, schools and shopping). The extensive research demonstrating benefits to low-income individuals from being in high-opportunity areas is based on this premise (Raj Chetty's research at Harvard being the most well known).

2. A development that largely functions as a single property from the residents' perspective, but has separate ownership and financing for the affordable and market-rate components (building condominiums or ground lease with common area easements). These properties must be very large and are feasible in only a few major metropolitan areas.

3. All units are income- and rent-restricted, but at varying levels. A common mix is most units are for households at 60% of area median income (AMI) and the rest targeted to 30%. Taking San Antonio, Texas, as an example, for a family of four, these percentages equal annual incomes of $52,680 and $26,340. If using average income, the range can be as much as 20% to 80% AMI.

4. What are known as "80-20" developments, meaning market-rate apartments represent the former percentage. The idea is buildings meet the minimum federal requirements to receive a small amount of subsidy. There are very few of these outside of New York City.

5. Most units are restricted (often more than 75%) and the rest are market rate, owned together by one entity (same equity and financing), where the market-rate rents are substantially higher. Exactly how much is covered in the discussion below.

6. Most units are rent-restricted and the rest are market-rate, but with similar rents for both.

After appreciating these nuances, the next step is understanding the challenges created by unrestricted units in LIHTC properties. As in the last two definitions, especially No. 6, this is true.

Compliance Difficulties

One of the widely recognized strengths of the LIHTC is the extremely high rate of compliance. This is an impressive reality given the many layers of statutes, regulations, procedures, notices and other restrictions imposed by all levels of government.

Including market-rate apartments makes compliance even more complex. Added complications include interbuilding transfers, available and vacant-unit rules, keeping up with the applicable fraction (two calculations), and issues related to the average income minimum set-aside. Novogradac's Property Compliance Certification training devotes roughly 15% of its content to how to handle unrestricted units.

Arguably worse is the requirement to recertify household incomes. This annual chore for tenants and management companies is not federally necessary when 100% of the units qualify for LIHTCs.

Investor Interest

In part because of the compliance difficulties, LIHTC investors are less interested in developments with unrestricted units. However a more important consideration is their organizational structure.

Almost all equity providers have separate teams for underwriting tax credit transactions versus strictly real estate transactions. The financial considerations for each are not entirely the same, which necessitates different kinds of expertise. The more market-rate units a property contains, the more it requires review by both teams. (A general standard is 20% or fewer market-rate units avoids duplicate review.) Naturally doing twice the amount work for the same outcome is unacceptably inefficient.

This lack of interest can translate into lower LIHTC equity pricing, more stringent deal terms or a decision not to make an offer at all.

Additional Debt Service Burden

All the forgoing describes both definitions No. 5 and 6 above. Next is what separates those two.

Congress ensured the federal government subsidizes only units with restricted rents and maximum household income limits. Units not covered by these rules do not generate LIHTCs and the resulting equity. Instead, the funding source for building market-rate units is debt, which unlike equity must be repaid from rental income. Accordingly, a development with unrestricted units will have a greater debt service burden.

A common assumption is the market-rate rents are high enough cover the cost of this additional debt service. Where this is possible, the housing fits in definition No. 5 above. Unfortunately, this is not the case in most of the nation, and the result is a property in definition No. 6.

For example, continuing the San Antonio example, including 15 unrestricted units in a 55-unit property can result in $4 million less equity. The uses (capital costs) are the same, which necessitates more debt. The market-rate units will carry the resulting increased debt service only if their rents are more than $3,000 a month. If below that level, which is likely, something else must change.

The preceding example fits into definition No. 6 above. The most obvious response is to increase rents paid by low-income tenants, which is naturally not a good outcome. Another approach might be to use gap financing. While doing so limits or avoids pressure on rents, such resources are limited. Committing them to create unrestricted units is a debatable choice.

By contrast, this same deal structuring in somewhere like the San Francisco Bay Area of California might not face the same challenge. In those jurisdictions, market-rate apartments may be able to charge rents that are two or three times as much as the LIHTC maximum.

Conclusion: Benefits Make it Worth Pursuing Options

The concept of mixed-income housing cannot be forced into one meaning. Ideally, the overall goal of mixed-income housing would work well in all forms, but unfortunately the financial realities of LIHTC projects cause unintended and problematic consequences when unrestricted units have rents similar to LIHTC units. This reality should not deter policymakers from using the other available options. The many benefits of income diversity in our communities are far too important to ignore.

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