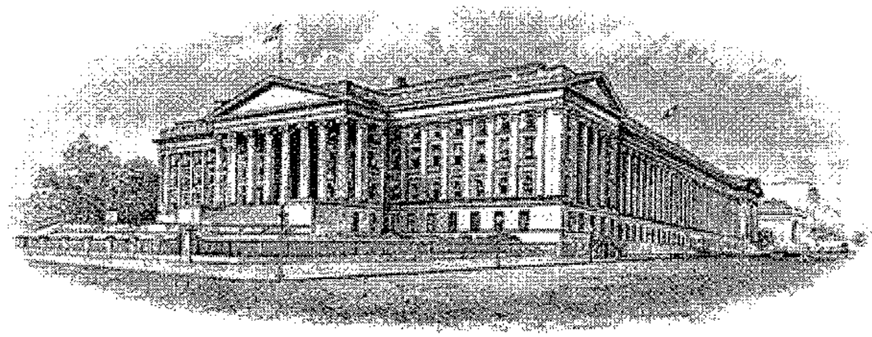

# U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

**EMBARGOED UNTIL** 10 a.m. (EDT), May 24 2007
**CONTACT** Andrew DeSouza, (202) 622-2960

## TESTIMONY OF TREASURY TAX LEGISLATIVE COUNSEL MICHAEL DESMOND BEFORE THE SUBCOMMITTEE OF SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS

**Washington, DC**—Mr. Chairman, Ranking Member English, and distinguished Members of the Subcommittee:

Thank you for the opportunity to discuss with you today incentives for affordable housing, including the low-income housing tax credit (LIHTC), the rehabilitation tax credit (RTC) and tax-exempt housing bonds (collectively, "the housing tax incentives"). The Treasury Department believes that affordable housing policies play an important role in encouraging the development of affordable housing units for low-income households. The Treasury Department shares the view that the goal of affordable housing is best achieved by continuing to examine low-income housing needs and addressing them through programs that are reviewed periodically to see how they can be better targeted and improved.

**Background on the Low-Income Housing Tax Credit**

Since it was enacted in 1986, the LIHTC has provided economic incentives responsible for creating significant amounts of affordable housing for low-income households. In fact, the LIHTC program is usually oversubscribed in that there are more applicants seeking allocations of the LIHTC than there is LIHTC available to allocate. The LIHTC is a complex program, however, and there may be ways to simplify the program and improve its effectiveness in serving the housing needs of low-income people while at the same time reducing the burden placed on the Internal Revenue Service (IRS) and State agencies administering the program. Simplification could also reduce the burden on property owners who take advantage of the program, increasing its efficiency.

The LIHTC provides an economic incentive in the form of tax credits to developers to build affordable rental housing. The LIHTC is allocated to owners of qualified low-income rental units. The tax benefit provided by the LIHTC reduces the financing cost for low-income housing, which results in lower rents to qualified tenants.

The LIHTC may be claimed over a 10 year period for a portion of the cost of rental housing occupied by tenants having incomes below specified levels. The 10 year tax credit period begins with the taxable year in which a qualified building is placed in service or, at the election of the building owner, the succeeding taxable year. The credit percentage for a newly constructed building that is not otherwise Federally subsidized is adjusted monthly by the IRS so that the 10 annual credit amounts generally have a present value of 70 percent of the portion of the owner's cost basis in the building allocable to low-income housing units ("qualified basis"). The credit percentage for new buildings that are otherwise

Federally subsidized and for existing buildings is calculated to have a present value of 30 percent of qualified basis.

For 2007 the aggregate first-year credit authority allocated to each State is $1.95 per resident, with a minimum of $2.275 million for certain small population states. These amounts are indexed for inflation. Because they are in the best position to determine local housing needs, State and local housing agencies allocate tax credits to particular projects pursuant to publicly announced qualified allocation plans (QAPs). Credit that is unallocated in one calendar year may be carried forward by these agencies to the following calendar year. Allocated credit that is not used may be returned to an agency by a building owner for reallocation.

Credit allocations generally must be made not later than the close of the calendar year in which the building is placed in service. Credit allocations may revert to the agency if less than 10 percent of the taxpayer's reasonably expected cost of the building, including land, is expended within the later of 6 months after the allocation is made or the end of the calendar in which the allocation is made. Credit authority allocated to a State but not used by the State in a timely manner reverts to a national pool for distribution to other States requesting additional authority.

Certain provisions permit a credit allocation prior to the year a building is placed in service. Rules are also provided for the allocation of costs to individual units in multi-unit projects and to property that is part of a project but used for purposes other than rental housing. The tax benefit that a building owner receives from the LIHTC may be recaptured if the required number of units is not rented to qualifying tenants for a period of 15 years or if a sale or other disposition of the building occurs during this period without meeting specific requirements for continuing to provide low-income housing.

In certain geographic areas designated by the Secretary of Housing and Urban Development, LIHTC amounts awarded to projects may be increased by up to 30 percent. These areas include Difficult Development Areas (areas where development costs are high relative to area incomes) and Qualified Census Tracts (generally census tracts where either at least 50 percent of households have incomes below 60 percent of area median income, or the poverty rate is at least 25 percent).

The LIHTC has been successful in producing more than a million rental housing units occupied by low-income households. Although rents are restricted under the LIHTC, rents are based on an average household income for the area rather than the individual household income of the tenant. Thus, units are leased only to eligible households with enough income to afford the rent, often excluding very low income households from benefiting from the credit.

The Treasury Department has taken steps to reduce some of the complexity and uncertainty in the LIHTC program by providing guidance through administrative regulations. For example, we are currently working on two regulation projects relating to the LIHTC. A utility allowance project, in particular, is an effort to address an issue that has caused concern for property owners, tenants, and State and local housing agencies. The statute requires inclusion in the gross rent that can be charged to qualified tenants of a utility allowance if any utilities are paid directly by the tenant. The Treasury Department and the IRS have received comments noting that the methods in the current regulations for calculating utility allowances often are inaccurate and outdated and, in many cases, result in flawed information being used for calculating rent adjustments. We anticipate issuing proposed regulations later this year that would permit more accurate utility allowance calculations. We also plan to issue proposed regulations that provide guidance concerning the circumstances in which a taxpayer is allowed to discontinue operating a LIHTC building as low-income housing. The statute provides for the termination of the requirement to operate the low-income portion of the building if the appropriate housing agency is unable to present within a specified period of time, after the 14th year of the compliance period, a qualified contract for the acquisition of the low-income portion of the building by any person who will continue to operate such portion as a low-income building. The proposed regulations will define a qualified contract for these purposes.

Some aspects of the LIHTC could benefit from simplification and clarification. The Treasury Department and IRS frequently meet with representatives of owners, tenants, and housing agencies who provide us with information regarding controversies, uncertainties, and complexities within the LIHTC. For example, the actual tax credit rate is not fixed, but is adjusted on a monthly basis to achieve a total present value of the subsidy over the 10 year credit period equal to 70 percent of the eligible basis, or if applicable, 30 percent of the eligible basis. It has been suggested that the credit percentage for newly constructed housing that is not Federally subsidized be fixed rather than adjusted monthly by the IRS. Although the computations may be routine, they require owners to make monthly computations based on changing percentages.

Another suggestion is that the credit be taken ratably over the 15 year compliance period, with an increased applicable percentage to make up any time value benefit that the present accelerated credit provides, rather than accelerating the credit over the present 10 year credit period. This would eliminate recapture in some cases and eliminate the requirement to post bond in the case of early property dispositions.

The qualified contract regulations project that I previously mentioned is another example of complexity in the statute. Additionally, whether certain types of students may be considered low-income for purposes of the credit is unclear, particularly for a single parent household in which both the parent and the child are full-time students. Although the credit should not be used to encourage the development of housing for all college students, the current uncertainty has become a disincentive for low-income persons living in LIHTC properties to go back to school. Difficult Development Areas (DDAs) have also been a source of complexity in recent years, particularly because the areas designated as DDAs may change from year to year, making it difficult for developers who need to phase in developments over a period of years to estimate financing needs accurately.

There are many other areas of the LIHTC that cause uncertainty or burden and complexity. The Treasury Department would welcome the opportunity to work with this Subcommittee to address these issues and make the LIHTC more efficient and administrable.

**Background on the Rehabilitation Tax Credit**

The Rehabilitation Tax Credit provides an incentive in the form of tax credits to stimulate private-sector capital investment in historic and older buildings and revitalize historic communities. The RTC provides a 20 percent income tax credit for qualified rehabilitation expenditures incurred in connection with the substantial rehabilitation of a certified historic structure and a 10 percent income tax credit for the substantial rehabilitation of nonresidential structures built before 1936. A certified historic structure is a building that is listed in the National Register or is located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to the district. The RTC is jointly administered by the IRS and the National Park Service.

The RTC is sometimes combined with the LIHTC to use rehabilitated, historic structures as low-income housing. The amount of rehabilitation expenditures eligible for the low-income housing tax credit is reduced by the amount of rehabilitation tax credit allowed. The computation for annual depreciation includes a reduction of the depreciable basis by the amount of rehabilitation tax credit allowed.
Like the LIHTC, the RTC is a complex provision. This complexity places burdens on property owners and the IRS alike and makes the credit less efficient. The RTC can be combined with other Federal tax programs like the LIHTC to provide a greater financial incentive. These combinations may, however, raise additional complexity and administrative concerns.

**Background on Tax-Exempt Private-Activity Housing Bonds**

The tax law also provides low- and moderate-income housing incentives in the form of tax-exempt private-activity bonds. In order for interest on tax-exempt bonds, including governmental bonds, to be excluded from taxable income, a number of specific requirements must be met. Private-activity bonds may be issued on a tax-exempt basis only if they meet the requirements for "qualified private-activity bonds," including targeting requirements that limit such financing to specifically defined facilities and programs such as low-income residential housing projects.

Exempt facility bonds may be used to fund qualified residential rental projects if at least 95 percent of the net bond proceeds are used to provide a qualified residential rental project. A qualified residential rental project is a multifamily rental project in which one of the following two requirements is met at all times during the qualified project period: (1) 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income; or (2) 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income.

Qualified private activity bonds are subject to State-by-State volume-cap limitation under section 146 of the Code. Allocations of tax exempt bond authority to specific low-income housing projects are generally made by the same State or local housing authorities that make allocations of LIHTC. Qualified private activity bonds are often combined with LIHTC to finance low-income rental projects.
Use of the Tax Law to Encourage Low- and Moderate-Income Housing

The LIHTC, RTC and tax-exempt private activity housing bonds have been successful in promoting the construction of affordable housing for low-income households. As this Subcommittee considers ways in which to expand or modify these existing programs, two general observations should be made. First, any expansion of targeted tax incentives invariably puts additional strain our tax system. Second, the housing tax incentives are, as currently structured, quite complex. This complexity places a significant burden on owners and developers of low- and moderate-income housing. This increases the cost of that housing and reduces the efficiency of the Federal subsidy provided by the housing tax incentives. The complexity of these programs likewise places a burden on the IRS to administer them. As this Subcommittee contemplates changes to the housing tax incentives, simplification of the incentives should also be considered.

**Conclusion**

Thank you Mr. Chairman, Ranking Member English and members of the Subcommittee for providing the Treasury Department with an opportunity to participate in today's hearing on this important subject. I would be pleased to respond to your questions.