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TAX CREDITS

Opportunities to Improve
Oversight of the
Low-Income Housing
Program

Statement of James R. White, Associate Director, Tax
Policy & Administration Issues, General Government
Division



Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program

Madam Chairman and Members of the Subcommittee,

We appreciate being here this afternoon to discuss our recently issued report entitled Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program ([GAO/GGD/RCED-97-55](#), March 28, 1997). Currently, the tax credit is the largest federal program for funding the development and rehabilitation of rental housing for low-income households. Under this program, the states award tax credits that could cost federal taxpayers as much as \$3 billion per year.

Our report, which is addressed to you, Madam Chairman, and the Chairman of the Ways and Means Committee, answers questions about the characteristics of tax credit projects and their residents and the controls the Internal Revenue Service (IRS) and the states have over the program. More specifically, with respect to controls we were asked to assess IRS and state controls for ensuring that (1) state priority housing needs are met; (2) housing project costs, including tax credit costs, are reasonable; and (3) states and project owners comply with program requirements.

In answering these questions, our report makes the following four main points:

- A substantial majority of the households served by the program had incomes considered “very low” by the Department of Housing and Urban Development and about three-fourths of all households benefited either directly or indirectly from other types of housing assistance. We estimate the average tax credit cost per-unit, in present value terms, to be about \$27,300.
- All the states had developed qualified allocation plans required by the Internal Revenue Code to direct tax credit awards to priority housing needs. Although the states met tax code requirements, we identified several factors that could affect the housing actually delivered over time. Some states reserve discretion for amending or bypassing the allocation process. In addition, many tax credits that were initially allocated may not have been used. Further, the long term economic viability of tax credit projects as low-income housing has not been tested.
- All states had cost control procedures in place that were intended to help ensure the reasonableness of project costs and tax credit awards. However, some projects lacked complete cost and financial data and some key data used in determining the basis for tax credit awards were not independently verified.

- While states had established compliance monitoring programs consistent with IRS regulations, the regulations did not provide adequate assurance that states perform agreed upon monitoring reviews. Also, IRS needs additional information to adequately monitor states' tax credit allocations and taxpayer compliance with credit requirements.

Before elaborating on these points I would like to describe our methodology and provide some background about how the low income housing tax credit program works and the responsibilities of the IRS and states for administration and oversight of the program.

Our analysis of the low-income housing tax credit program is based primarily on a survey of tax credit policies and procedures in 54 state tax credit allocating agencies, a review of state files for 423 randomly selected housing projects, and a survey of project managers for these projects. We also reviewed IRS' low-income housing tax credit procedures and programs.

How the Program Works

The low income housing tax credit program is a joint federal, state and private sector initiative. Figure 1 attached to this statement illustrates for a simple case how tax credits help finance low-income housing development. Under the program, a developer finances a low income housing project in part using a private mortgage, with payments made out of rental revenues, and in part using equity paid into the project from investors who receive the credit. The greater the private financing, the smaller the amount of tax credit needed.

The process of awarding tax credits to private investors begins with IRS annually allocating tax credits to each state housing agency in an amount equal to \$1.25 per state resident. Developers proposing to build low-income housing apply to the state agencies for credits. Winning developers receive credits which they in turn offer, in effect sell, to private investors, often organized into partnerships by syndicators, who use the credits to offset taxes otherwise owed on their tax returns. In return for the credits, the private investors provide equity financing for the projects. This equity financing fills the gap between the development costs and the non-tax credit financing. The equity paid into a project is less than the sum of the tax credits. The difference provides the investors with a rate of return over 10 years as well as compensation for housing project evaluation and monitoring. A complication not shown in the figure is that many projects also receive other housing subsidies.

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About \$300 million in new credits are made available nationally each year for award to new housing projects. Assuming project owners remain eligible, they would be entitled to take the \$300 million in credits each year for 10 years. Thus, if this occurred, in any one year, 10 years worth of federal tax credits would be outstanding and the aggregate annual cost to the federal government would be \$3 billion.

The states and IRS share responsibility for administering the tax credit program. Once projects have been placed in service, state agencies are responsible for monitoring the projects for compliance with federal requirements concerning household income and rents and project habitability. Noncompliance with these requirements may result in IRS recapturing or denying previously issued or used tax credits.

IRS is responsible for issuing regulations on state monitoring requirements, ensuring that taxpayers take no more tax credits than they are entitled to take, and ensuring that states allocate no more credits than they were authorized to allocate. In implementing these responsibilities, IRS requires annual reports from the states on the amount of tax credit allocations made in total and amounts awarded to individual projects. IRS also requires taxpayers to disclose tax credit information on their tax returns and requires the states to report findings of project noncompliance.

Housing Delivered Under the Program

We estimated, based on our random sample, that about 4,100 properties with about 172,000 tax credit qualified units were placed in service in the continental United States between 1992 and 1994. We also estimated that, for these projects, the states annually awarded tax credits with a potential value over their 10-year lifetime of about \$2 billion (about \$1.6 billion in present value terms), or about \$6.1 billion for the three years combined.

On the basis of information from our survey of property managers, we estimated that the 1996 average annual income of households in units qualifying for tax credits was about \$13,300. The distribution of incomes is shown in figure 2, which is attached to this statement. About three-fourths of tax credit households met HUD's definition of "very low income"—that is, their incomes were below 50 percent of their area's median income. About 71 percent of the tax credit households, benefited directly or indirectly from one or more types of housing assistance besides tax credits. One type of housing assistance, direct rental assistance, enabled the tax credit program to serve many households whose reported income was well below the qualifying limits established by the program. Overall,

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an estimated 39 percent of the households received direct rental assistance. The average income for these households was about \$7,900.

Tax credit households were small—about two-thirds were one or two person households. About a quarter of the projects were developed primarily to serve the elderly.

Tax credit properties were located throughout the country. The most common type of property was a walk-up/garden-style apartment building but properties ranged from row houses to elevator buildings. Most of the projects were newly constructed.

The average monthly rent was about \$450. For some tenants rental payments were covered in part by other federal housing assistance.

We estimated that for the tax credit properties placed in service between 1992 and 1994, the states had annually awarded tax credits with a potential value over 10 years of about \$2 billion (about \$1.6 billion in present value terms). Thus, the taxpayer costs for the tax credits attributable to these three years could be as high as \$6.1 billion over the 10-year credit period. We also estimated that the present value of the average tax credit cost per unit would be about \$27,310. As shown in figure 3, which is attached to this statement, about 60 percent of the units had tax credit costs at or below the estimated average and about 2 percent had tax credit costs of \$100,000 or more. The federal costs of the tax credits is a function of many factors, including property development costs and the market price of the tax credit.

Project development costs, including land and building acquisition outlays, construction costs, builders' profit, and financing costs, varied widely. We estimate that the average cost of developing the units was about \$60,000. About two-thirds of these units cost less than or the same as the average unit. As shown in figure 4, which is attached to this statement, the per-unit costs of the properties varied widely. About 10 percent of the properties cost less than \$20,000, and about 10 percent cost more than \$100,000—including 3 percent whose costs exceeded \$160,000 per unit. Development costs may vary because of differences in the physical characteristics of properties, broader community development needs, and the extent to which tax credit allocating agencies use various controls to limit costs.

State Controls for Allocating Credits to Housing Needs Vary

All the states had developed qualified tax credit allocation plans required by the Internal Revenue Code to direct tax credit awards to meet priority housing needs. The plans generally targeted the credit to the priority housing needs identified by the states. Consistent with the latitude given them in the Code, the states had defined and weighted the selection criteria for awarding credits in different ways. Most states used some sort of scoring system to rank project proposals. The states also used varying amounts of data and analyses in assessing housing needs.

Although all states had adopted required allocation plans for meeting state set housing priorities, we identified several factors that could affect the housing actually delivered over time.

- One factor involves the use of discretionary judgment. Nearly all of the agencies reserved some discretion for amending or bypassing their allocation process. We recognize that discretion can be beneficial—it can target needs resulting from unforeseen circumstances. But, unless the use of discretion is well documented and made public it could undermine the credibility of the allocation process. For example, in one recently completed allocation cycle in Texas senior managers overrode over half the decisions made through the allocation process without documenting their decisions.
- A second factor involves the timely use of tax credits. Data from the states, IRS, and a study contracted by HUD suggest that the states may not be fully using their tax credit allocations. The data show a significant gap between the amount of tax credits that have been allocated by the states to proposed projects and the tax credits that have been awarded to projects when they were completed and been placed in service. For example, IRS data showed that the cohort of projects proposed in 1992 received tax credit allocations of about \$322 million. However, by the end of calendar year 1994 only about half the credits had been actually used—that is, awarded to projects placed in service. These data raise the question of whether the allocating agencies produced the total amount of housing that the federal government was prepared to fund. From the available data, we cannot determine how much of the total federal allocation that has not been awarded may have lapsed and how much may have been reallocated for future use.
- A third factor involves the long-term economic viability of the tax credit projects after the 15 year tax credit compliance period ends. Under the Code, projects receiving tax credits are required to have an extended-use agreement requiring that the property serve low-income tenants for 30 years, but with a contingency clause that allows for conversion to market

rate housing after 15 years under certain conditions. Within the next decade, the first properties subsidized with tax credits will enter the period covered by extended-use agreements. Whether these properties convert to market rate housing, continue to provide high-quality housing for low-income tenants, or gradually deteriorate will depend on such factors as the economics of the alternative uses, the states' ability to find buyers willing to keep the properties in low-income use, and the need to obtain additional subsidies.

State Controls for Ensuring the Reasonableness of Project Costs Can Be Strengthened

All states had some cost control procedures in place that were intended to help ensure the reasonableness of tax credit awards. However, we identified opportunities for the states to improve their cost controls. Figure 5, which is attached to this statement, provides an overview of the development costs or uses of funds and the financing or sources of funds for projects placed in service from 1992 through 1994. The height of the bars represents total development costs or the uses of funds. The financing of these development costs, the sources of funds, was provided by the three components shown:

- Equity paid into projects by tax credit investors, which was about \$3.1 billion and which was generated by about \$6.1 billion in tax credits investors can claim on their tax returns over 10 years.
- Commercial mortgage loans of about \$3.8 billion.
- Concessionary financing of about \$3.8 billion, which was provided primarily by other federal housing programs.

Controlling the amount of tax credits awarded to individual projects limits federal taxpayers' cost for the project and allows a state, with an overall tax credit allocation proportional to its population, to finance more projects. To do this the states should consider

- the reasonableness of a project's development cost;
- the extent of a project's financing gap, which is the difference between the cost of a project and the amount of non-tax credit financing that a project can raise to cover those development costs; and
- the yield obtained from a project's tax credit award, which is the amount of equity investment a project could raise for each tax credit dollar received.

All state agencies had controls over development costs. Many states relied on HUD cost standards, others believed their own standards were more

effective in limiting costs, and some relied on their staffs' expertise because they said that differences in project types and location made setting standards impractical. These standards acted as a ceiling on costs. Additionally, most supplemented these practices by using competition among project developers to control costs, i.e., cost was a factor in ranking projects applying for tax credit awards. State agency practices for determining the reasonableness of the non-tax credit financing varied, but they generally included reviewing projects' rents and operating expenses, private mortgage terms, and non-tax credit public subsidies—in the case of HUD financing the evaluation is called a “subsidy layering review”.

As already mentioned, the equity yield per dollar of tax credit is a factor influencing the federal cost of an individual project and the \$3.1 billion in equity paid in by investors during 1992 through 1994 was generated by \$6.1 billion in tax credits. This works out to about \$0.53 on the dollar. States generally relied on the market to determine the yield obtained from a project's tax credit award. The tax credit yield or price has gone up over time, from about \$0.45 in 1987 to over \$0.60 in 1996, according to several major syndicators and state allocating agency officials.

In controlling costs—that is, in evaluating the reasonableness of project costs, the financing gap, and the tax credit price—allocating agencies are largely dependent on information submitted by developers. To the extent that the agencies do not have complete and reliable information, they lack assurance about the effectiveness of their cost controls.

We found some control weaknesses in terms of the way states assured the reliability of information from developers about their sources and uses of project funds. For example, although all but one state required some form of independent verification of cost and financing data, the scope of the required cost verification work varied. It ranged from audits to more limited work, that did not require verification of costs included in the base for calculating the tax credit award. Overall, we estimated that for about 14 percent of the total projects, the states lacked complete information on the sources and uses of project funds. Without assurance of the validity of developer costs and without a complete and documented basis for determining equity needs, such as a detailed sources and uses of funds analysis, states are vulnerable to providing more (or fewer) credits to projects than needed.

Accordingly, we recommended that the Commissioner of Internal Revenue amend regulations for the tax credit program to establish clear

requirements for ensuring independent verification of key information on sources and uses of funds submitted to states by developers.

State and IRS Oversight Can Be Improved

The Internal Revenue Code provides for dual oversight of the tax credit program by state tax credit allocating agencies and IRS. In general, we found that not all allocating agencies fulfilled the requirements of their compliance monitoring programs; and although IRS has been developing programs, it did not have sufficient information to determine state or taxpayer compliance.

State Monitoring Programs

In general states are responsible for monitoring project compliance with rent, income, and habitability requirements after the projects are placed in service and for reporting any noncompliance to IRS. In 1995, several states did not do the number of desk reviews and on-site inspections they had agreed to do. Because IRS' regulations do not require states to submit annual reports to IRS on the number of monitoring inspections made, IRS was not in a position to readily determine whether states met their agreed-upon monitoring responsibilities. Also, IRS' monitoring regulations do not require states to make on-site visits to projects or obtain information from other sources, such as local government reports on building code violations, that would allow states to detect violations of the Code's habitability requirements. For IRS to better ensure that habitability problems are identified during monitoring reviews, states would have to do on-site inspections or obtain information on these types of problems from other sources. We also found that IRS was not collecting enough information from states on the number of units in each project where states found noncompliance for IRS to determine whether the noncompliance has a tax consequence for the project owners.

Accordingly, we recommended that the Commissioner of Internal Revenue amend regulations for the tax credit program to (1) require that states report sufficient information about monitoring inspections or reviews, including the number and types of inspections made, so that IRS can determine whether states have complied with their monitoring plans; and (2) require that states' monitoring plans include specific steps that will provide information to permit IRS to more effectively ensure that the Code's habitability requirements are met. We also recommended that IRS explore modifying the form states use to report noncompliance so that IRS can better determine whether the noncompliance has a tax consequence for the project owners.

IRS Compliance Oversight Activities

IRS is responsible for ensuring that taxpayers claim only those tax credits for which they are entitled and for ensuring that states do not exceed their annual tax credit ceilings.

In 1995, IRS instituted an audit program to determine whether taxpayers are entitled to the credits claimed on their tax returns. As of the end of fiscal year 1996, IRS had completed work on 35 audit cases and found 12 to be in noncompliance.

IRS is relying on the results of its audit initiative to provide estimates on the extent and types of noncompliance that exist in the tax credit program. It is important for IRS to have information on compliance so that it can determine how best to allocate its compliance resources. However, IRS' current audit program is not based on a random sample of returns and will not provide statistically reliable compliance data.

With respect to monitoring state use of tax credits, IRS is currently developing a document matching program using state tax credit reports to determine whether states have allocated more credits than allowed by law. However, the reports do not contain information on the allocation year of the tax credits that developers returned to the allocating agencies for reallocation to other projects. IRS needs this information in order to determine whether states stay within their tax credit ceilings. Collecting this additional data on returned credits would also allow IRS to determine whether the states are fully using their tax credit allocations. As I indicated earlier, a significant gap exists between the amount of tax credits that have been allocated by states and the amount of credits that states and IRS records show were awarded to projects that were placed in service.

To supplement its tax credit audit initiative, IRS is exploring the possibility of computer-matching these data against tax credit amounts reported on housing project partnership returns. However, this match would not detect noncompliance at the partner level. But overreporting of tax credits by partners could be detected by matching tax credits reported on the Schedule K-1s, which shows the individual partners' credit allocations, to the partners' income tax returns. In a June 1995 report on partnership compliance, we recommended that IRS match Schedule K-1 to tax returns.¹ However, resource constraints have prevented IRS from transcribing all the

¹Tax Administration: IRS' Partnership Compliance Activities Could be Improved (GAO/GGD 95-151, June 16, 1995).

Schedule K-1s reporting tax credits it receives so that it could have an effective matching program.

Accordingly, we recommended that the Commissioner of Internal Revenue (1) explore alternative ways to develop an estimate of tax credit compliance so that IRS can better determine the resources needed to address noncompliance and (2) explore alternative ways to obtain better information to verify that states' allocations do not exceed tax credit authorizations.

Independent Oversight of the Tax Credit Program

Unlike most programs operated by state and local governments that receive federal financial assistance, the low-income housing tax credit program is not covered by the Single Audit Act. The Single Audit Act, which is an important accountability tool for the hundreds of billions of dollars of federal financial assistance administered by state and local governments and nonprofit organizations, does not apply to tax credits because credits are not considered federal financial assistance under the Office of Management and Budget's implementing guidance. Subjecting the low-income housing tax credit program to the single audit process may be a more efficient, effective, and less federally intrusive way of monitoring state agency controls than other types of independent audits.

Accordingly, to help ensure appropriate oversight of state allocating agencies' overall compliance with tax credit laws and regulations, we recommended that the Director, Office of Management and Budget, incorporate the low-income housing tax credit program in the definition of federal financial assistance included in implementing guidance for the Single Audit Act so that the program would be subject to audits conducted under the Single Audit Act.

Madam Chairman, this concludes my prepared statement. I would be pleased to answer any questions.

Figures Used in GAO's Low-Income Housing Tax Credit Testimony

Figures

Figure 1: Transferring Tax Credits From the Federal Government to the Private Sector

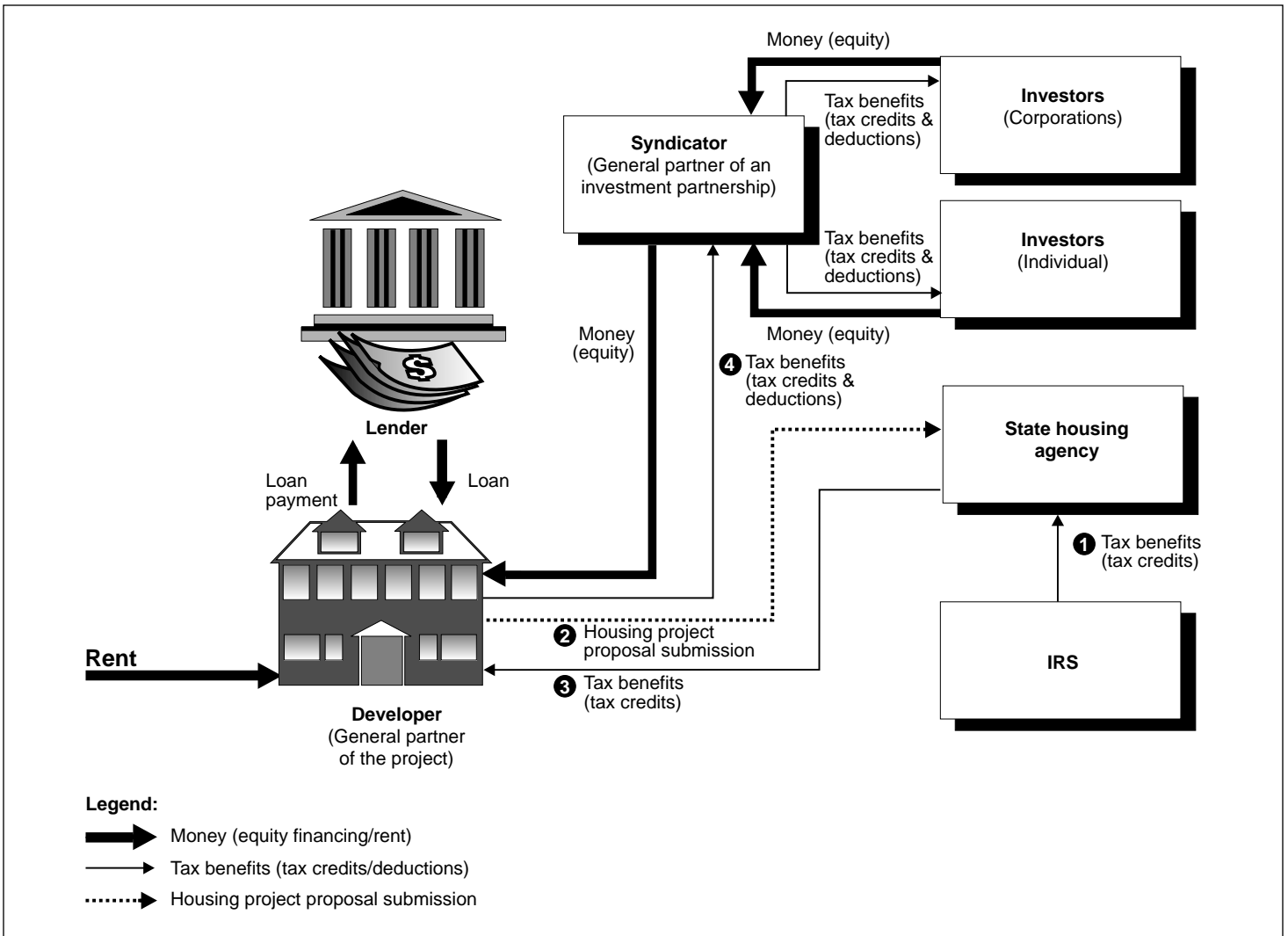
Figure 2: Estimated 1996 Incomes of Households in Tax Credits Units

Figure 3: Estimated Average Per-Unit Credit Costs of Properties Placed in Service, 1992-94

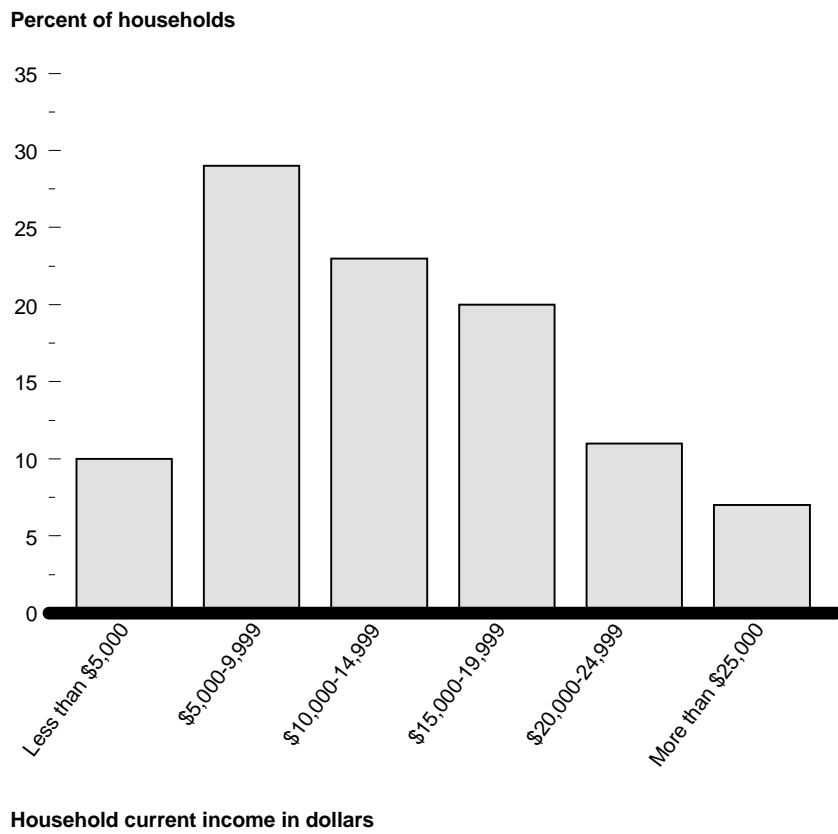
Figure 4: Estimated Average Per-Unit Development Costs of Tax Credit Properties Placed in Service, 1992-94

Figure 5: Estimates on Housing Project Sources and Uses of Funds

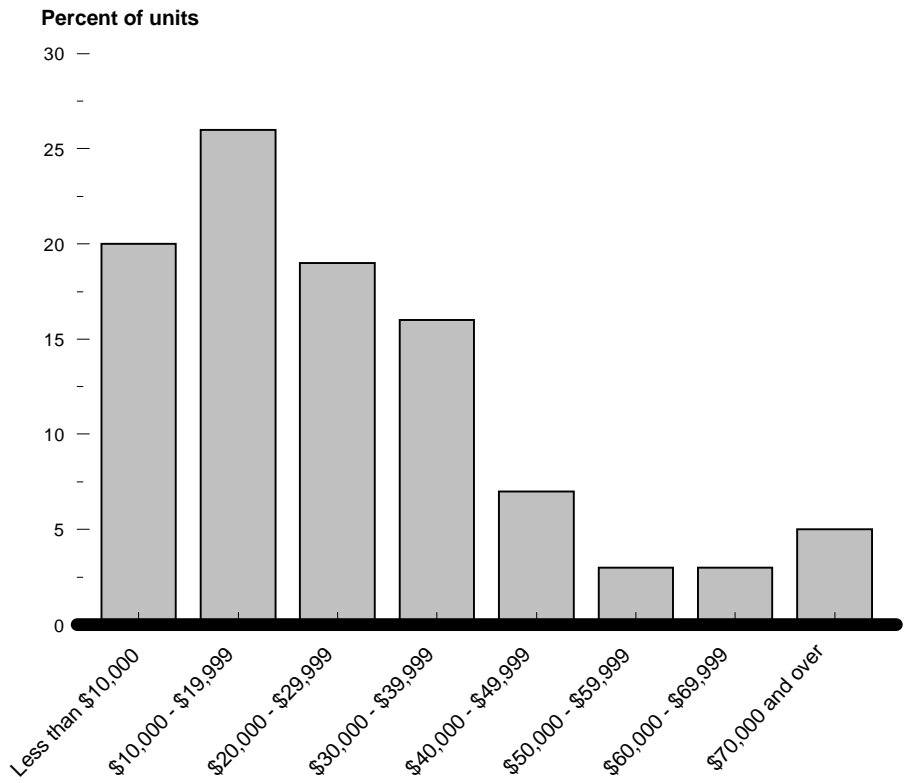
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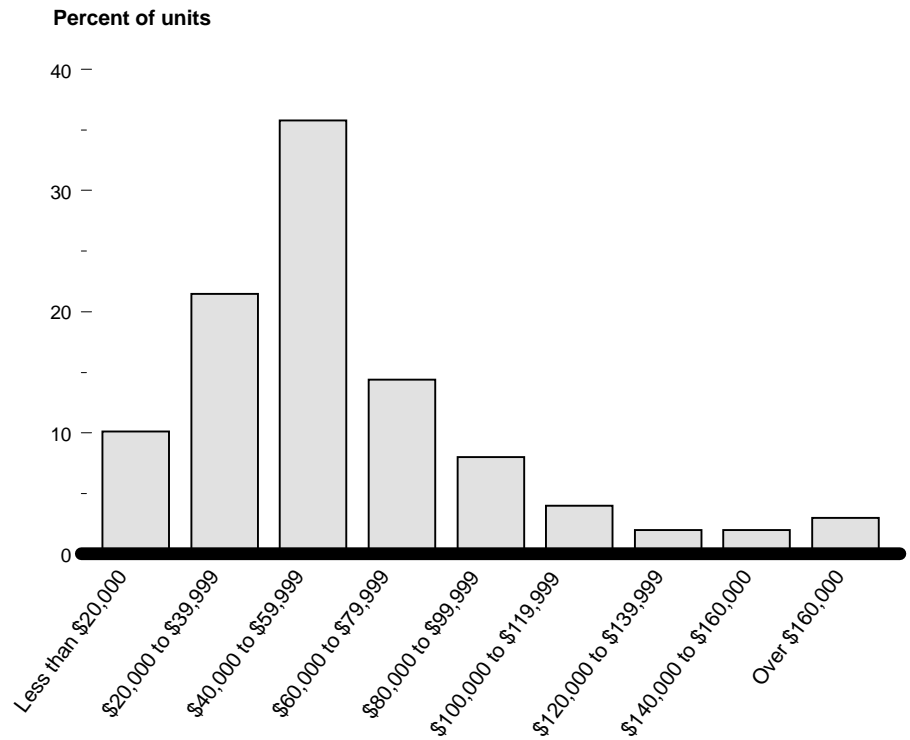
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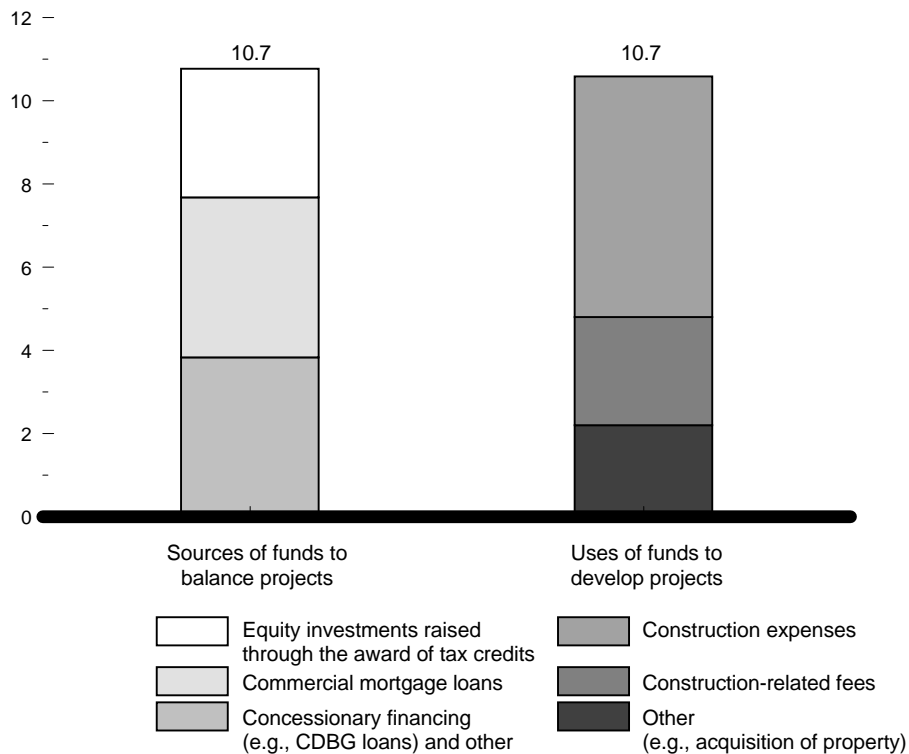


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