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The Honorable Judy Biggert
Chairwoman
Subcommittee on Insurance, Housing and Community Opportunity
Committee on Financial Services
House of Representatives

The Honorable Shelley Moore Capito
Chairwoman
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
House of Representatives

Subject: *Community Reinvestment Act: Challenges in Quantifying Its Effect on Low-Income Housing Tax Credit Investment*

The Low-Income Housing Tax Credit (LIHTC), which is estimated to cost $6.5 billion in forgone revenue in fiscal year 2012, is the largest federal program for financing affordable rental housing.[1] This program is jointly administered by the Internal Revenue Service (IRS), within the Department of the Treasury, and state housing finance agencies (HFA). HFAs competitively award LIHTCs to owners of qualified rental housing projects that reserve all or a portion of their units for low-income tenants. Developers typically attempt to obtain funding for their projects by attracting third-party investors that are willing to contribute equity to the projects, and the project investors can then claim the LIHTCs. This process of providing LIHTCs in exchange for equity is generally referred to as “selling” the tax credits.[2]

Banks invest in LIHTC projects in part to meet regulatory tests under the Community Reinvestment Act (CRA), which encourages depository institutions to meet the credit needs of communities where they operate, consistent with safe and sound banking operations. Housing and banking industry experts cite concerns about the impact of CRA on bank investors’ demand

[1]The federal government provides assistance for financing rental housing through approximately 25 programs, tax expenditures, and other tools administered by four federal agencies; see GAO, *Housing Assistance: Opportunities Exist to Increase Collaboration and Consider Consolidation*, GAO-12-554 (Washington, D.C.: Aug. 16, 2012), and *2012 Annual Report: Opportunities to Reduce Duplication, Overlap and Fragmentation, Achieve Savings, and Enhance Revenue,* GAO-12-342SP, (Washington, D.C.: Feb. 28, 2012).

[2]The owners of the LIHTC project are permitted to claim the LIHTCs on their income tax return. Technically, what is sold to the investor is not the credit but an ownership interest in the project (through a partnership or other entity). For purpose of this report, we refer to direct investors and syndicators generally as “investors.”

for LIHTCs in urban areas compared to rural areas. Based on your request, our objective was to determine, to the extent data allow, how CRA and other factors influence the market for LIHTCs, including investors' equity contributions.

Scope and Methodology

For this report, we conducted a review of academic articles and industry reports on the determinants of LIHTC pricing and analyzed data from a survey of state HFAs responses on recent LIHTC investor equity contributions and factors that influence pricing. We identified factors that influence investor demand for LIHTCs and the supply of LIHTCs projects and developed a conceptual example of the benefits that investors receive in exchange for their equity contribution. We identified one common method for measuring investor equity contributions—price per tax credit; how that measure is used within the LIHTC community; and what that measure does and does not account for. As part of our review, we determined major data and methodological challenges in quantifying the effect of CRA on LIHTC pricing and identified any empirical analyses of the effect of CRA on LIHTC prices. Finally, we gathered documentation and interviewed officials from the IRS, Department of Housing and Urban Development, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, as well as state HFAs, private sector market participants and academic researchers knowledgeable about the LIHTC and CRA. Enclosure II contains more details on our scope and methodology, and enclosure III provides results from our survey of state HFAs.[3]

Background

Community Reinvestment Act

Enacted in 1977, the purpose of CRA is to encourage insured depository institutions (banks) to help meet the credit needs of communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations.[4] Federal financial regulators—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency—are required to assess periodically each bank's record of helping to meet the credit needs of its entire community. A bank is evaluated primarily on its performance in its local communities or assessment areas.[5] Its performance in the broader statewide or regional area that includes its assessment area is considered when evaluating community development activities.

While small banks are evaluated based on lending in their local communities, small-intermediate banks—with assets totaling at least $290 million and less than $1.16 billion—are subject to a two-part test and large banks—with assets totaling at least $1.16 billion—are subject to a three-

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[3]Enclosure III presents survey questions about LIHTC pricing and the effect of CRA and other factors on the low-income housing tax credit market. These questions were part of a larger survey; see, GAO, *Recovery Act: Housing Programs Met Spending Milestones, but Asset Management Information Needs Evaluation*, GAO-12-634 (Washington, D.C.: June 18, 2012).

[4]12 U.S.C. §§ 2901-2908.

[5]Under CRA regulations, assessment areas are delineated by banks and (1) must consist of whole geographies (i.e., census tracts), (2) may not reflect illegal discriminations, (3) may not arbitrarily exclude low- or moderate-income geographies, and (4) may not extend substantially beyond a metropolitan statistical area or state boundary unless the assessment area is located in a multistate metropolitan statistical area.

part test that also evaluates investments. [6] The standards relate to both the quantity of a bank's activities, as well as the quality of those activities. Under the large bank investment test and intermediate-small bank community development investment test, banks can choose to invest in various qualified community development investments, including LIHTC projects.[7] Examiners evaluating a bank under the investment test consider not only how much money the bank has invested but also the quality in terms of how innovative or complex the investments are; how well the investments respond to credit and community development needs; and whether the investments differ from those provided by most private investors.

Low-Income Housing Tax Credit

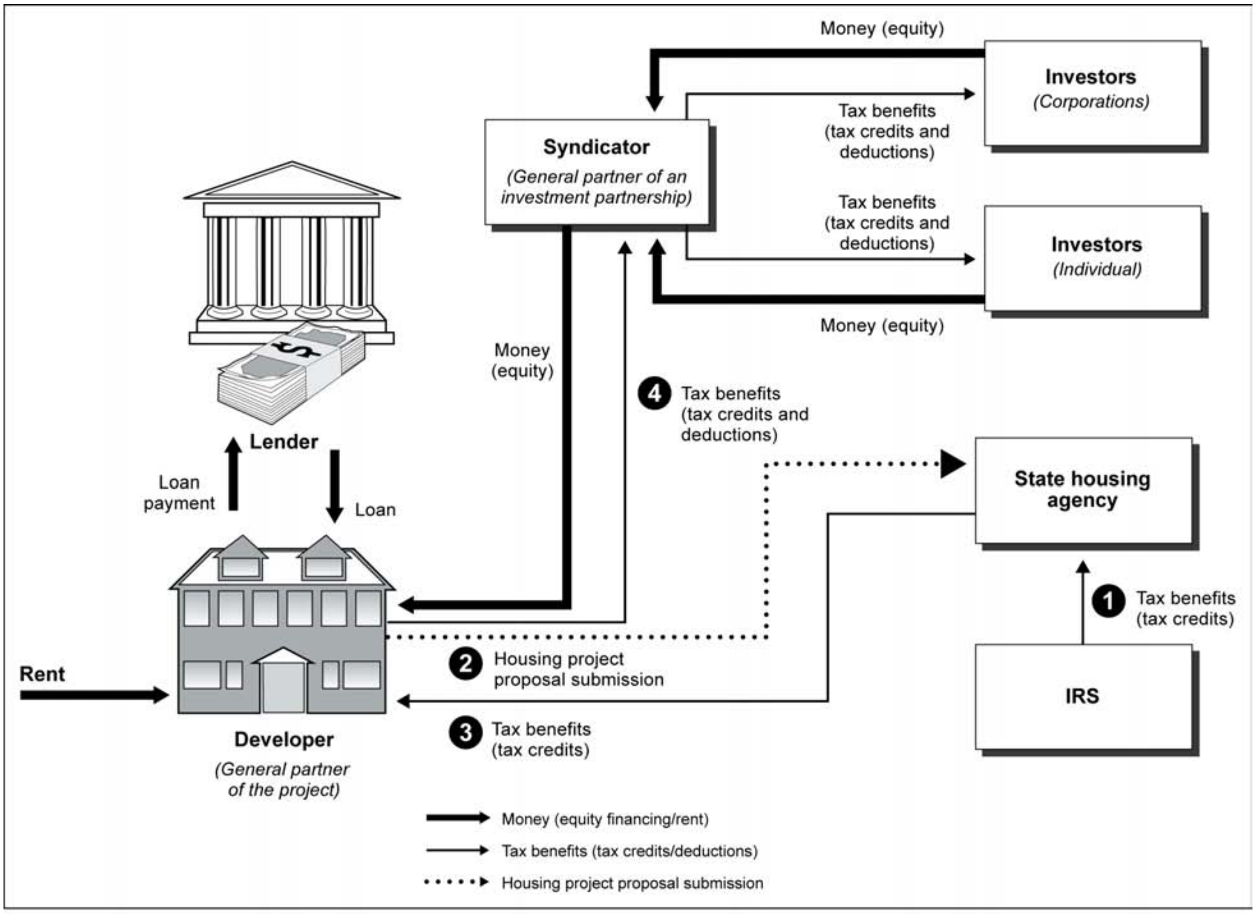
Enacted in 1986, the LIHTC provides an incentive for developers and investors to provide affordable rental housing for households whose income is at or below specified income levels.[8] The program is jointly administered by IRS and HFAs, state-chartered authorities established to help meet the affordable housing needs of the residents of their states. The LIHTC is an indirect financing source and resembles a grant program in that HFAs are responsible for allocating the credit on a competitive basis to owners of qualified low-income rental projects. Figure 1 depicts the multistep federal/state process.

[6]The asset threshold amounts as of January 2012. Thresholds for small, intermediate-small, and large banks are updated annually.

[7]Limited purpose banks, which provide services such as credit cards, and wholesale banks, which are not in the business of offering mortgages or loans to retail customers, are also assessed under a community development test.

[8]26 U.S.C. § 42.

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



Source: GAO.

Note: For a fuller description and additional graphic on the LIHTC oversight and compliance system, see GAO, *Opportunities to Improve Oversight of the Low-Income Housing Program*, GAO/GGD/RCED-97-55 (Washington, D.C.: Mar. 27, 1997).

1. *The Department of the Treasury and IRS administer the LIHTC program and state HFAs receive tax credit allocations*. LIHTCs are allocated by statutory formula to states annually according to population, with a minimum amount awarded to states with small populations.[9] For 2012, the formula was $2.20 per capita or a minimum of $2,525,000.[10] When the credits have been awarded, they are usually available to the owners/investors annually for a 10-year credit period as long as the project meets LIHTC requirements.

[9]26 U.S.C. § 42(h)(3).

[10]The annual state credit volume ceiling applies to the 9 percent LIHTC and does not cover 4 percent tax credits issued for low-income housing projects financed with tax-exempt rental housing bonds. These bonds are subject to annual state-by-state caps on the volume of private activity bonds.

2. *Developers apply to HFAs for tax credits*. A project's developer submits a detailed proposal to an HFA. To qualify for consideration, a project must:

- be a residential rental property,
- meet occupancy thresholds by reserving either 20 percent or more of the available units for households earning 50 percent or less of the area's median gross income adjusted for family size or 40 percent or more of the units for households earning 60 percent or less of the area's median gross income adjusted for family size,
- restrict the rents (including the utility charges) for tenants in low-income units to 30 percent of an imputed income limitation based on the number of bedrooms in the unit,
- meet habitability standards, and
- operate under the program's rent and income restrictions for at least 30 years for projects placed in service since 1990.[11]

3. *HFAs award tax credits to selected housing projects*. Tax credits are competitively awarded to housing projects in accordance with states' qualified allocation plans. Qualified allocation plans outline a state's affordable housing priorities and set out its procedure for ranking the projects on the basis of how well they meet state priorities and selection criteria that are appropriate to local conditions. For example, some states establish geographic preferences setting aside a specific portion of tax credits by region or for rural areas. By law, each state must set aside at least 10 percent of its credit allocation for projects developed by qualified nonprofits, but states may set aside a larger share. In addition, the qualified allocation plan must give preference to projects that serve the lowest income tenants, serve qualifying tenants for the longest period of time, and are located in a qualified census tract and contribute to a local community revitalization plan.[12] HFAs are responsible for providing no more tax credits to projects than necessary for their financial viability for the 10-year credit period.[13] LIHTC projects receiving other federal subsidies are to receive less in tax credits than projects not otherwise subsidized by the federal government.[14]

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[11]A LIHTC project is subject to a 15-year compliance period during which a taxpayer is subject to IRS oversight and an extended use period of at least 30 years during which the project is subject to HFA oversight. The 15-year compliance period and the extended use period begin at the same time.

[12]Under 26 U.S.C. § 42(d)(5)(B)(ii)(I), qualified census tracts are designated by the Secretary of Housing and Urban Development and include census tracts where either 50 percent or more of the households have income below 60 percent of the area median gross income or the poverty rate is at least 25 percent.

[13]26 U.S.C. 42(m)(2)(A).

[14]To guard against oversubsidization, almost all federal housing programs have statutory requirements requiring the administering agencies to confirm that, at the time of making a grant or subsidized loan, the total amount of subsidy being provided by public sources does not exceed eligible costs.

4. *Tax benefits provide a return on equity investments*. Investment partnerships are a primary source of equity financing for LIHTC projects. Syndicators recruit investors who are willing to become partners (generally, limited partners with 99.99 percent ownership share) in LIHTC projects. The money investors pay for the partnership interest is paid into the LIHTC project as equity financing. Although investors are buying an interest in a rental housing partnership, this process is commonly referred to as buying tax credits. Once the LIHTC project is placed into service—ready for occupancy—investors can claim their share of the credits to offset taxes otherwise owed on their tax returns annually for a 10-year credit period. Investors also receive a share of other tax benefits, such as deductions for interest on debt and depreciation and amortization deductions, and the possibility of cash proceeds from the sale of the project.

After LIHTC projects are placed into service, HFAs monitor the projects for compliance with federal requirements for LIHTC eligibility, such as household income, rents, and project habitability. The private sector, both investors and lenders, has an interest in overseeing the LIHTC project, in part to ensure that they receive their full complement of LIHTCs over the designated credit period. In general, IRS only collects information necessary for tax administration and other purposes required by law. IRS collects data on LIHTCs awarded and other information necessary to check the amount claimed on tax returns. Noncompliance with federal LIHTC requirements within the 15-year compliance period may result in IRS's denying claims for the credit in the current year or recapturing credits claimed in prior years. HFAs are also responsible for overseeing compliance over the entire LIHTC extended use period, which is at least 30 years. Noncompliance after the 15-year LIHTC compliance period is not reported to IRS, but may result in action under state or local law. Although not an administering agency, the Department of Housing and Urban Development collects data from HFAs and maintains a database of LIHTC project-level data, such as geographic location, total number of units and LIHTC units, allocation year of the LIHTC, and the year the property was placed into service. The Department of Housing and Urban Development commissioned a recent study examining what happened to projects placed in service between 1987 and 1994 after the end of the 15-year compliance period.

Summary of Findings

While CRA should increase investor demand for LIHTCs, quantifying the extent of any effect of CRA on LIHTC equity contributions is difficult given data and methodological challenges. In part because of the qualitative nature of the CRA investment test, regulatory ratings cannot be systematically linked to banks' LIHTC investments. Although a bank's overall rating and the associated narrative of its CRA examination are publicly available, the performance evaluation report does not individually list qualified investments and how they were considered for that examination. Furthermore, quantifying potential bank demand for LIHTCs in specific geographic areas is complicated because not every bank assessment area is considered to the same degree in a CRA examination. Although one way to assess demand for LIHTCs is by examining how much equity investors are willing to contribute, the common LIHTC price measure—the ratio of investors' equity contribution to the total amount of LIHTCs in nominal dollars—is subject to misinterpretation. Specifically, an investor's equity contribution reflects the value of not just the LIHTCs, but also any other tax and regulatory benefits—such as higher CRA ratings—plus project risks. Such other tax benefits include deductions for depreciation and interest expenses. Furthermore, complete and reliable data on LIHTC investor equity contributions are not readily available, creating a challenge to analyzing the determinants of pricing. Although no empirical analyses of the effect of CRA on LIHTCs are available, CRA is widely cited by academic researchers, federal officials, and LIHTC market participants, and HFAs surveyed as one factor that increases bank demand for LIHTC investments particularly in urban areas. LIHTC market participants interviewed and HFAs surveyed indicated other factors that influence investors' decisions to invest in LIHTCs, such as the strength of housing markets in urban areas and developer experience with LIHTC projects.

Enclosure I provides more details about the challenges in linking bank regulatory ratings to LIHTC investments, as well as, information about how the LIHTC is calculated and how an investor evaluates a LIHTC investment in deciding how much equity to contribute. Enclosure I also summarizes our findings about evidence available about the effect of CRA and other factors on LIHTC investor demand and equity contributions.

Agency Comments and Our Evaluation

We provided a draft of this report to the Department of the Treasury, IRS, Department of Housing and Urban Development, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency for review and comment. The Department of Housing and Urban Development stated that it had no comments, and the other agencies provided technical comments, which we incorporated as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days after the date of this report. At that time, we will send copies of this report to other congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, the Secretary of the Department of Housing and Urban Development, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and other interested parties. Copies are also available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made major contributions to this report include MaryLynn Sergent, Assistant Director; Kevin Daly; Lois Hanshaw; Edward Nannenhorn; Melanie Papasian; Erinn L. Sauer; and Elwood D. White.

James R. White
Director
Tax Issues
Strategic Issues

Enclosures–3

The Community Reinvestment Act and Low-Income Housing Tax Credit Investment

Bank Regulatory Ratings Cannot Be Linked Specifically to Housing Tax Credit Investments

Background

Enacted in 1977, the purpose of the Community Reinvestment Act (CRA) is to encourage insured depository institutions (banks) to help meet the credit needs of communities in which they operate—including low- and moderate-income neighborhoods—consistent with safe and sound banking operations. CRA is implemented by federal financial regulators, including the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

CRA regulators are required to examine periodically each bank's record in helping meet the credit needs of its entire community. That record is taken into account in considering a bank's application for deposit facilities, including mergers and acquisitions. Banks are evaluated primarily on their performance in their local communities, which the regulations define as the banks' assessment area. Assessment areas are delineated by banks and (1) must consist of whole geographies (i.e., census tracts), (2) may not reflect illegal discrimination, (3) may not arbitrarily exclude low- or moderate-income areas, and (4) may not extend substantially beyond a metropolitan statistical area or state boundary unless the assessment area is located in a multistate metropolitan statistical area. A bank's performance outside its assessment area or broader statewide or regional area that includes its assessment area is considered only when evaluating community development activities.

How CRA Works

The CRA framework sets out regulatory tests and performance standards for banks based on the dollar value of an institution's assets for the previous 2 years, as shown in the figure on the following page. While small banks are evaluated based on lending in their local communities, small-intermediate banks—with assets totaling at least $290 million and less than $1.16 billion—are subject to a two-part test and large banks—with assets totaling at least $1.16 billion—are subject to a three-part test that also evaluates community development investments. The standards relate to both the quantity of a bank's activities, as well as the quality of those activities.

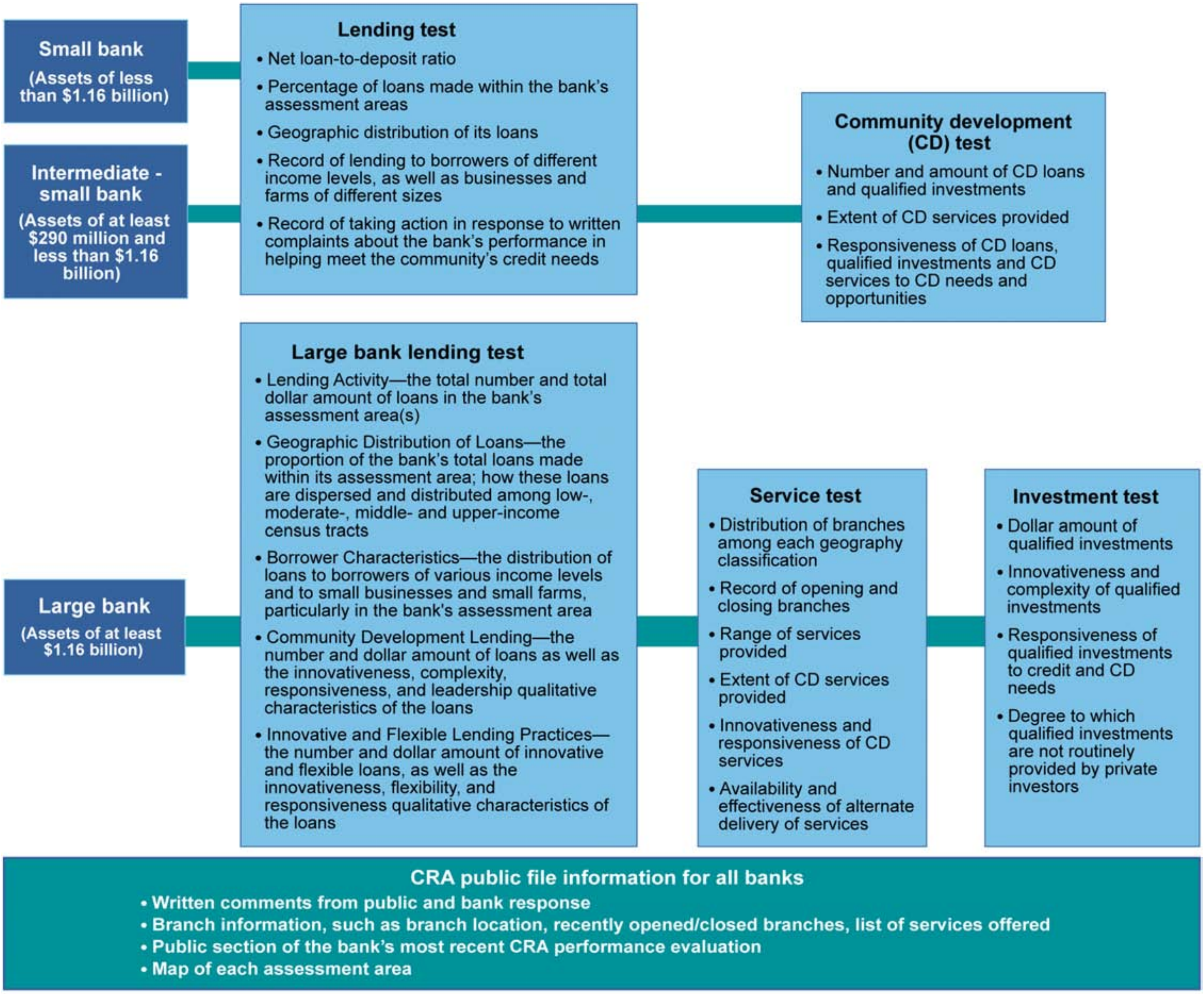
CRA-Qualified Investments May Include Low-Income Housing Tax Credit Projects

The large bank investment test and intermediate-small bank community development test consider a bank's record of helping to meet the credit needs of its assessment area through qualified investments that benefit its assessment area or a broader statewide or regional area that includes its assessment area. A qualified investment is a lawful investment, deposit, membership share, or grant that has community development as its primary purpose. Under CRA, community development includes affordable housing for low- and moderate-income individuals; community services targeted to the low- and moderate income; activities that promote economic development by financing small businesses and farms; activities to revitalize or stabilize low- and moderate-income neighborhoods; and loans, investments, and services that among other things benefit low-, moderate-, and middle-income individuals and geographies in the bank's assessment area. Banks can invest in various qualified community development investments, including Low-Income Housing Tax Credit (LIHTC) projects, as well as other tax-preferred investments such as New Markets Tax Credits and state and local tax-exempt bonds.

As shown in the figure below, examiners evaluating a large bank under the investment test consider not only how much money the bank has invested, but also the quality in terms of how innovative or complex the investments are, how well the investments respond to credit and community development needs, and whether the investments differ from those provided by most private investors.

Regulators consider a bank's investments within the context of the bank, its community, and its competitors. A qualified investment of a lower dollar amount may receive more weight under the investment test than one with a higher dollar amount that has fewer qualitative aspects. For example, an LIHTC investment that is particularly responsive to the needs of low- and moderate-income neighborhoods in the bank's community may receive greater consideration than those not as responsive. Examiners assign a bank's rating based on its demonstrated response to the performance criteria. Although a bank's overall rating and the associated narrative of its CRA examination are publicly available, the performance evaluation report does not individually identify qualified investments and how they were considered for that examination. Thus, it is difficult to determine in a systematic way the extent to which certain qualified investments, such as LIHTC investments, were considered as part of a bank's CRA performance evaluations.

CRA Tests and Performance Standards



Source: GAO analysis of CRA regulations.

Notes: Asset thresholds as of January 2012; thresholds for small, intermediate-small, and large banks are updated annually. A bank may choose to develop its own strategic plan, subject to public comment and prior regulatory approval, or may be evaluated using the standards. Limited purpose banks, which provide services such as credit cards, and wholesale banks, which are not in the business of offering mortgages or loans to retail customers, are assessed under a community development test that differs from the intermediate-small bank test shown.

Role of Geography in CRA Examinations

Under the interagency CRA examination procedures, all of a bank's assessment areas are reviewed as part of the CRA evaluation process. For a large bank with multiple assessment areas, each area will receive either a full- or limited-scope review. The determination of the review scope is based on a variety of factors, including the number of branches, volume of deposits, and/or reportable loans. During the CRA exam, the relative importance of the selected assessment areas to the bank's operations and activities is also determined to derive an overall rating.

The criteria used in that determination are similar to those used to determine which assessment areas receive a full-scope review. Quantifying bank demand for certain qualified investments, such as LIHTCs, in specific geographic areas is complicated because not every bank assessment area is considered to the same degree in a CRA examination.

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The Community Reinvestment Act and Low-Income Housing Tax Credit Investment

Investors Benefit from Claiming Low-Income Housing Tax Credits to Reduce Their Tax Liability

Background

The Department of the Treasury (Treasury) estimates that the Low-Income Housing Tax Credit (LIHTC) will cost $6.5 billion in forgone revenue in fiscal year 2012. Taxpayers claiming the LIHTC may be individual investors, although in recent years the majority of investors are corporations—either investing directly or through partnerships—such as banks, real estate, insurance, utility, or manufacturing firms.

The 9 percent LIHTC was designed to provide a 70 percent subsidy for new rental construction not receiving other federal subsidies or for certain rehabilitation expenses. To achieve the 70 percent subsidy, a credit rate is calculated such that the present value of the stream of LIHTCs over the 10-year credit period is equal to 70 percent of the qualified basis of the LIHTC project. Tax credit percentage rates are prescribed monthly by Treasury. From 1986 to 2008, the rate fluctuated from between 7.89 percent to 9.27 percent to maintain the subsidy of 70 percent. The Housing and Economic Recovery Act of 2008 (HERA) established a temporary minimum rate of 9 percent for projects placed in service after the date of enactment and before December 31, 2013. Under HERA, the credit rate may fluctuate, but will not be less than 9 percent. As a result, the present value of the credits cannot fall below 70 percent and can exceed 70 percent if interest rates are low.

While this report focuses on the 9 percent LIHTC, a 4 percent LIHTC providing a 30 percent subsidy is also available.

Calculation of LIHTC Project Costs and Eligible Credit

A portion of the total project development costs for a qualified rental housing project are eligible for the LIHTC. Eligible costs include depreciable rental real estate, common areas, facilities reasonably required for the operation of the project, and community service facilities. Costs associated with the land, most land improvements, partnership start-up costs, and certain financing costs are not eligible. Further, only the applicable fraction of qualifying costs associated with providing low-income housing is included in the basis for claiming the credit. This fraction is the lesser of the fraction of affordable units to total units or the fraction of square feet in the affordable units to the total square feet for all the residential rental units in the building. The annual credit amount is equal to the qualified basis multiplied by the applicable percentage. The applicable percentage is determined either on the month the LIHTC project is placed into service—that is ready for occupancy—or at the taxpayer's irrevocable election at the time the credit is allocated. Once the LIHTC project is placed in service, project owners and investors can claim the LIHTCs to offset taxes otherwise owed on their tax returns over a 10-year credit period. The following table shows how project costs and total credit are calculated for an illustrative LIHTC project with all units set aside for low-income renters.

Example of LIHTC Project Costs and Total Credit

Project cost and LIHTC calculation	
Total project development cost	$11,500,000
Less ineligible costs	($1,500,000)
Eligible basis[a]	$10,000,000
Multiplied by applicable fraction[b]	100%
Qualified basis	$10,000,000
Multiplied by applicable percentage (or credit rate)	9%
Annual credit amount	$900,000
Total amount taken over 10 year credit period	$9,000,000

Source: GAO analysis.

Notes:
[a]Projects located in a qualified census tract or difficult to develop area can have their eligible basis increased by up to 130 percent, referred to as a "basis boost." HERA allows a housing finance agency to designate certain buildings which need the "basis boost" to be financially feasible as located in a difficult to develop area, and hence, eligible for the enhanced credit. Allowing a property to use the basis boost and claim a higher credit does not change the state's total credit allocation.
[b]This example shows a project with 100 percent of the units eligible for the credit.

In exchange for the LIHTCs, the rental project owner must agree to set aside a minimum number of units for qualified low-income households and charge no more than the maximum allowable rents. An extended use agreement with these affordability restrictions for the LIHTC project for at least 30 years, or longer if agreed to by the state and project owner, must be in place to begin claiming the credits.

The Community Reinvestment Act and Low-Income Housing Tax Credit Investment

Equity Contribution Is the Investor's Valuation of a Low-Income Housing Tax Credit Investment

Background

In deciding to invest in a Low-Income Housing Tax Credit (LIHTC) project, investors consider the total benefits and risks associated with the investment. In addition to the dollar for dollar reduction in tax liability provided by the LIHTC, additional benefits may include:

- Tax deductions for interest on debt and depreciation, which can be claimed from the time an LIHTC project is placed in service until the investor disposes of its interest. For tax purposes, rental real estate structures are depreciated using the straight line method over a 27.5 year recovery period.
- Regulatory benefits for banks investing in communities they serve, such as through higher Community Reinvestment Act (CRA) ratings.

Investment risks include:

- Potential lack of tax liability and therefore being unable to make full use of the LIHTCs.
- Unanticipated inflation (LIHTC amounts are not adjusted for inflation after the projects are completed).
- Variation in the actual value of the LIHTCs from year to year depending on the number of habitable, rent-restricted units occupied by qualifying low-income households.
- Operational losses from the LIHTC project (typically limited to the amount of investment in the property).
- Potential LIHTC recapture if the project is not compliant with federal requirements.

Investor Equity Contribution Reflects Additional Benefits and Risks Associated with LIHTC Investment

In evaluating the attractiveness of an LIHTC investment relative to alternative investments and determining how much equity to contribute, an investor would consider the stream of tax benefits and operating income as well as the risks associated with achieving those flows. Because of rent restrictions, LIHTC investors would generally not expect to receive rental profits. For our illustrative project, the following table shows certain tax benefits—$9 million in LIHTCs over the 10-year tax credit period and $1.9 million in reduced taxes from depreciation deducted over the 15-year compliance period. An investor would receive a share of tax benefits proportionate to its partnership share, typically 99.99 percent.

Example of LIHTC Project Tax Benefits

LIHTC Project Cycle		Year	Tax credits	Other tax benefits[a]	Project cash flow[b]	Total annual tax benefits
Construction period		1	$0	-	-	**-**
10-year tax credit period	15-year compliance period	2	900,000	$127,273	$0	**$1,027,273**
		3	900,000	127,273	0	**$1,027,273**
		4	900,000	127,273	0	**$1,027,273**
		5	900,000	127,273	0	**$1,027,273**
		6	900,000	127,273	0	**$1,027,273**
		7	900,000	127,273	0	**$1,027,273**
		8	900,000	127,273	0	**$1,027,273**
		9	900,000	127,273	0	**$1,027,273**
		10	900,000	127,273	0	**$1,027,273**
		11	900,000	127,273	0	**$1,027,273**
		12	0	127,273	0	**$127,273**
		13	0	127,273	0	**$127,273**
		14	0	127,273	0	**$127,273**
		15	0	127,273	0	**$127,273**
		16	0	127,273	0	**$127,273**
Totals through the 15-year compliance period[c]			**$9,000,000**	**$1,909,091**	**$0**	**$10,909,091**

Source: GAO analysis.

[a]Other tax benefits reflect $363,636 annually in depreciation on a $10 million LIHTC project basis for a corporate taxpayer with a 35 percent tax rate. This simplified example does not include interest expense or other deductions associated with an LIHTC project.
[b]Profits are shared according to the partnership agreement. Typically, investors do not expect an LIHTC project to produce income, and the principal flows are the tax benefits.
[c]Nominal totals for the project not adjusted for time value of money. Investors typically have a 99.99 percent partnership share in an LIHTC project and would receive a proportionate share of the tax benefits and possibly cash proceeds from the sale of their ownership interest.

In calculating the upfront equity contribution, the investor would discount the returns from the investment to take into account that equity is contributed early in the life cycle of the project while the tax benefits will be received over time. In general, investors choose an equity contribution that will give them a high enough rate of return to justify investing in an LIHTC project rather than an alternative asset. The discount rate is the rate of return that could be earned on alternative investments in the financial markets with similar risks. In our illustrative example, the investor contributes equity of $6,750,000 upfront during the construction period. The investor's expected return would depend on its ability to claim any tax benefits, such as those illustrated in the table above. If the LIHTC investment was riskier, for example, because the investor is less certain to have sufficient tax liability to fully use the tax benefits, the discount rate would be higher and the investor would be willing only to make a smaller equity contribution.

In addition to the tax benefits accruing to any LIHTC investor, a bank may receive positive consideration towards its regulatory rating for LIHTC projects that qualify under the CRA investment test. In determining the amount of equity to contribute, a bank investor would likely account for this additional regulatory benefit for LIHTC investments in its assessment area or the broader statewide or regional areas that includes its assessment area. According to one researcher, large banks focus their qualified investments in larger urban areas, which represent a larger share of their deposits or total branches and are more likely to be selected for full-scope review in a CRA examination. Qualified investments in other assessment areas, while inside a bank's overall footprint, receive less consideration, and, as a result, banks may not receive the same regulatory benefit from investing in those areas.

In addition to the amount of benefits expected and timing of the equity payment, an investor's equity contribution would take into account project characteristics and risks that may affect the flow of tax benefits and potential operating gains and losses. LIHTC market participants interviewed and state housing finance agencies surveyed identified a number of conditions that could influence investor equity contributions. For example, delays in the developer completing the project on time or renting the units to income qualified tenants would, in turn, delay the flow of tax benefits. Potential LIHTC investors would consider both a developer's experience both with a specific LIHTC project type, such as senior housing or family housing, as well as reputation in the local market and be willing to contribute more equity for a project with an experienced developer and less to a project with an unproven developer. Similarly, investors would be willing to contribute more equity for an LIHTC project with a reasonable cash flow to cover expenses and mortgage debt service and well-capitalized reserves to cover any unforeseen costs. Our example assumed that investors expect no cash flow from operations. An investor would also take into account investment fees, costs to monitor compliance with LIHTC rules, and the financial viability of the LIHTC project. Syndicators and bank regulators reported that investor demand for LIHTCs is weaker in rural areas in part because rural LIHTC projects tend to be smaller in scale. As a result, fixed transaction costs are spread over fewer units, and a few vacancies can have a relatively greater impact on the viability of a small project. Also, rural areas tend to have smaller margins between allowable LIHTC rents and market rents, so the risk that tenants could move to alternative housing and create LIHTC vacancies would be greater than in urban areas.

The Community Reinvestment Act and Low-Income Housing Tax Credit Investment

CRA is One of Many Factors that Influence Investor Demand and LIHTC Equity Contributions

Background

Low-Income Housing Tax Credit (LIHTC) market participants—project developers, syndicators and state housing financial agencies (HFA)—commonly calculate the LIHTC "price" by dividing the investor equity contribution by the total LIHTCs to be claimed over the 10-year tax credit period. The sum of LIHTCs received over time is nominal and is not discounted to reflect the time value of money. The ratio of equity to the sum of nominal LIHTCs is expressed as cents per LIHTC dollar. Complete and reliable data on investor equity contributions or price ratios are not readily available. HFAs obtain data on equity investments to ensure that projects receive no more LIHTCs than necessary for their financial viability, but there is no centralized national database.

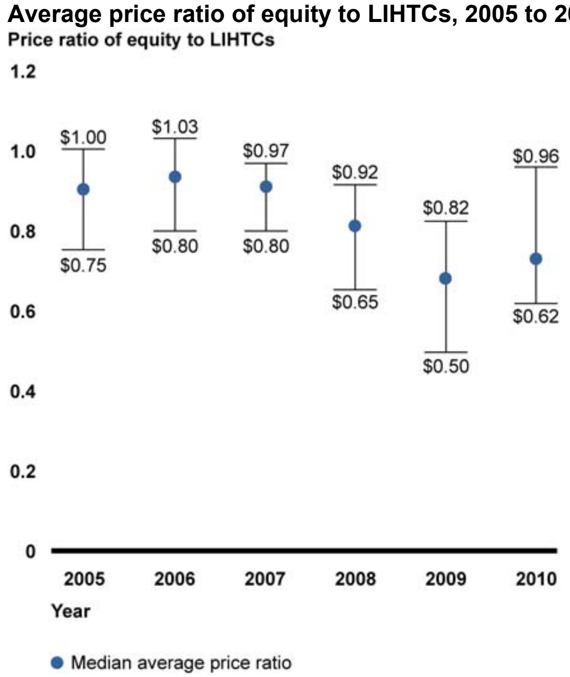
In February 2009, the American Recovery and Reinvestment Act (Recovery Act) created two grant programs to provide stopgap funding for LIHTC projects. As part of our Recovery Act work, managers of all HFAs were asked to participate in a survey in 2009 and 2011 to collect HFA responses on LIHTC prices and market condition. We did not verify HFA-reported price averages, and states may have used varying methods to calculate average prices. All HFAs responded to both surveys. The 2011 survey included questions on how the Community Reinvestment Act (CRA) and other factors affect LIHTC pricing. See enclosure III for survey questions and responses. We also interviewed market participants about factors that influence investor demand for LIHTC projects.

Industry Price Ratio May be Misleading If Interpreted as Measuring What Investors Pay for LIHTCs Only

The common LIHTC price measure is a ratio of the equity contribution to the sum of nominal LIHTCs only, whereas equity contributed reflects an investor's valuation of an LIHTC project's total returns and risks discounted to account for the time value of money. For our illustrative project receiving $9,000,000 in LIHTCs, an investor equity contribution of $6,750,000 would be expressed as a price ratio of $0.75; the price ratio would be lower if measured as equity contributed per dollar of total nominal tax benefits. However, the equity contributed reflects both the LIHTCs and additional benefits discounted for the timing of those benefits and taking into account the rate of return available on other investments with similar risks. The common LIHTC price ratio can be misleading if it is interpreted as the price that investors pay for the LIHTCs only. An equity contribution buys a partnership interest in an LIHTC project including all tax benefits flowing over time and subject to the risks inherent in investing in these types of rental housing.

Despite its limitations, the price ratio used by market participants is the measure commonly used to gauge LIHTC pricing, thus facilitating broad comparisons across equity invested in LIHTC projects and gauging investment trends. The following figure summarizes the range of average price ratios reported by the 50 states and the District of Columbia for 2005 through 2010. As reported by HFAs, average LIHTC price ratios peaked in 2006, then declined from 2007 to 2009, and generally increased in 2010.

Average price ratio of equity to LIHTCs, 2005 to 2010



Source: GAO analysis of HFA survey for 50 states and the District of Columbia.

Notes: The price typically refers to the ratio of investor equity per dollar of LIHTC and does not take into account other tax and investment benefits received. The median is the value—in this case, the average price—which falls in the middle of a set of values arranged from smallest to largest; there are an equal number of values above and below the median value.

Many Factors, Including CRA, Likely Contribute To Investor Demand and LIHTC Equity Contributions

HFA officials, regulatory officials, academics, and other experts we talked to all cited a number of factors affecting investor demand for and equity contributions to LIHTC projects in recent years. The onset of financial struggles for large banks and the exit of two large LIHTC investors—Fannie Mae and Freddie Mac—contributed greatly to decreased investor demand. Changes in the mix of the limited supply of LIHTC projects can also lower the average price ratio if state HFAs award LIHTCs to rental housing projects viewed by investors as riskier. However, it is unclear how much of the broad decline in the average price ratio shown in the previous figure reflects investors' valuation of increased risks associated with available LIHTC projects.

While we identified multiple articles and papers describing LIHTC price ratio trends, we found few studies that empirically modeled various determinants of LIHTC equity contributions and found none that quantified the effect of CRA on LIHTC investment. One researcher who used state-level data said that the lack of readily available data on investor equity contributions was a challenge in conducting LIHTC analysis.

Across the range of market participants interviewed and HFAs surveyed, CRA was widely cited as one factor that increases bank demand for LIHTC investments. HFA survey responses supported this general view with 40 of 56 HFAs responding that CRA increased pricing to some extent. LIHTC market participants stated that CRA increases banks' demand for LIHTC investment opportunities in urban areas. In August 2010, a group of LIHTC market participants attributed pricing differences at that time of 20 to 30 percent between large urban markets and the rest of the country to CRA-motivated investor demand. Of the 40 HFA respondents that provided written comments on CRA as a factor, 14 HFAs commented that CRA was more influential in urban or suburban areas, and 21 cited specific cities or regions within their states—in almost every case a metropolitan area. Three states—Maine, Nebraska, and Vermont—indicated that CRA motivates banks to invest in LIHTC projects in rural as well as urban areas.

There was widespread agreement about the direction and the effect of other factors that affect the level of LIHTC equity investments in urban versus rural areas. According to some LIHTC market participants, investors tend to invest in a limited number of geographic areas that they understand and those tend to be areas with stronger housing markets. The majority (40) of HFA survey respondents indicated that the LIHTC market is stronger in urban areas than rural areas within their state. Some market participants interviewed said that, for example, New York City, Boston, and San Francisco generally have strong housing markets and also have strong LIHTC markets. One reason cited for the correlation is that increased demand for housing results in higher housing prices, thus increasing the need for more affordable housing, including LIHTC projects. Most HFA survey respondents indicated that a strong housing market (49) and low rental vacancy rates (47) would increase the price of LIHTCs.

Enclosure II: Objective, Scope, and Methodology

Our objective was to determine, to the extent data allow, how the Community Reinvestment Act (CRA) and other factors influence the market for Low-Income Housing Tax Credits (LIHTC), including investors' equity contributions.

We gathered documentation and interviewed officials from the Internal Revenue Service (IRS), Department of Housing and Urban Development, Board of Governors of the Federal Reserve Board System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.

We conducted a review of academic articles and industry reports on the determinants of pricing for the LIHTC, including studies that empirically modeled various determinants of LIHTC equity contributions.[15] We identified factors that influence investor demand for LIHTCs and the supply of LIHTC projects. We also developed a conceptual example of the benefits that investors receive in exchange for their equity contribution. We identified one common method for measuring investor equity contributions—price per tax credit; how that measure is used within the LIHTC community; and what that measure does and does not account for. As part of our review we determined major data and methodological challenges in quantifying the effect of CRA on LIHTC pricing and identified any empirical analyses of the effect of CRA on LIHTC prices. We interviewed Reznick Group about its ongoing study examining the relationship between CRA assessment areas and LIHTC pricing, but the final study was not available at the time we did our work.

We selected a group of LIHTC market participants to interview on the extent and nature of the interaction between the CRA and LIHTC prices. LIHTC market participants were selected from a variety of organizations, including government agencies, universities and academic research centers, and industry groups. Methods used to select LIHTC market participants for interviews included our review of literature, referrals from our internal housing-industry experts, or referrals from external experts consulted for this or related engagements. We interviewed officials from six state housing finance agencies (HFA) that administer the LIHTC in their states. HFAs were selected in coordination with audit work conducted for our June 2012 report on American Recovery and Reinvestment Act (Recovery Act) housing programs.[16] HFAs selected include California, Colorado, Illinois, Massachusetts, Mississippi, and Pennsylvania. The selection of states provided geographic diversity and included states with varying amounts of urban and rural areas.

To assess state LIHTC markets, we asked mangers of state HFAs in all 50 states, the District of Columbia, and the insular areas to complete a web survey as part of our Recovery Act work. We added questions regarding LITHC pricing to our 2011 survey of HFAs' use of two LIHTC

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[15]Michael D, Eriksen, "The market price of Low-Income Housing Tax Credits," *Journal of Urban Economics* 66 (2009): 141-149; and Leslie A. Robinson, "Do Firms Incur Costs to Avoid Reducing Pre-Tax Earnings? Evidence from the Accounting for Low-Income Housing Tax Credits," *The Accounting Review* vol. 85, no. 2 (2010): 637-669.

[16]GAO, *Recovery Act: Housing Programs Met Spending Milestones, but Asset Management Information Needs Evaluation,* GAO-12-634 (Washington, D.C.: June,18, 2012).

temporary financing programs.[17] Our questions asked how CRA and other factors affected LIHTC pricing. Data collection took place from December 2011 through February 2012. We received usable responses from all 56 agencies. In addition, when reporting on approximate average tax credit price for 2007, 2008, and 2009, we used information gathered from HFAs in response to our 2009 questionnaire.[18] The "price" as reported by HFAs typically reflects the ratio of equity contributed per dollar of LIHTC. We did not verify HFA-reported price averages, and states may have used varying methods to calculate average prices. While this common industry measure does not account for additional tax benefits received by an LIHTC investor, the equity to LIHTC ratio is commonly used in describing overall trends in LIHTC pricing.

See enclosure III for the wording of our 2011 survey questions and a summary of the results. While all state agencies returned questionnaires, and thus our results are not subject to sampling or overall questionnaire nonresponse error, the practical difficulties of conducting any survey may introduce other errors in our findings. We took steps to minimize errors of measurement, question-specific nonresponse, and data processing. We obtained comments on a draft of our self-administered questionnaire from the National Council of State Housing Agencies, the Department of the Treasury that administers the Recovery Act Section 1602 grant program, and pretested draft questionnaires with two housing finance agencies. During the survey, we made follow-up contacts with nonrespondents to encourage participation, and to clarify answers respondents made, as necessary. In addition, our analysts resolved respondent difficulties in answering one question during the survey. Finally, analysis programs and other data analyses were independently verified.

We conducted our work from July 2011 to August 2012 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

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[17] The Recovery Act established two temporary funding programs that provided capital investments to LIHTC projects: (1) the Tax Credit Assistance Program (TCAP) administered by the Department of Housing and Urban Development and (2) the Grants to States for Low-Income Housing Projects in Lieu of Low-Income Housing Credits Program under Section 1602 of the Recovery Act (Section 1602 Program) administered by the Department of the Treasury. TCAP provided gap financing to be used by state HFAs in the form of grants or loans for capital investment in LIHTC projects that were awarded tax credits in fiscal year 2007, 2008, or 2009; project owners were to spend all TCAP funds by February 2012. Designed to be used in lieu of tax credits, the Section 1602 Program allowed state HFAs to exchange a portion of their 2009 ceiling (up to 100 percent of unused 2008 LIHTC and 40 percent of their 2009 allocation) for grant funds from Treasury at the rate of 85 cents for every tax credit dollar, and then award proceeds to finance the construction or acquisition and rehabilitation of qualified low-income buildings.

[18] GAO, *Recovery Act: Results of GAO's Survey of State Housing Finance Agencies' Use of The Low-Income Housing Tax Credit Assistance Program (TCAP) and Section 1602 Program*, GAO-10-1023SP (Washington, D.C.: Sept. 20, 2010).

Enclosure III: Results from Survey of State Housing Finance Agencies for Selected Questions about the Low-Income Housing Tax Credit Market

Questions about the Low-Income Housing Tax Credit (LIHTC) market were part of a larger Survey of State Housing Finance Agencies on Recovery Act Funding. Only results from these questions (1 through 10) are shown in this enclosure. For the results for questions 11 through 46, please see appendix II in GAO-12-634.[19]

Background on Your State's LIHTC Market

1. Compared to 2009, considering both urban and rural areas, is your state's market for low income housing tax credits: Click one button.

Much stronger	Somewhat stronger	About the Same	Somewhat weaker	Much weaker	Don't know	Number of respondents
33	18	3	0	1	1	56

2. Compared to 2009, how would you characterize the current housing tax credit market in urban versus rural areas (however you may define them) in your state? Is it:

Much stronger in urban areas	Somewhat stronger in urban areas	About the same in urban and rural areas	Somewhat stronger in rural areas	Much stronger in rural areas	Don't have both urban and rural areas	Don't know	Number of respondents
12	28	14	0	0	1	1	56

Tax Credit Pricing

3. In our previous survey we asked for the approximate average tax credit price set at closing with investors in your state for 2007, 2008 and 2009. What were the approximate prices for the following years? Enter cents using numeric digits and decimal points, if needed, in the boxes below

2005 – cents paid per dollar tax credit

Mean	Median	Minimum	Maximum	Number of respondents
89.2	90	75	100	48

2006 – cents paid per dollar tax credit

Mean	Median	Minimum	Maximum	Number of respondents
92.4	93	80	103	48

[19]See GAO, *Recovery Act: Housing Programs Met Spending Milestones, but Asset Management Information Needs Evaluation*, GAO-12-634 (Washington, D.C.: June 18, 2012).

2007 – your previous report was: _____ cents paid per dollar tax credit

2008 – your previous report was: _____ cents paid per dollar tax credit

2009 – your previous report was: _____ cents paid per dollar tax credit

2010 – cents paid per dollar tax credit

Mean	Median	Minimum	Maximum	Number of respondents
74.4	73	47	96	53

4. If you have any additional comments or would like to explain any of your answers on tax credit pricing, please provide them below. Box will scroll to accommodate text as necessary.

(Open-ended answers not displayed.)

Impact of CRA on Tax Credit Pricing

5. In your opinion, does the Community Reinvestment Act (CRA) tend to increase, decrease, or have no effect on the pricing of low-income housing tax credits in your state?

Greatly increase	Moderately increase	Slightly increase	No effect	Slightly decrease	Moderately decrease	Greatly decrease	Don't know	Number of respondents
14	20	6	5	2	0	1	7	55

6. Are there specific geographic location(s) within your state where CRA is more influential than others?

Yes	No	Number of respondents
38	16	54

7. IF YES: In what geographic locations is CRA more influential?

(Open-ended answers not displayed.)

8. In your opinion, do each of the following project or market characteristics generally tend to increase, decrease, or have no effect on the pricing of low-income housing tax credits in your state? *Click one button in each row*.

Project Features

A relatively large number of housing units in the project

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don't know	Number of respondents
8	32	9	1	0	6	56

Multi-family structures, such as apartment buildings

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
4	10	31	0	0	10	55

Single-family structures, such as detached homes

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
0	5	23	10	2	16	56

Inclusion of other federal sources of funding

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
3	24	17	3	0	8	55

Project Feasibility

Experienced developer team

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
29	25	0	0	0	2	56

Well-capitalized reserves

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
15	34	1	0	0	6	56

Expectation of reasonable cash flow

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
11	33	6	0	0	6	56

Market Characteristics

Low rental vacancy rates

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don’t know	Number of respondents
13	34	4	0	0	4	55

A strong housing market

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don't know	Number of respondents
19	30	3	0	0	3	55

Presence of large banks within the state

Greatly increase	Slightly increase	No effect	Slightly decrease	Greatly decrease	Don't know	Number of respondents
13	20	10	0	0	13	56

9. Are there any other factors that generally tend to increase or decrease pricing of low-income housing tax credits in your state? If so, describe them in the box below.

(Open-ended answers not displayed.)

10. If you have any additional comments or would like to explain any of your answers on the impact of CRA on tax credit pricing, please provide them below.

(Open-ended answers not displayed.)

Questions 11 through 46 intentionally not reported.[20]

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[20]See GAO-12-634, appendix II.

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