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Tax Credit Attracts Investors, Creates Housing

By Wayne E. Etter

Instructor's Notebook presents a lecture on a basic real estate subject. Written by an expert, *Instructor's Notebook* takes readers into the classroom to hear the professor's talk. This regular feature is designed as an introductory lecture on a different topic each issue.

The Tax Credit for Low-Income Rental Housing Program (TCLIRHP), initially enacted as a temporary program through the 1986 Tax Reform Act, became a permanent program in 1993. The program's purpose is to encourage private sector development and rehabilitation of multifamily housing for lower-income individuals and families.

The TCLIRHP does not directly subsidize tenants or a low-income rental property's development, rehabilitation, financing or operation. Instead, the property's equity investors receive federal income tax credits in return for providing the rental housing at predetermined below-market rents.

Not all units in a TCLIRHP development need be for low-income individuals and families. As few as 20 percent of the units must be reserved for these persons if the units are occupied by households with incomes less than 50 percent of the area's median gross income; as few as 40 percent of the units need to be reserved for these persons if the units are occupied by households with incomes less than 60 percent of the area's median gross income. Thus, the property need not (and ordinarily does not) resemble typical public housing projects. Of course, tax credits are received only for that portion of the property allocated for low-income individuals and families.

State Allocates Tax Credit

The TCLIRHP provides investors with federal income tax credits which individual investors use to reduce their total federal income taxes up to a maximum of $9,900 per investor per year. Corporations have no limit on the annual amount of tax credits they may use, although tax credits cannot be used to reduce a corporation's alternative minimum tax liability. Accordingly, corporations are important investors in TCLIRHP properties. And, although the TCLIRHP results in federal income tax credits for particular investors to construct or rehabilitate selected multifamily housing projects, these tax credits are allocated by the states.

Each state may allocate tax credits equal to $1.25 per person per state; the most recent allocation in Texas resulted in the distribution of tax credits totaling $30.5 million.

In Texas, investors receive tax credits by having their proposal to construct or rehabilitate a multifamily housing project selected by the Department of Housing and Community Affairs. For example, suppose a partnership's proposal to construct 50 units of low-income rental housing with the following cost is selected.

Land cost	$ 250,000
Hard cost	2,000,000
Soft cost	200,000
Total development cost	$2,450,000

The investors' tax credits are calculated as follows:

Total development cost	$2,450,000
Less land cost	- 250,000
Eligible costs multiplied by	$2,200,000
Tax credit rate	× .09
Annual tax credit	$ 198,000

The annual tax credit is received for ten years; thus, the project's selection as a TCLIRHP property results in total tax credits of $1,980,000 during the ten-year period–slightly more than 80 percent of the property's total development cost on an undiscounted basis. Changes in the property's ownership or use within 15 years may result in the recapture of the tax credits.

The TCLIRHP differs significantly from the former use of tax shelter by real estate investors. Prior to the 1986 Tax Reform Act, investors gained tax benefits by offsetting a rental property's tax losses against their other taxable income. Tax losses were brought about through the use of rapid depreciation schedules and interest deductions; properties that could supply these losses were sought after by investors. Except for local land-use controls, no government agency–federal, state or local–normally had a role restricting the supply of properties entering the market. As a result of the perceived value of tax losses and the lack of control over supply, too many properties were constructed in some areas.

With the TCLIRHP, however, the tax inducement to construct or rehabilitate low-income rental housing is limited each year within each state to the state's available tax credits. Furthermore, the Department of Housing and Community Affairs normally requires that a market study be part of the developer's application; this should preclude over-development in particular markets.

Evaluating the Market

The market study provides information about the supply and demand for low-income housing in the market area and the suit ability of the proposed development or rehabilitation for the market area. In particular, an independent, qualified market analyst must evaluate the physical condition, occupancy rates and absorption rates of comparable rental property within the proposed project's market area. The analyst also must evaluate the need for low-income housing in the market area and the suitability of the proposed project's unit size, amenities and location to meet the need. Finally, the analyst must evaluate the appropriateness of the proposed project development or rehabilitation cost and its expected operating costs. Based on these evaluations, the analyst must certify whether or not the:

- projected development or rehabilitation costs and the projected operating costs are reasonable,
- proposed project is likely to result in an excessive vacancy rate for comparable properties in the market area,
- proposed rents are affordable by the target tenants,
- proposed rents are below the rental range for comparable properties within the market area and
- project reserves are sufficient to cover operating shortfalls until sufficient occupancy is achieved.

If the data required to support these evaluations and certifications are carefully collected by a qualified, independent market analyst and carefully reviewed by the Department of Housing and Community Affairs when proposals are being evaluated for designation as a TCLIRHP property, particular market areas should not be overbuilt with low-income rental housing.

Investor Considerations

The development or rehabilitation of a property is financially feasible if it can generate adequate annual net operating income to support the debt necessary to finance the property and provide a satisfactory cash return to the investor. Ordinarily, financial feasibility analysis begins with either using the market rental rate to determine the maximum project cost that can be financed or using the estimated project cost to determine the market rental rate required to finance the estimated cost. In the case of a TCLIRHP property, however, the analysis must begin with the determination of the **allowable rental rate.**

Eligibility to occupy a particular unit is a function of a family's gross income, the number of persons occupying the unit and the MSA's or the county's median gross income. Because gross income varies among Texas MSAs and counties, allowable maximum income varies and affects a family's eligibility to occupy a unit.

For example, assume a TCLIRHP property that is available for families with gross incomes equal to 60 percent or less of the MSA's gross family income. In Dallas, in 1994, a three-person household with gross family income of $24,660 would be eligible, but in Laredo the gross income of the same-sized family could not exceed $15,480.

Furthermore, total housing payments for a TCLIRHP unit of a particular size, including utilities, can not exceed 30 percent of the family's monthly gross income. Thus, the maximum rental rates for different sized units vary by county and are a function of each MSA's or county's medium gross income, utility costs and family size. For example, for a family with a gross income no greater than 60 percent of the area's median gross income, the 1994 monthly total housing payment for a two-bedroom apartment is $616 in Dallas and $387 in Laredo. The monthly cost of utilities for each area is then subtracted from these rents to determine the maximum rent that can be charged to an eligible tenant.

Ordinarily at these maximum monthly rents, undertaking the development or rehabilitation an apartment property might not be financially attractive because the property's maximum rent might be inadequate to pay operating expenses, support sufficient debt to finance the property and provide a satisfactory return on equity to the owner.

However, the additional benefits of the tax credits must be considered. Because these benefits are received annually for ten years, their present value is the proper measure of their worth. Using the annual $198,000 example tax credit cited earlier, the present value of the annual tax credit received each year for ten years discounted at 10, 12 and 14 percent is:

Discount rate	Annual tax credit	Present value
10 percent	$198,000	$1,216,624
12 percent	198,000	1,118,744
14 percent	198,000	1,032,791

Viewed simply, the present value of the annual tax credits is a significant offset to the project's total development cost of $2,450,000. If a discounted cash-flow analysis were being used, the annual tax credits would be added to each year's after-tax cash flow to equity; they, together with the property's residual value, would be an important component of the project's expected internal rate of return. Viewed either way, the property's rate of return would be enhanced as compared to developing the property without the tax credits.

However, this analysis suggests an investor bias toward higher-income areas and away from lower-income areas for the following reasons:

- Higher rents can be charged in these areas.
- Although development and rehabilitation costs vary, it is likely that these costs vary less than median incomes across the state.

- The tax credit is directly related to eligible cost; therefore, for a given project, the potential tax credit is reasonably the same in different geographic areas of the state.
- Accordingly, investors can maximize their return by developing or rehabilitating low-income rental properties in areas where they can charge the highest allowable rent because their potential tax credit is not significantly affected by location.
- Developing or rehabilitating TCLIRHP properties may not be financially feasible in lower-income areas.

Rental housing development under the TCLIRHP offers considerable incentive because the present value of the tax credit received during the ten-year period is a significant proportion of the property's total development costs. Thus, the requirement for a market study by a qualified, independent analyst is an important part of the TCLIRHP as it should ensure that the low-income rental market is not overbuilt in particular market areas. Guarding against this possibility is important because investors seeking to maximize their returns will initiate proposals to develop or rehabilitate TCLIRHP properties in the higher-income areas of the state. ⊞

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