

A Tax-Based Affordable Housing Program for Canada

Marion Steele



For many years, thousands of affordable housing units in the US have been created through the Low Income Housing Tax Credit (LIHTC) program, which is by far the dominant presence in new low-income housing. Remarkably, this federal program is run through the US equivalent of the Canada Revenue Agency (CRA) rather than the US equivalent of CMHC. But this is understandable given the Credit's genesis. When the US was undertaking tax reform in the mid-1980s, officials realized at the last minute that the drastic cut in tax shelters for real estate would sharply reduce the construction of rental housing. This would hurt low-income renters. So the Credit was introduced to soften the blow.

Just a few years later, Canada followed the US lead by reducing tax incentives to build rental housing, but it did not implement a Credit program. At the same time, the federal government was cutting back on social housing subsidies. Whereas in the past Canada was well known for its generosity to social housing providers, it has recently become *less* generous than the US. Now, with expenditures on housing running down — as agreements made decades ago expire — the time has come for Canada to rectify the situation.

In this article, I assume—unless indicated otherwise—that a Credit

program in Canada would be the same as the one in the US, with minimal adjustments to account for Canadian differences. I also report on the feasibility of some alternatives to US provisions, using simulations reported in more detail in Des Rosiers and Steele (2006).

Giving Non-Profits the Same Tax Benefits as For-Profits

Fundamentally, the Credit is an ingenious way of putting non-profit developers on the same tax-benefit footing as for-profits. Both would be able to attract funds from individuals and corporations to finance their developments. In this respect, the Credit is very different from the Multiple Unit Residential Building (MURB) tax subsidy of the 1970s.

Under the MURB provision, tax losses resulting from the large allowable depreciation deduction¹ on a new building were deductible from employment income. For example, suppose a high-earning surgeon wished to find a way to pay less income tax. An investment in a MURB would yield a large loss for tax purposes, even if there had been a profit (net rental income) under standard accounting rules. This loss

would be deducted against the surgeon's professional income, reducing taxes payable. In the 1970s, syndicators sold partnerships in MURBs and the funds raised were used by private developers to build rental housing. But non-profits were not attractive to investors because their insufficient rental income made them ineligible for this tax subsidy. The MURB provision in the income tax act was eliminated in the 1980s, condemned not only because it was an inefficient subsidy to private rental housing, but also because the government had little control over its fiscal cost. There was no statutory limit to the number of MURBs, in contrast to a Credit program where there is a maximum amount in credits available each year.

An unfortunate result of the tax subsidy to for-profits was that the general public, and indeed most economists, did not understand that the market rents of private units were subsidized via the tax system. In fact, private units still are, because of aspects of the income tax system that were not eliminated with the MURB. Few people realize that when non-profit developments need a direct subsidy even for market rent units, this amount is more or less equivalent to the indirect subsidies that for-profit landlords—and ultimately, private renters—receive through the tax system.



Esther Short Commons, a mixed-use, mixed-income development.

One of the major reasons the Credit is a great boon is that it largely eliminates the difference in subsidy status between non-profit and for-profit owners of rental housing.

What is the Credit and Why Does it Attract Private Funds to Non-Profits?

The Credit program provides tax credits to low-income housing projects each year for 10 years. Buildings must be kept in low-income use for 30 years (15 years in the original US legislation). The value of the credits for a new building is 70 percent (except 91 percent for certain high-cost cities like Boston) of the cost of construction of designated Credit units. These units must satisfy Credit rent and income requirements as outlined below.²

Owners of a share in the project are able to deduct their portion of the project's tax credits against their tax payable. Thus, just as a surgeon owning part of a MURB could reduce taxes, so too can a surgeon in the US

owning part of a Credit development.

A typical corporation in the US, but not the typical surgeon, receives an additional tax benefit. The corporation can deduct a tax loss resulting from the depreciation allowance against its other income. So, for a restricted group of investors, the Credit program is topped up with a MURB-like subsidy. This applies to both for-profits and non-profits.

Someone might still be puzzled by the fact that investors are willing to buy a share in non-profit building. It is thus important to realize that:

- the major value of the share to investors is the stream of tax credits that reduces their tax payments
- the tax loss resulting from the depreciation deduction (for certain investors) results in a further reduction in tax
- there is sometimes a positive before-tax cash flow at the project level because of the low level of amortization and interest associated with a small mortgage. The

mortgage is small because of the equity provided by the Credit investors.

The importance of the tax credits to investors is indicated by the fact that the purchase of part of the project is commonly referred to as "buying credits," an expression I will use often. The "price" of a tax credit is commonly defined as the cost of buying a dollar worth of credits. Let us suppose, for example, that one share in the project costs \$7,500 and gives the purchaser \$1,000 in credits per year over the next 10 years, totaling \$10,000. The price of the credit would thus be \$0.75.³

Outline of the Credit Development Process for a Non-Profit Developer

1. The non-profit developer determines whether, at the permitted rents and costs for the site and for construction, a project receiving tax credits is feasible. The developer will need to find a site, estimate the cost of new construction or substantial rehabilitation and determine whether:
 - at the required rents, there is sufficient demand for their proposed housing units.
 - a syndicator is willing to sell the credits they might receive, and the price the credits are expected to fetch is high enough. The syndicator's fees and the price of the credits determine the infusion of funds for the project from the tax credits.
 - a lender, typically a bank, will approve the size of mortgage tentatively required, after taking into account the funds expected from investors buying the credits. The equity from these investors will leave less than half the cost to be financed by a mortgage and other financing. Thus interest costs will be quite low.
 - it can get additional subsidies, if needed, to make the project

- feasible. Subsidies could include donations of land from a municipal government.
- The non-profit applies to the provincial housing agency that allocates the credits. For example, non-profits in British Columbia might apply to BC Housing, which would establish a set of criteria such as percentage of units of various sizes and the target types, e.g. the previously homeless, seniors, and income range, etc. In the application, the non-profit specifies how it will meet or exceed minimum criteria, just as they did under previous competitive programs like the recent Affordable Housing Program.
 - The provincial agency awards the credits it has received from the federal government (because the credit is against federal taxes, although a province could also add a provincial credit, as was the case with labour-sponsored investment fund tax credits). Each province would specify its criteria for allocating its credits, within broad parameters set by the federal tax legislation. In the early years there might be few applicants, but the US experience suggests that keen competition would be the rule when the program matures, except in some slow-growth provinces. For-profit developers would compete against non-profits. US legislation requires that at least 10 percent of the credits go to non-profits, and typically the ratio has been about one to three. For California and New York in 2002, the ratio was much higher.
 - Non-profits awarded credits will then firm up the mortgage and other financing and build the project. If the financing falls through, the credits will be returned to the provincial agency, which will award them in the following year.
 - Completed projects receive the stream of credits and these are sold through the syndicator. Buyers may pay up-front or in installments.
 - Projects generate the stream of 10 annual credits, which are distributed to buyers. Projects are closely monitored for compliance with rent and income requirements for 15 years. In addition to being part-owner, the non-profit will manage the project and ensure compliance.

The Effect of Variations in Investor Payments and Syndicator Charges on the Mortgage Required

		Example 1	Example 2	Example 3	Example 4
Long-term government bond interest rate(1)	(1)	4.50%			
Development cost	(2)	\$180,000			
Construction cost	(3)	\$144,000			
Annual credit	(4)	\$16,561			
Total credits (arithmetic sum)	(5)	\$165,610			
Cost to government	(6)				
(Present value of credits at rate shown in row (1))		\$131,040			
Investor expenditure for credits (gross equity)	(7)	\$111,384	\$121,000	\$130,000	\$151,000
Syndication costs	(8)	\$11,138	\$12,100	\$10,000	\$10,000
Net equity (gross equity net of syndication costs) (7)-(8)	(9)	\$100,246	\$108,900	\$120,000	\$141,000
First mortgage and gap financing	(2)-(9) (10)	\$79,754	\$71,100	\$60,000	\$39,000
Portion financed	(10)/(2) (11)	44.3%	39.5%	33.3%	21.7%
Credit price (net equity/arithmetic sum of credits)(9)/(5)	(12)'	\$0.61	\$0.66	\$0.72	\$0.85

Notes: "Annual credit" equals the amount that, when received annually for 10 years, has a current value of 1.3 times 70% (= 91%) of construction costs, where the discount rate is the long-term government bond rate. Investor expenditure for the credits is the amount investors pay to "buy" the credits, or more correctly, their share in the value of the property; net equity is net of syndication costs.

The numbers in the table illustrate the effect of differing amounts that buyers are willing to pay for the credits, and differing syndicators' fees, on the mortgage required. The Canadian long-term bond interest rate is assumed to be 4.5 percent (used to calculate the annual credit amounts). For any given construction cost, the higher the interest rate, the greater are each of the 10 credits. The table supposes that the total cost per housing unit is \$180,000, and \$144,000 of that goes to construction. The tax credits will be valued at \$131,040 (row 4, col. 1), which is 91 percent of construction cost. This rate of subsidy is provided because the city is assumed to be high cost.

The annual credit will be \$16, 561 (row 5) because the current discounted value (at 4.5 percent) of this amount received annually for 10 years equals \$131,040.⁴ The simple sum of the 10 credits is \$165,610 (row 6).

The numbers in the next rows differ from example to example. Example 1 gives numbers reflecting quite a high perceived risk, likely at the program's start. Investors are willing to pay only \$111,384 (row 7)—85 percent of the government's cost of \$131,040—for the credits. Investors may be unwilling to pay more because they are unsure of how the new program is going to work. They may be concerned that the projects will not actually get the credits over the 10 years, or they may be unwilling to, in effect, buy an illiquid asset (very difficult to sell if they need the money). That is, at the outset, investors perceive more risk and other problems, and price their bids accordingly.

Let us suppose, for example, that the syndicator's fees (row 8) are 10 percent. Then, deducting these fees from the investors' payments gives \$100,246 as the net amount of equity going into the project (row 9). Subtracting this amount from the total cost per unit, \$180,000, gives the remaining funding needed.



Photo Credit: Sally Painter

Part of the ground floor of Esther Short Commons is a permanent, year-round, indoor farmers' market.

This is \$79,754 (row 10) or 44 percent of the total cost.

As we go from Example 1 to Example 4, investors are willing to pay more and more for the credits, up to \$151,000 in the last example. This might be expected to happen as a Credit program matures and perceived risk falls. Also, in Examples 3 and 4, syndicators' fees fall, as they become more experienced and efficient, and competition increases. As a consequence, the required mortgage plus gap financing (row 10) falls, as does the loan-to-value (LTV) ratio (row 11); the LTV is only 22 percent in the last example. Notice also that the Credit price (row 12), as defined in Wallace (1998)—the net amount investors pay for the credits (after syndicators' fees), divided by the arithmetic sum of the credits—rises from 61 cents in the first example to 86 cents in the last one.

It may seem puzzling as to why, in Example 4, investors are willing to pay *more* (\$151,000) for the credits than they cost the government (\$131,040). There are several ways of explaining this. First, notice that investors in Example 4 are paying \$151,000 to purchase

housing that costs \$180,000, so they are still buying property below cost. Second, and more importantly, when they buy a share of the property, they receive a share of the depreciation allowance deduction as well as the credits. In other words, the MURB-like top-up is valuable. Third, mortgage payments will be so low that there will likely be positive cash flow for distribution to investors. However, in most cases, the financing appears structured so that the cash flow goes solely to the developer.

Syndicators, Buyers, Funds

Developers generally require the services of syndicators as credits are usually sold to many buyers, each buyer having only a limited amount of income tax to be offset by credits. Furthermore, only those confident of their liability for a substantial number of the tax credits in each of the 10 years will find the purchase worthwhile. In the US, due to the difference in tax treatment of corporations versus individuals, the Credits have been purchased primarily by corporations. In Canada, certain financial



Affordable rental housing.

institutions, medical doctors and high-income retired people with stable income should find it beneficial to buy the credits, especially if they already hold rental real estate. Some people might switch part of their portfolio from units in Real Estate Investment Trusts (REITs) to housing credits. To reduce risk, purchasers should buy only a small part of the credits being sold by any one development.

In the US, syndicators tend to specialize. Some that serve the non-profit sector are the National Equity Fund, sponsored by the Local Initiatives Support Corporation, a charitable foundation, and the Enterprise Community Investment Inc, sponsored by Enterprise Community Partners Inc. As the names imply, these syndicators sell shares in a fund that receives credits from many developments. This structure minimizes risk as compared to depending on just one development.⁵ These intermediaries also provide a high level of expertise, which creates credibility and helps in marketing the credits to investors.

The Income and Rent Requirements for the Development

Most Credit projects in the US are built to satisfy the requirement that rents in Credit units are affordable to families (and individuals) with an income of 60 percent of the area median, as adjusted by the Department of Housing and Urban Development. Only families below this income are eligible tenants. Maximum affordable rent is defined as 30 percent of income. Median income for a mother with two children in Toronto is about \$69,700. Sixty percent of this is nearly \$42,000, implying that the rent for a two-bedroom unit would be about \$1,050 per month. If the income of the family actually living in the apartment is \$32,000, the rent-to-income ratio is 39 percent, which is unaffordable unless subsidized further.

In both the US and Canada, renter incomes are well below those of homeowners and the *typical* tenant has an income of about 60 percent of the area median. As a result, Credit units will tend to attract typical renters rather than lower-income needy ones unless rents are set below the

maximum or tenants receive additional subsidy. Otherwise, rents will be too high for needy renters.

It is not surprising, then, that it can be difficult to fill certain Credit units. Rents tend to be too high for those who are income-eligible. At the same time, the units are often attractive to higher income renters, so that there is a temptation for owners to fill Credit units with these people. However, there is a huge penalty for doing so: credit purchasers must pay back to the Internal Revenue Service the credits they have used. Non-compliance with income and rent requirements carries the risk of losing most of the investment (i.e., recapture of the tax savings by the tax department).

It is crucial to reassure investors that projects will be kept in compliance. It is believed that the risk of non-compliance greatly reduced demand for the credits, especially by corporations, in the early years of the US program. Syndicators such as the Equity Fund acknowledge this risk by having their own compliance teams. In addition, states may require projects to designate a staff person to monitor compliance. Low perceived risk and good expected returns would yield numbers like the last example in the table.

The Fundamental Reason Rents Need to be High Without Additional Subsidy

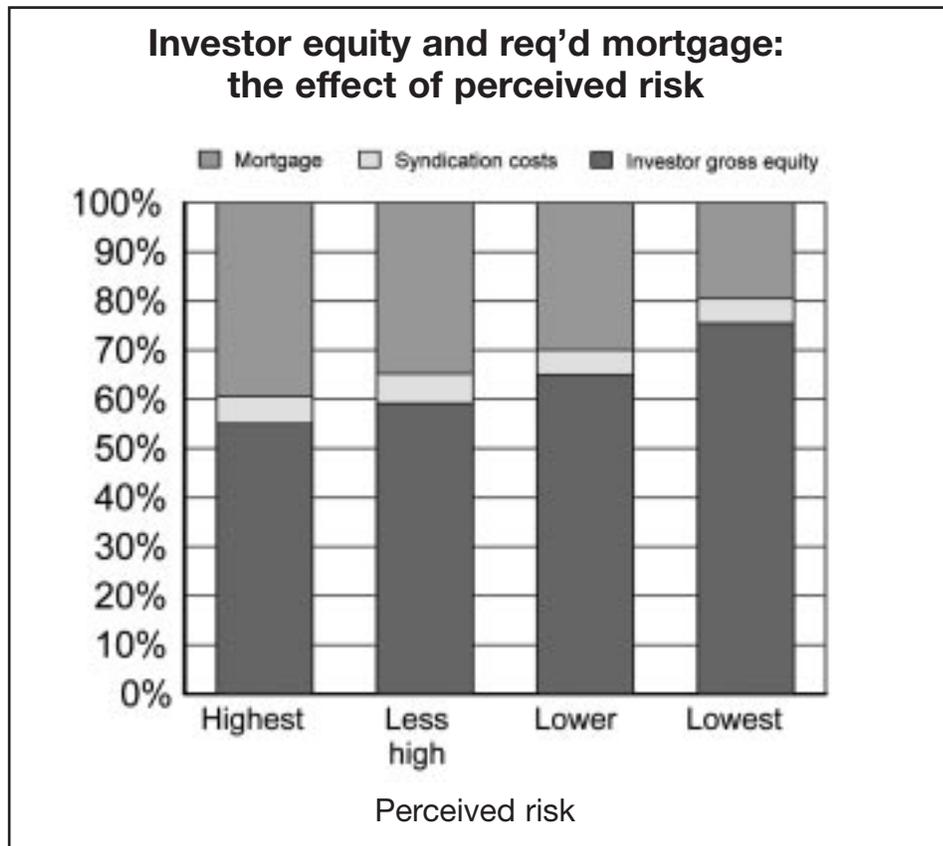
Surprisingly, even with tax credits costing the government 91 percent of construction costs—or about 73 percent of total development cost including land (see table)—rents have to be as high or higher than mean market rents to cover costs. This is due, in part, to the fact that the net equity infused into the project by investors is often much less (see Example 1 in the table). But more importantly, buildings are new

and these often cost twice as much per unit to build as existing buildings. And even though existing buildings are considerably cheaper, the much-reduced value of credits (30 percent or 39 percent of non-land acquisition cost plus 70 percent or 91 percent of substantial rehabilitation cost) means that new projects work better financially than existing ones.

A more fundamental question is why is there a huge disparity between the values of new apartment buildings and existing ones? The answer at one level is that units in new private apartment buildings are condominiums. But why are buyers willing to pay a high price? The answer is that some are owner-occupiers who expect to reap a tax-free capital gain, and some are individual investors who expect to make a capital gain—they will have to pay a capital gains tax but it will be low. Furthermore, in the early years, owners will likely benefit from an annual tax refund. They can deduct a loss resulting from any excess interest and operating expense over rent against their other income. If they use a personal line of credit on their home for the downpayment, they can have 100 percent debt, high interest expenses—and thus possibly high tax losses—and a large tax refund. Their negative annual cash flow is absorbed by their employment income. Of course, the tax refund is costly for other taxpayers. This is one rationale for a Credit program—it gives balancing tax benefits to purpose-built rental buildings.

The Role of Rent Supplements

To fill Credit projects and to ensure they provide affordable housing for families in core need, additional subsidies are usually required. In the US, there is a wide range of additional subsidies, some through federal urban regeneration programs (such as the Public Housing, HOPE VI regeneration



program), and many are offered at the state level. California and some other states top up the federal subsidy with their own Credit program.

In the US, a large number of Credit tenants receive the Housing Choice Voucher.⁶ This is similar to Canada's Rent Supplement (RS) except that the holder (a) must first find a housing unit with a landlord willing to accept the voucher and the associated regulation and inspection and (b) holders can pay more than affordable rent—up to 40 percent of income—because while the amount of the voucher depends on family-sized-adjusted median rent in the urban area, the landlord is free to charge more. Both the voucher and the RS pay 100 percent of the affordability gap (in the case of the voucher, however, the gap depends on average area rent, not actual rent), quality is assured by government inspection and the landlord is the legal recipient of the monthly subsidy.

An important aspect of the Credit program is that it ensures a supply of housing units accepting vouchers—landlords of Credit projects *must* accept the voucher. In cities like Boston and San Francisco, where the rental housing market is tight, this is crucial assistance to the voucher program.

If a similar condition were imposed on Credit landlords in Canada, RS tenants would be assured a level of security of tenure now missing in for-profit buildings. While RS recipients are an ongoing component of the tenant mix in non-profits, they are unlikely to be found in for-profit buildings. Instead, landlords tend to be eager to sign RS contracts when the vacancy rate is high but not to renew them when it is low. A requirement that all Credit projects, especially for-profits, must make available a minimum number of units for RS would help the private RS program in cities like Montreal and Vancouver.⁷

Anthem Park at Dusk

Photo credit: Vancouver Housing Authority, Vancouver, Washington



Mixed-income, mixed use development.

The Range of Projects that Could be Funded through the Credit

The Credit has funded many types of housing. In California, Oregon, Illinois, and Maine, it has funded single-room occupancy units and housing for the homeless. In Canada, the provinces could give priority to applications for projects that house people with special needs. These kinds of projects would need top-up funding, but the Credit provides a crucial base subsidy.

Costing Some Alternatives

In my recent study with Professor Francois Des Rosiers of Laval University, we undertook calculations to determine how alternative provisions in the Credit program might work. We compared the after-tax return (technically, the after-tax internal rate-of-return) to investors under the various alternatives.

Most simulations deal with for-profit developers, but some apply to non-profits—as in cases where there are no

sales proceeds. When a Toronto developer receives credits valued at 91 percent of the construction cost, the return after taxes is quite high, enough to make it an attractive investment relative to a REIT. It is important to realize, however, that the project is financially viable due to the assumed low rate of inflation, two percent, and the mortgage interest rate, seven percent.

For this Toronto project, rent is set at the maximum allowed by the Credit program, \$1045 for a two-bedroom apartment, which is only slightly less than the 2005 mean rent reported by the Canada Mortgage and Housing Corporation. When rent is reduced to \$958, so that it is just affordable to families at 50 percent of the median income, the investment is still quite attractive. But most renters in core need would still need additional subsidy.

The results in the case of for-profit projects are interesting, particularly if owners are required to take RS tenants. Overall returns to the developer and other owners are noticeably higher than in the non-profit case, because of the value of the property at the end of the commitment period. The return

rises substantially when the commitment period is only 15 years rather than 30, because it is advantageous to sell soon after the 10-year tax credit stream ends. A longer commitment period is desirable for security of tenure reasons, so there is a tradeoff between return to investors and security of tenure for tenants.

We also did simulations set in Montreal and the results were not as favourable because mean actual rents there are less than the Credit maximum.

Unfortunately, this is probably true for most cities. Setting the rent for a two-bedroom apartment at \$705 per month—midway between the mean rent for 2005 and the Credit maximum—the return is more than a percentage point less than the Toronto project's, for a 30-year commitment. Clearly, without further assistance, the Credit program is less desirable for Montreal on two grounds: less attractive to investors (lower return) and less desirable to renters (higher than mean rent). However, the Quebec housing allowance, *Allocation Logement*, would help very low-income families with children and singles 55 and over. Furthermore, some single mothers and low-income singles desperate to find accommodation might decide that a unit at a higher-than-average rent is better than no unit at all.

Our results depend on investors' perception that there is a moderately low risk associated with their investment, and on syndicators' ability to supply their services efficiently. The results would be negatively affected if the program seemed temporary. But if perceived risk and syndicator efficiency were as favourable as the long-established US program, returns would be even better than our results suggest. In Table 1, the last three examples show the considerable impact that improved investor confidence has, as indicated by the gross equity they contribute, on the size of the mortgage required. The last example is quite conservative as an indicator of the current US situation.

Concluding Remarks

A low-income housing tax credit program is a desirable option for Canada, in large part because non-profit housing providers could benefit from the tax system in the same way as for-profit developers. The viability of a Credit program in assisting the provision of housing seems virtually assured in the current low inflation and low interest rate environment. The tax credit, as it exists in the US, is misnamed—it should be called a *moderate*-income housing tax credit. But with the Credit subsidy as base, other subsidies can be stacked on, transforming it into a program to assist those in core need. It should also prove a major source of long-tenure private RS units.

This article has assumed that a Canadian Credit program would be the same as the pioneering US program. But while a Canadian program has been proposed, its details are still under development. For one thing, it might lack some of the desirable characteristics of the US program, such as making non-profit developers eligible, and indeed favouring them, through its minimum non-profit allocation requirement. The Canadian legislation might not do that. Second, it might not require Credit projects to take RS tenants by signing contracts with housing agencies for some of their units. US projects are required to take Housing Choice Voucher recipients. Third, the Canadian program might not be administered at the federal level solely by the CRA. It may be that the willingness of syndicators to become involved, and the willingness of corporations and individuals to buy credits, is influenced in the US by the fact that the Credit program is run by the Internal Revenue Service, not the federal housing agency. Because the Credit is a tax program, it must be administered by the tax authority. Having a second agency involved in

administration might add unduly to the perceived complexity of the program.

On the other hand, the Canadian program might be more desirable than the US one. A Canadian program might distribute funds to provinces on the basis of core need, as established by CMHC, instead of on a per capita basis. The credits might represent a higher percentage of construction costs than in the US program. MURB provisions might be re-introduced to apply only to Credit projects, making the Credits desirable to a wide range of corporations and individuals. And the federal government might, through CMHC, allocate funds to help non-profits put forward applications for the credits. Whatever the final details of the program, it seems almost certain to mark a revolutionary change for non-profits, virtually assuring them a solid base for funding in the long term.

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Dr. Marion Steele teaches urban economics at the University of Guelph and is a resident research associate at the Centre for Urban and Community Studies, University of Toronto. She is a specialist in housing economics and is the author of many articles and reports in that area. Reflecting a recent focus on taxation issues, she has participated for several years in the Canadian Tax Foundation's Tax Policy Research Symposium.

- 1 This is called the Capital Consumption Allowance (CCA).
- 2 In the examples below, the 91 percent credit is used, reflecting a high-cost city like Toronto.
- 3 Note that economists do not like this definition because \$1,000 received today is worth more than the same dollar amount received a year from now. If \$1,000 is invested today it will earn interest and become \$1,050 by the end of a year if the interest rate is five percent. However, the price definition given here is used in the industry. But there is,

unfortunately, some disagreement in the literature on whether the investor's payment for tax credits is the gross amount of the syndicator's fees, as here and as in the Ernst and Young chart shown in Novogradac (2006), or the net, as in Wallace (1998).

- 4 This assumes that rents are set at the maximum permitted.

In other words, once it is determined that the project qualifies for \$131,034 per unit, the annual credit is derived by finding what annual amount, **discounted**, given for each of 10 years equals \$131,034.
- 5 Purchasers of credits, whether from a single development or from a fund of many developments, have the legal status of Limited Partners. The legal structure of a partnership (General Partner—usually the developer—and Limited Partners) would also probably be used in any Canadian program. In non-profit projects, the non-profit would usually be the General Partner. Limited partners are generally passive investors, that is, they do not take part in running the project.
- 6 It is difficult to determine a precise percentage but experts suggest somewhere between one-third and one-half of units have voucher-assisted tenants.
- 7 There was a similar requirement in Canada under the Assisted Rental Program (ARP) (1975-78) wherein developers were obligated to offer 25 percent of units for rent supplements. In many cases, provinces choose not to exercise this option, as the new market rents on ARP projects were higher than those in existing rental properties.

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