MARCH 07

research works

A bridge linking housing research and practice

volume 4, number 3

Tax Credits Boost Housing Rehabilitation

Tax credits are one of the most significant resources available for housing rehabilitation.

While rehabilitation is often a cost-effective alternative to new construction, practical guidance on overcoming the many barriers to rehabbing older structures has been in short supply. Despite their value as both an affordable and a renewable resource in housing markets nationwide, the existing housing stock varies so much in terms of condition, age, and construction methods that the rehabilitation process is far from predictable, and often more challenging than new construction. Obtaining a sound grasp of these issues is difficult because the barriers vary across projects and communities.

To assist decisionmakers and housing professionals, The National Trust for Historic Preservation, The Center for Urban Policy Research at Rutgers University, Enterprise Community Partners, Inc., The National Center for Healthy Housing, and HUD collaboratively undertook an investigation into the status and potential of housing rehabilitation for positively influencing the nation's supply of affordable housing. The results are available in a two-volume report, *Best Practices for Effecting the Rehabilitation of Affordable Housing*, which addresses the challenges to rehabilitation at the development, construction, and occupancy stages.

Tax Credit Resources

This study finds that tax credits are traditionally among the most significant resources available to rehabbers, especially low-income housing tax credits (LIHTCs), historic rehabilitation tax credits (HRTCs), and new markets tax credits (NMTCs). Federal funds in the amount of $3.6 billion a year leverage another $8.5 billion in private funding for a total of $12 billion being used to rehabilitate 115,000 housing units annually. Tax credits account for $2 billion of that $3.6 billion.

Low-Income Housing Tax Credits

Many states participate in both the federal LIHTC program, as well as sponsoring their own tax credit programs. Applications are competitive, and are scored according to criteria that vary from state to

continued on page 2

contents

PD&R U.S. Department of Housing and Urban Development Office of Policy Development and Research

HUD USER

www.huduser.org • 800.245.2691

Tax Credits Boost Housing Rehabilitation *continued from page 1*

state. This study found that although some scoring systems favor rehabilitation, they more frequently are neutral or favor new construction. An analysis of the criteria in use identified four scoring features that give rehabilitation projects a better chance to compete: state set-asides for rehabilitation projects, points for historic rehabilitation, points for small projects, and points for rehabilitation projects in challenging locations, such as Difficult Development Areas.

Historic Rehabilitation Tax Credits

Since the late 1970s, more than 325,400 housing units were completed with the help of federal historic preservation tax incentives, with 23 percent of them being affordable to low- or moderate-income families. A 20-percent HRTC is available for rehabilitating certified historic structures to serve as residential rentals. Developers often use HRTCs in combination with other subsidies, such as LIHTCs, property tax exemptions, and preservation easements.

The researchers found that HRTCs seem underutilized as a tool for rehabilitation, due to a number of congressionally controlled constraints. For example, a 10-percent rehabilitation tax credit is available for substantial rehabilitation of nonhistoric buildings built before 1936, but it can't be used for residential projects. Removing the nonresidential restriction could be very useful in financing the transition of older, nonhistoric buildings to affordable housing.

Another problem with the 10-percent credit is that a rehabilitated building has to have been built before 1936. This requirement, which was passed in 1986, is seemingly based on the assumption that an "old" building is at least 50 years old. The reference year of 1936 still stands, however, meaning that buildings now have to be over 70 years old to qualify. A simple solution, investigators point out, is to index the age requirement. Other recommended improvements would change the way in which the tax basis is calculated, allow a larger subsidy in distressed areas, and make HRTCs more viable for small projects.

New Markets Tax Credits

New Market Tax Credits were created in 2000 to stimulate long-term investment in the economic development of low-income communities by attracting investor capital. NMTCs give taxpayers credit against their federal income taxes in exchange for making equity investments in Community Development Entities (CDEs). CDEs use this equity to invest in or make loans to businesses in low-income communities. Investments that qualify include those which finance start-up businesses, inventory expansion, business expansion or acquisition costs, rehabilitation of commercial space, location of small-scale industries in upper stories, and stimulation of mixed-use commercial and residential space.

An investor earns a dollar-for-dollar reduction in taxes spread out over 7 years, equal to 5 percent of the equity investment for each of the first 3 years and 6 percent for the remaining 4 years, for a total of 39 percent. Investors may not redeem their investments in CDEs before the end of this 7-year period. In this way, NMTCs attract new capital to underserved communities that are cash poor, but rich in deteriorated properties. NMTCs can bring 20 to 25 percent more dollars to a qualifying rehabilitation project and can be combined with the 20- or the 10-percent HRTC.

Although NMTCs were meant to stimulate business development and expansion, the law permits their application in mixed-use projects that include condominium housing. One example of what is possible is the McKessow Building in Rock Island, Illinois, a mixed-use project using NMTCs that includes retail space at ground level and two floors of condominiums above. Another example is the Heritage Building in Auburn, Washington, which was once a bank, but is now being adapted to offer both retail and living spaces thanks to NMTCs. In St. Louis, Missouri, the adaptive reuse of the Old Post Office was subsidized with $13.5 million in NMTCs. In turn, the project stimulated the rehabilitation of five adjacent buildings that resulted in 400 market-rate and affordable housing units, plus parking, retail space, and office space.

Tax credits represent a powerful resource for housing rehabilitation efforts. The study team suggests that this resource can be enhanced if states revise LIHTC scoring criteria to eliminate any bias against rehabilitation, if states supplement federal LIHTC and HRTC programs with similar programs of their own, and if federal HRTCs are made more accessible to rehabilitation initiatives.

Best Practices for Effecting the Rehabilitation of Affordable Housing can be downloaded at **www.huduser.org/publications/affhsg/bestpractices.html**. Print copies are available for a nominal fee by calling HUD USER at 800.245.2691, option 1.

Changes in Area Designations Help Promote New Development

The Low-Income Housing Tax Credit (LIHTC), a tax incentive for the development or rehabilitation of affordable rental housing, is a key resource that is helping to create an adequate supply of affordable housing. Since its inception in 1986, the LIHTC program has contributed to the production of nearly 1.3 million housing units. LIHTC projects in Difficult Development Areas (DDAs) and Qualified Census Tracts (QCTs) are eligible for additional incentives to create affordable housing in high-cost areas.

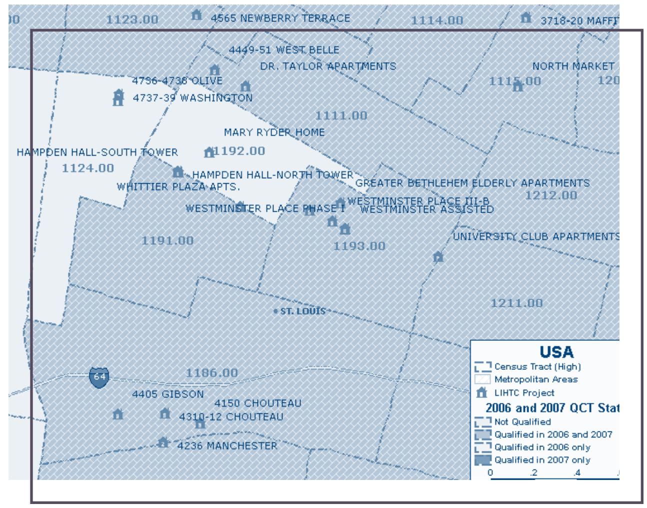
The Internal Revenue Code defines a DDA as "any area designated by the Secretary of Housing and Urban Development as an area which has high construction, land, and utility costs relative to area median gross income." QCTs are census tracts in which one-half or more of the households have incomes below 60 percent of area median income *or* the poverty rate is 25 percent or higher. A 20-percent population cap in each metropolitan area or nonmetropolitan part of a state limits the designation of eligible census tracts as QCTs.

For 2007, the Department of Housing and Urban Development (HUD) changed the designations of both DDA and QCT areas. In a recent interview with Dr. Kurt Usowski, Associate Deputy Assistant Secretary for Economic Affairs in HUD's Office of Policy Development and Research (PD&R), Research*Works* learned about changes to the DDAs and QCTs and their effect on future development.

RW: Dr. Usowski, how do DDAs promote development?

Usowski: LIHTC projects in DDAs qualify for an additional subsidy to encourage their location where development costs are high relative to rents that can be collected on units in the project. LIHTC unit rents are set according to area median income, (Section 8 very-low-income limits that are based on 50 percent of an area's median family income). LIHTC projects in DDAs are eligible for an additional tax-credit subsidy of up to 30 percent.

Because there are no uniform national measures of construction, land, and utility costs, HUD uses the two-bedroom Fair Market Rent (FMR) as a summary measure of these costs. To designate DDAs, HUD uses the ratio of FMR to the HUD very-low-income limit (which forms the basis of the LIHTC maximum rent) to rank areas of the country from most to least



The overwhelming majority of Qualified Census Tracts (QCTs) maintained their designation in 2007.

expensive, relative to area income. The highest ranked (most expensive) areas totaling 20 percent of the population of all metropolitan areas and, separately, nonmetropolitan counties, are designated DDAs.

RW: How do QCTs promote development?

Usowski: LIHTC projects in QCTs are eligible for an additional tax-credit subsidy of up to 30 percent. This encourages the improvement of rental housing conditions in low-income areas by providing a larger subsidy for rehabilitating existing units or constructing new units in these neighborhoods.

RW: How have DDA and QCT designations promoted development in the past?

Usowski: Statistics in PD&R's report *Updating the Low-Income Housing Tax Credit Database: Projects Placed in Service Through 2003* show that QCTs do influence the development of LIHTC projects and units. Although less than 13 percent of the population resides in designated QCTs, more than 26 percent of LIHTC units were produced within these areas between 1995 and 2003.

Developing any kind of rental housing, whether subsidized or unsubsidized, is difficult in high-cost DDA housing markets. While DDAs do not capture a disproportionate share of LIHTC development relative to their populations, they do contain a higher than expected share of LIHTC development when measured against multifamily building permits. Although

continued on page 5

Major Study Examines Errors in Rental Assistance Subsidies

"HUD's goal remains to ensure that the right benefits go to the right people," states a recent report by the U.S. Department of Housing and Urban Development. In 2001, HUD undertook a major effort to improve the quality control measures used in determining rental assistance subsidies. Through these efforts, the Department continues to reduce errors in subsidy calculations.

Quality Control for Rental Assistance Subsidies Determinations for FY 2003 presents the latest findings from a series of quality reviews of more than 600 representative projects covering more than 4.3 million units in the United States and Puerto Rico, and proposes remedial actions. The projects for the study were selected from several programs: public housing, public housing authority (PHA)-administered Section 8, owner-administered Section 8, Section 202 Project Rental Assistance Contract (PRAC), Section 811 PRAC, and Section 202/162 Project Assistance Contracts.

Translating Data Into Dollars

Errors in the amount that HUD pays on behalf of families receiving public housing and Section 8 program assistance occur for a number of reasons, but the most common are miscalculations, failure to verify tenant financial information, and incorrect income and deduction amounts. The study found that rent underpayments totaled $1.7 billion, or $32 per unit annually —nearly three times that of rent overpayments, which totaled more than $600 million, or $12 per unit annually. When combined, the average gross rent error per case is $44 per unit. Over- and underpayments partly offset each other, meaning that the resulting net average rent error is $20 per unit annually.

Addressing the Issue

The study makes recommendations for improving quality control and accuracy in rental assistance determinations, and identifies ways of reducing costly errors in the local administration of both public housing and Section 8 programs. Recommendations also support a plan to use the U.S. Department of Health and Human Service's National Directory of New Hires. Because most of the subsidy overpayment errors are associated with earned income determinations, full implementation of an income matching system should quickly reduce by half the errors in the public housing and Section 8 voucher programs. The report also suggests the following actions:

Implementation of an income-matching system could reduce the rental assistance subsidy errors in the public housing and Section 8 voucher programs by half.

- Provide PHAs and owners with accurate and consistent guidance about the apartment size for which residents qualify;
- Conduct an outreach campaign to inform PHAs and owners of the Department's available resources; and
- Provide PHAs and owners with the forms, training, and tools needed to correctly determine rents.

The report notes that, "The reduction in errors and improper payments is unlikely to have an equivalent impact on budget outlays." HUD's efforts are likely to cause some higher income tenants to leave assisted housing and to be replaced with lower income tenants who require increased outlays. Nevertheless, HUD's goal remains to ensure that the right benefits go to the right people.

Quality Control for Rental Assistance Subsidies Determinations for FY 2003 is available free online at **www.huduser.org/publications/pubasst/qualcontrol03.html** or from HUD USER for a nominal fee by calling 800.245.2691 and selecting option 1.

This report is one of three studies, completed in 1996, 2001, and 2003 that comprise HUD's Quality Control Project. Each study contains national estimates of the extent, severity, costs, and sources of errors occurring in the certification and recertification procedures used by Public Housing Agencies (PHAs) and owner-administered assisted housing programs. The two earlier studies, *Assisted Housing Quality Control* **(www.huduser.org/publications/pubasst/asthsgqalcntrl.html)** and *Quality Control for Rental Assistance Subsidies Determinations* **(www.huduser.org/publications/pubasst/qualitycontrol.html)** can be downloaded for free or ordered for a nominal fee by calling HUD USER at the number shown above.

Changes in Area Designations Help Promote New Development *continued from page 3*

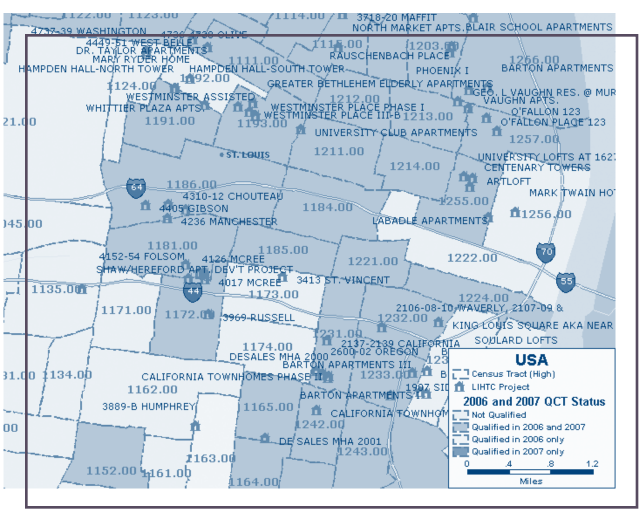
DDAs constitute 20 percent of the population, they accounted for only about 14 percent of the multifamily building permits issued between 1994 and 2002. However, about 19 percent of LIHTC units were constructed in DDAs between 1995 and 2003.

RW: How did the DDAs and QCTs change between 2006 and 2007, and what will the impact of those changes be?

Usowski: Both designations were changed for 2007, largely because metropolitan area boundaries were redrawn following the 2000 Census. The boundaries for the DDAs match the areas for FMRs and very-low-income limits, which are the bases for their determination. Because the 2006 FMRs were determined using revised metropolitan area geography, the 2007 DDAs were changed to coincide with the 2006 FMR areas. This means that some areas previously identified as metropolitan or nonmetropolitan changed and some areas lost or gained designation as a DDA.

The 2007 QCT designation process uses a more detailed census tract-level household income distribution from the 2000 Census tabulation that allows for a more accurate determination of the percentage of households below 60 percent of area median income. This new data, combined with some new higher population caps in redefined metropolitan areas, resulted in the net addition of 249 QCTs.

The overwhelming majority of the QCTs maintain their designation in 2007.



More detailed census tract-level household income distribution and revised metro area definitions resulted in 249 additional QCTs in 2007.

RW: Who will benefit from these changes?

Usowski: Clearly, the 477 newly designated QCTs should benefit, whereas the 228 tracts that lost QCT status may be hurt. The intent, however, is to conform the designations to the requirements of the statute.

RW: In addition to the HUD USER data sets, what other information would be valuable to Research*Works* readers?

Usowski: Anyone interested in the LIHTC should read the report *Updating the Low-Income Housing Tax Credit Database: Projects Placed in Service Through 2003* to get a thorough grounding in how the program is producing rental housing across the nation. The report has a wealth of national, state, and metropolitan-level statistics, as well as some interesting geographic analysis.

QCT and DDA tables for areas and links to QCT maps are available through the HUD USER website at **qct.huduser.org/**. *Updating the Low-Income Housing Tax Credit Database: Projects Placed in Service Through 2003* is available for free online at **www.huduser.org/Datasets/lihtc/report9503.pdf** or in print from HUD USER for a nominal fee by calling 800.245.2691 and selecting option 1.

Seattle Promotes the Rehabilitation of Affordable Dwellings

Thousands of affordable housing units are lost each year as older buildings become dilapidated. In Seattle, Washington, one of the most expensive markets in the country, state and local governments are working together to promote housing rehabilitation and increase its cost effectiveness. The city has created solutions that address the economic, development, and construction obstacles to successful rehabilitation. This article discusses Seattle's solutions, which receive special attention in a new HUD report, *Best Practices for Effecting the Rehabilitation of Affordable Housing*.

Economic Constraints and Solutions

Many Seattle households simply can't afford the area's current housing costs, leading some families to look to subsidized housing, much of it rehabilitated. Although renovation is expensive, Seattle rehabbers often combine subsidies to underwrite restoration projects that will produce affordable housing, as demonstrated by the newly rehabilitated Pacific Hotel. This building, a transient hotel built in 1916, now has 112 affordable living units. The project was supported by combining low-income housing tax credits and historic rehabilitation tax credits with debt financing. The debt's cost was reduced with subsidies from the Federal Home Loan Bank, the state's Housing Trust Fund, the city, and HUD's Section 8 Moderate Rehabilitation Single Room Occupancy Program for Homeless Individuals.

Photo credit: National Park Service

Using tax credits and debt financing, rehabilitation of the Pacific Hotel in Seattle, Washington produced 112 affordable living units.

Best Practices for Effecting the Rehabilitation of Affordable Housing offers solutions developed by state and local governments in Seattle and elsewhere, as well as other information on housing rehabilitation.

In addition to combining funds from multiple sources to make housing units more affordable, the state, county, and city promote coordination of resources with a common application form. Other tools used include property tax incentives, transfer of development rights, tax-exempt financing, bargain sales, and partnerships.

Development-Phase Barriers and Solutions

Acquiring properties to rehabilitate in Seattle is often difficult, because developers need up-front capital. The options available to developers include bridge loans and cooperative strategies. Seattle's Office of Housing offers bridge loans with terms of up to three years, interest-only payments, and deferred repayment. Nonprofits may seek mutually beneficial approaches to acquisition by either trading properties or combining resources to purchase a larger property.

Another obstacle to rehabilitation that commonly arises during development is the estimation of rehab costs, which rarely match those of new construction. To obtain the best estimates, Seattle rehabbers recommend having a knowledgeable cost estimator who works closely with contractors experienced in the types and areas of rehabilitation contemplated or underway. Another suggestion is that the city ease cost estimation difficulties by identifying rehabilitation

continued on page 7

Seattle Promotes the Rehabilitation of Affordable Dwellings *continued from page 6*

costs for particular types of properties by neighborhood.

Land use requirements for sustainability, parking, and open space may also interfere with the rehabilitation of affordable housing. To eliminate some of the barriers created by these mandates, Seattle reduced parking space requirements from 1.5 to 1.3 spaces per housing unit. The city is further weighing the merits of supplementing auto with bicycle parking, surveying tenants for actual parking needs, granting shared parking allocations across housing complexes, and implementing car-sharing programs (such as Flexcar) to help alleviate the obstacles created by parking requirements.

Construction-Phase Barriers and Solutions

The transition to construction presents more challenges. Stringent retrofitting of rehabilitated buildings, required by the federal government under the Americans with Disabilities Act (ADA), is seen by some as one construction barrier to overcome. The state of Washington allows flexibility under certain circumstances so that Seattle, unlike many cities, can more judiciously evaluate modifications. Seattle's Pacific Hotel project, for example, faced prohibitive costs if forced to comply with the strict ADA requirements. To satisfy the law and regulations while controlling expenses, the state approved a solution that included altering a doorway and window to meet accessibility requirements, while continuing to uphold the building's historic integrity.

Volume 2 of Best Practices for Effecting the Rehabilitation of Affordable Housing offers technical analyses and case studies to assist rehabilitation professionals.

Although Seattle often provides financial incentives to encourage local historic preservation, historic regulations can also present obstacles to rehabilitation. Historic regulations, monitored by local historic preservation boards, may lengthen the approval process. In addition, developers applying for historic rehabilitation tax credits must comply with regulations from both the State Historic Preservation Office and the National Park Service (NPS). If standards for a project cannot be reconciled between the two agencies, meeting both sets of requirements significantly increases rehabilitation costs. To resolve differences between the NPS and local historic districts, rehabilitation professionals throughout Seattle suggest meeting early with these stakeholders to satisfy the interests of all parties. Seattle's ability to produce a substantial number of rehabilitated historic properties to house low- and moderate-income families demonstrates how affordability and preservation objectives can often be complementary.

Rehabilitation projects are often costly and extremely difficult to complete. Seattle is home to many such enterprises, and the city is working to eliminate many of the obstacles to rehabilitating affordable housing. *Best Practices for Effecting the Rehabilitation of Affordable Housing* contains additional solutions crafted by state and local governments in Seattle and elsewhere, as well as other information on housing rehabilitation. The report is available free of charge online at **www.huduser.org/publications/affhsg/bestpractices.html**, or a print version is available for a nominal fee by calling 800.245.2691, option 1. **HI**

U.S. Department of Housing and Urban Development
HUD USER
P.O. Box 23268
Washington, DC 20026—3268

www.huduser.org • 800.245.2691

In the Next Issue of... research works

- Working with Florida agriculture producers and others, HUD has developed a new generation of affordable, storm-resistant housing for migrant farm workers. The HUD Migrant Worker Prototype House was introduced at the Florida Agriculture Expo in early December 2006. The prototype, built to withstand a Category 4 hurricane, has two bedrooms, offers excellent fire protection, and costs less than $100 per square foot to construct. We'll look at the public-private partnership that brought the house into being, where the prototype will be constructed, and potential uses in other areas of the country.
- The Community Development Corporation of Utah (CDCU) is one of three subject study sites reviewed in the process of developing an evaluation mechanism for HUD's 602 Non-Profit Disposition program. The program makes HUD-held single-family homes available at deep discounts to local governments and nonprofits that rehabilitate the properties for resale to low- and moderate-income families. We'll explore CDCU's experience with the 602 Program to gain a sense of how local communities are using this resource to increase homeownership opportunities.
- The final analysis of a study designed to measure the impacts of housing vouchers provided to Welfare to Work program participants was recently published in the *Effects of Housing Vouchers on Welfare Families*. This article briefly discusses the conclusions reached regarding the influence of vouchers on housing location, household composition, material hardship, employment, education, and the children of recipient families.
- New models of delivering health-related and supportive services that are both attractive and affordable to low- and modest-income older adults is increasingly important as the number of senior Americans grows. Affordable housing plus services (AHPS) that link older residents of subsidized housing with health and supportive services may be one promising strategy. HUD recently participated in an exploration of what AHPS initiatives have to offer low- and modest-income seniors who wish to age in place. We'll review the results.

U.S. Department of Housing and Urban Development
PD&R U.S. Department of Housing and Urban Development
Office of Policy Development and Research
HUD USER