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Profiting from Poverty: The Competition Between For-Profit and Nonprofit Developers for Low-Income Housing Tax Credits

MEGAN J. BALLARD*

*"[T]he housing that is subsidized through tax credits is more suited to the needs of investors than poor renters."*¹

Governmental actors gradually have been withdrawing from the role of providing social services over the past few decades. Various reasons account for this retreat, but it is largely a product of political determinations that the sphere of government ought to be diminished, as well as a recognition of economic realities that tend to constrain public sector activities. Regardless of the reasons, for-profit entities and nonprofit organizations are left to fill the gap.² In health care, job training, day care, education, and business development, among other realms, the private sector performs functions that the government is no longer willing or able to perform.³

* Associate Professor of Law, Washburn University School of Law. For their helpful comments on earlier drafts, I am grateful to Florence Wagman Roisman, Thomas A. Bishop, Myrl Duncan, Ali Khan, David Pierce, and Bill Rich. Sharonda Friday provided valuable research assistance. A grant from Washburn University School of Law supported this article. Cited documents acquired from the Internet are on file with the author.

1. CONG. BUDGET OFF., *The Cost-Effectiveness of the Low-Income Housing Tax Credit Compared with Housing Vouchers: A CBO Staff Memorandum*, 56 TAX NOTES 493, 493 (1992).

2. Private actors have long provided social services in the United States. Since the New Deal, when the federal government first became involved in poverty relief on a large scale, the role of nonprofit organizations, in particular, has increased. Michele Estrin Gilman, *Legal Accountability in an Era of Privatized Welfare*, 89 CAL. L. REV. 569, 581 (2001) (citing LESTER M. SALAMON, PARTNERS IN PUBLIC SERVICE: GOVERNMENT-NONPROFIT RELATIONS IN THE MODERN WELFARE STATE 15 (1995)).

3. See, e.g., XAVIER DE SOUZA BRIGGS, COMMUNITY BUILDING: THE NEW (AND OLD) POLITICS OF URBAN PROBLEM-SOLVING IN THE NEW CENTURY 12-14 (John F. Kennedy Sch. of Gov't, Harvard Univ. Faculty Research, Working Paper Series No. RWP02-003, 2002), at <http://ksghome.harvard.edu/~xbriggs.academic.ksq/keynote%20wood%20comm%20bldg%200900%20cond.doc> (discussing the "marketization and nonprofitization of social policy"). Generally, observers refer to this trend as privatization and broadly define the term as the transfer of governmental functions to the private sector. Gilman, *supra* note 2, at 594. See also Jody Freeman, *Extending Public Law Norms Through Privatiza-*

The construction and management of low-income rental housing presents a vivid example of functions once filled by the government, now largely privatized. Federal and local governments have been in the business of providing subsidized rental housing since the mid-1930s.⁴ Government participation has gradually shifted from an emphasis on owning and operating housing to providing rent vouchers to low-income tenants so that they may more easily secure private, market-rate housing. The Low-Income Housing Tax Credit (LIHTC) program is the most recent development in this shift towards privatizing subsidized housing.

The LIHTC, created by Congress under the auspices of the Internal Revenue Service in the 1986 Tax Reform Act,⁵ is currently the largest federal subsidy for the development and rehabilitation of affordable housing.⁶ The program subsidizes developers of low-income rental housing, rather than directly subsidizing tenants. Most of the developers of tax credit properties are for-profit entities. They are awarded income tax credits through a competitive process, open to both for-profit and non-profit developers, based on a project proposal. In exchange for the credits, developers agree to restrict the rents on a percentage of their units and to dedicate these units only to low-income renters who meet strict income limits. Developers usually sell their credits to investors wishing to offset federal taxes owed, then use the proceeds as capital for constructing or rehabilitating rental housing.⁷

This Article introduces four interrelated ideas through an analysis of the LIHTC program. First, the social service gap that private actors are filling represents contested terrain. Specifically, for-profit actors spar with nonprofit organizations for access to incentives that the government provides to encourage the privatization of social services.⁸ The LIHTC program exemplifies this competition: For-profit and nonprofit housing

tion, 116 HARV. L. REV. 1285, 1286-87 (2003) [hereinafter Freeman, *Extending Public Law Norms*] (describing various forms of "privatization").

4. See, e.g., William H. Simon, *The Community Economic Development Movement*, 2002 WIS. L. REV. 377.

5. Tax Reform Act of 1986, Pub. L. No. 99-514, § 252, 101 Stat. 2189.

6. Nonetheless, housing developed with LIHTC constitutes a small proportion of the total inventory of federally subsidized rental housing. Katherine M. O'Regan & John M. Quigley, *Federal Policy and the Rise of Nonprofit Housing Providers*, 11 J. OF HOUSING RES. 297, 305 (2000).

7. See discussion *infra* Part I.A. for a description of how the LIHTC operates.

8. Nonprofit actors are organizations formed under the Internal Revenue Code. 26 U.S.C. § 501(c) (2000). They are exempt from federal income tax liability and receive several other tax benefits. For-profit actors are all other individuals or nongovernmental entities. While this distinction seems clear, the lines can become somewhat blurred when a for-profit group establishes a nonprofit branch, or when the reverse occurs and a nonprofit organization creates a for-profit subsidiary. See, e.g., John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 514-15 (2002).

developers vie for limited tax credits to build or rehabilitate and manage affordable housing. Second, the tableau on which this competition unfolds is not level. For-profit providers of social services tend to be more politically powerful than traditional nonprofit social service providers, as in the case of competitors for low-income housing tax credits. Third, this slanted competition can be detrimental to the beneficiaries of privatized social programs. Because for-profit competitors carry more political clout, they are positioned to overpower nonprofit social service providers in the design and operation of privatized social service programs. To the extent that nonprofits add a valuable difference to the service or product that they provide, the loss or minimization of their contributions could harm the beneficiaries of social policies. In the LIHTC program, powerful for-profit developers have succeeded in amending federal legislation to the disadvantage of nonprofit developers, potentially limiting the space for important nonprofit contributions. Finally, the sum of these ideas leads to the conclusion that policy makers ought to regulate this competition. In the LIHTC realm, Congress must continue to protect the participation of nonprofit developers.

The LIHTC program presents a rich context in which to analyze these ideas for several reasons. Significantly, the limited supply of rental housing tax credits is a substantial benefit drawing developers into stiff competition.⁹ From the program's inception in 1987, through 2000, the federal government allocated \$4.38 billion in tax credit dollars.¹⁰ The program provides states with approximately \$315 million in new tax credits each year.¹¹ Tax credit allocations have resulted in the development of an average of 88,000 new low-income rental units annually between 1995 and 2000.¹² The magnitude of the program, and the importance of tax credits to housing development, are also reflected in the fact that housing

9. Section 42 requires the federal government to allocate to each state agency administering the LIHTC program a \$1.75 housing tax credit per citizen of the state, indexed to inflation. 26 U.S.C. § 42(h)(3) (2000). Most states allocate all, or substantially all, of their credits on an annual basis. *See, e.g., NAT'L COUNCIL OF STATE HOUS. AGENCIES*, 2001 HOUS. CREDIT UTILIZATION, available at <http://www.ncsha.org/uploads/ACFFBDE.pdf> (Dec. 17, 2002).

10. DANTER CO., STATISTICAL OVERVIEW OF THE LIHTC PROGRAM, 1987 TO 2001, available at <http://www.danter.com/taxcredit/stats.htm> (last visited Feb. 8, 2003). These numbers are consistent with older figures reported in James E. Wallace, *Evaluating the Low-Income Housing Tax Credit*, in *EVALUATING TAX EXPENDITURES: TOOLS AND TECHNIQUES FOR ASSESSING OUTCOMES* 43 (Lois-ellin Datta & Patrick G. Grasso eds., 1998) [hereinafter *EVALUATING TAX EXPENDITURES*].

11. SANDRA NOLDEN ET AL., ABT ASSOCS. INC., UPDATING THE LOW-INCOME HOUSING TAX CREDIT (LIHTC) DATABASE: FINAL REPORT, at 2 (Nov. 10, 2000).

12. *See* SANDRA NOLDEN ET AL., ABT ASSOCS. INC., UPDATING THE LOW-INCOME HOUSING TAX CREDIT (LIHTC) DATABASE: PROJECTS PLACED IN SERVICE THROUGH 2000, at ii (Dec. 2002). No reliable data exists for the number of units constructed or rehabilitated with tax credits. *See infra* Part III.B. (discussing murky data related to the number of units constructed).

units approved for tax credits between 1987 and the end of 2001 comprise almost 28% of all multifamily housing units approved for construction over this same period.¹³

The dwindling supply of low-income housing implicates significant social policy concerns, rendering even more important an analysis of how competition between for-profit and nonprofit developers impacts tax credit tenants. Housing poor families has been a perpetual challenge for this nation. Even in times of sustained economic growth, we cannot provide adequate shelter for all in need. While the decade of record economic expansion in the 1990s raised the incomes of many Americans, it produced scant benefit for the most disadvantaged households. The lowest earning one-fifth of the population has experienced almost no income gains since 1975.¹⁴ Meanwhile, the cost of housing has been on the rise since the 1980s.¹⁵ As the economy continues to sputter in the aftermath of the events of September 11, 2001, increasing numbers of families find affordable housing far beyond their reach. Rising poverty rates continue to outstrip the rate at which owners provide rental housing units affordable for low-income people.¹⁶ We are stumbling towards a housing crisis that could culminate in a lack of affordable housing for well over 15 million households.¹⁷

Finally, recognition of this competition within the LIHTC program, and its effects on tax credit tenants, is all the more important in light of recent proposals to create a similar tax credit to provide home ownership opportunities for low-income families.¹⁸

13. Multi-family housing consists of five or more units. Stephen Malpezzi & Kerry Vandell, *Does the Low-Income Housing Tax Credit Increase the Supply of Housing?*, 11 J. HOUSING ECON. 360, 361-62 (2002) (citing the National Council of State Housing Authorities [sic] and the U.S. Census).

14. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION'S HOUSING 3* (2002), available at <http://www.jchs.harvard.edu/publications/markets/Son2002.pdf> [hereinafter *STATE OF THE NATION'S HOUSING 2002*] (reporting an average annual income of \$10,500 in 2000 for the 20% lowest earning households).

15. BIPARTISAN MILLENNIAL HOUS. COMM'N, *MEETING OUR NATION'S HOUSING CHALLENGES 12* (2002), available at <http://www.mhc.gov/MHCReport.pdf> [hereinafter *MILLENNIAL HOUS. COMM'N*] (stating that the price of housing since the 1980s has outstripped income gains). The Bipartisan Millennial Housing Commission was established pursuant to federal legislation, passed December 2000, to analyze issues related to housing in the United States. Pub. L. No. 106-74, § 206(b), 113 Stat. 1070 (2000).

16. John W. Fountain, *In Trenches of a War on Unyielding Poverty*, N.Y. TIMES, Sept. 29, 2002, § 1 at 1 (reporting that the number of Americans in poverty has risen for the first time in eight years, according to U.S. Census figures reported in September). See also *STATE OF THE NATION'S HOUSING 2002*, *supra* note 14, at 22.

17. MILLENNIAL HOUS. COMM'N, *supra* note 15, at 15.

18. OFFICE OF MGMT. AND BUDGET, *BUDGET OF THE UNITED STATES GOV'T: FISCAL YEAR 2004*, at 165, available at <http://w3.access.gpo.gov/usbudget/fy2004/pdf/budget.pdf> (transmitted to Congress on

In spite of the increase in privatized social services, scholars have devoted little attention to the competition that privatization spawns between for-profit and nonprofit entities.¹⁹ This Article leaves open the question of whether the for-profit/nonprofit tension in the LIHTC is the same as one might observe in competition between for-profits and nonprofits for other limited governmental incentives to implement social policy. Private actors are assuming former governmental responsibilities through a variety of different mechanisms, including contracting, vouchers, subsidies, and tax credits.²⁰ Accordingly, my conclusions may not hold true in other privatized arenas. Nonetheless, this tension is not unique to the realm of low-income rental housing and should be evaluated in other areas.

Part I of this Article illustrates that the roots of nonprofit and for-profit competition are evident in the legislative history of the LIHTC. Significantly, profit-motivated real estate developers sought to restore tax advantages lost in the process of crafting the 1986 federal tax code revisions. Yet nonprofit organizations initially envisioned the LIHTC program as a tax credit for nonprofit developers to provide housing to poor families. Part I also includes an example of how the tax credit works to provide a context for the analysis presented in subsequent parts.

Parts II and III analyze the nature and effects of nonprofit/for-profit competition in the LIHTC process. Part II explores the power differentiation that stunts competition, suggesting that for-profit real estate developers wield more political power than do nonprofit tax credit developers. Profit-motivated developers are harnessing their political influence to eradicate legislative provisions related to nonprofit participation in tax credit housing.²¹

Part III analyzes the relative merits of for-profit and nonprofit tax credit housing in an effort to determine whether nonprofit contributions are worthy of protection to compensate for these power imbalances.

Feb. 3, 2003) (promoting the creation of a Single Family Homeownership Tax Credit to encourage the development of affordable single-family homes for low-income buyers).

19. Analysts have contemplated concerns related to the accountability of for-profit actors (*see, e.g.,* Freeman, *Extending Public Law Norms*, *supra* note 3; Gilman, *supra* note 2; Susan Vivian Mangold, *Protection, Privatization, and Profit in the Foster Care System*, 60 OHIO ST. L.J. 1295 (1999); Martha Minow, *Public and Private Partnerships: Accounting for the New Religion*, 116 HARV. L. REV. 1229 (2003)) and the rationale underlying welfare privatization (*see, e.g.,* Matthew Diller, *Form and Substance in the Privatization of Poverty Programs*, 49 UCLA L. REV. 1739 (2002)). More generally, scholars have explored the parameters of subcontracting government responsibilities to private parties. *See, e.g.,* Jody Freeman, *The Contracting State*, 28 FLA. ST. U. L. REV. 155 (2000); Ellen Danning, *To Market, To Market: Legislating on Privatization and Subcontracting*, 60 MD. L. REV. 249 (2001).

20. Gilman, *supra* note 2, at 594.

21. *See infra* notes 70–74 and accompanying text.

Nonprofit tax credit housing is different from profit-motivated tax credit housing in a way that tends to benefit poor renters. For example, empirical data indicate that nonprofit developers set lower rents than do for-profit developers, meaning that nonprofit LIHTC housing is more accessible to poor people.²² This section concludes that nonprofit participation in the LIHTC program should not be left to unregulated competition with politically influential for-profit developers. In an unregulated field, for-profit developers could shape the program to minimize nonprofits' participation in tax credit housing and the loss of nonprofits' contributions would adversely impact tax credit tenants. Instead, policy-makers would be wise to preserve, through statutory protections, the value that nonprofits lend to tax credit housing. This legislative response would also be consistent with social policy supportive of nonprofit charitable organizations.

I. CLASHES AT THE EARLY STAGES

The legislative history of the LIHTC reflects competition between for-profit real estate developers and nonprofit organizations even at the initial phases of crafting the program. This Part first illustrates, in simplistic terms, how the tax credit operates to give the reader a reference point for the subsequent discussion of the program's creation.²³ It then addresses salient features of the tax credit's legislative background that exemplify for-profit and nonprofit competition, followed by a brief review of how the LIHTC fits into the broader historical spectrum of federally subsidized housing.

A. HOW THE TAX CREDIT WORKS

A developer wishing to construct or rehabilitate low-income rental housing with tax credits—either a for-profit developer or a nonprofit one—first creates a proposal for the project and submits it as an applica-

22. See *infra* notes 101–04 and accompanying text.

23. Other authors have also detailed various nuts and bolts features of the LIHTC. See, e.g., Marc Jolin, *Good Cause Eviction and the Low Income Housing Tax Credit*, 67 U. CHI. L. REV. 521, 526–27 (2000); Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 VILL. L. REV. 871, 878–80 (1993); Malpezzi & Vandell, *supra* note 13, at 361 n.1; Dan Nnamdi Mbulu, *Affordable Housing: How Effective Are Existing Federal Laws in Addressing the Housing Needs of Lower Income Families?*, 8 AM. U. J. GENDER SOC. POL'Y & L. 387, 411–17 (2000); Charles J. Orlebeke, *The Evolution of Low-Income Housing Policy, 1949 to 1999*, 11 HOUSING POL'Y DEBATE 489, 511–12 (2000); Florence Wagman Roisman, *Mandates Unsatisfied: The Low Income Housing Tax Credit Program and the Civil Rights Laws*, 52 U. MIAMI L. REV. 1011, 1013–14 (1998); Allison D. Christians, *Breaking the Subsidy Cycle: A Proposal for Affordable Housing*, 32 COLUM. J.L. & SOC. PROBS. 131, 141–44 (1999).

tion for tax credits to the state agency administering the program.²⁴ Suppose that this developer proposed to build a fifty-unit apartment building. The developer estimates construction costs (not including the cost of the land) to be \$2 million. These construction costs include, for example, architects' fees, developers' fees, building materials, and engineering reports, as well as accountants' and lawyers' fees. The developer's proposal is judged within a competitive process according to criteria largely dictated by each state.²⁵ Federal law mandates that developers promise to dedicate a minimum of 20% of the building's units to low-income families for at least fifteen years.²⁶ For purposes of the LIHTC, a "low-income" tenant is one earning 60% or less of the area median gross income.²⁷

The amount of tax credits that a developer may request is related to the proportion of a building that she pledges to dedicate to low-income use. In this case, suppose that the developer proposes to dedicate 100% of the building's units to low-income tenants for the required fifteen years. If the developer wins the process and is allocated tax credits, she may receive up to \$1,800,000 worth of credits, spread out over ten years, so that each year she would receive \$180,000 of tax credits. This amount is a product of her allowable costs²⁸ (\$2 million) times the fractional por-

24. State housing agencies are responsible for evaluating applications for tax credits and awarding credits to successful applicants. 26 U.S.C. § 42(m)(1) (2000). Local housing agencies administer tax credits in Chicago, the District of Columbia, and New York City. JEAN L. CUMMINGS & DENISE DI-PASQUALE, *BUILDING AFFORDABLE RENTAL HOUSING: AN ANALYSIS OF THE LOW-INCOME HOUSING TAX CREDIT* 3 n.6 (1998), available at http://www.cityresearch.com/reports/cr_lihtc.pdf.

25. Section 42 directs state agencies to develop guidelines for allocating credits through qualified allocation plans. 26 U.S.C. § 42(m). Congress added this provision in 1989. *See infra* notes 70–71 and accompanying text (discussing relevant portions of the Omnibus Budget Reconciliation Act of 1989). The law currently requires states to give preference to "projects serving the lowest income tenants," those obligated to serve such low-income tenants for the longest periods of time, and projects that contribute to community revitalization plans in certain poverty-stricken areas. 26 U.S.C. § 42(m)(1)(B)(ii)(I)–(III). It also requires state agencies to evaluate eight aspects of every application, including the project location and characteristics, tenant populations with children and those with special housing needs, among other criteria. *Id.* § 42(m)(1)(C).

26. 26 U.S.C. § 42(g)(1)–(2). The period during which the IRS monitors compliance with rent restrictions is fifteen years. *Id.* § 42(i)(1). The statute, however, requires a tax credit developer to engage in an "extended low-income housing commitment" of an additional fifteen years. *Id.* § 42(h)(6)(A). This would lead one to believe that the tax credit property must be dedicated to low-income tenants for thirty years. However, § 42 also allows a developer to break the extended low-income housing commitment if it cannot find a buyer willing to maintain the project's low-income use, as long as existing tenants have three years' notice. *Id.* § 42(h)(6)(E). In other words, an owner of tax credit property may opt to turn tax credit units into luxury condominiums after fifteen years of compliance if it cannot find a buyer willing to uphold the low-income use commitment, but the owner cannot evict low-income tenants for an additional three years.

27. *See infra* notes 87–88 and accompanying text.

28. A successful developer receives tax credits based on the percentage of the developer's basis in the rental units that it promises to set aside for low-income tenants. 26 U.S.C. § 42(d). The eligible ba-

tion of the building to be occupied by low-income tenants (100%) multiplied by a statutorily determined 9% annual credit amount (2,000,000 x .09 = 180,000). A developer generally is eligible for the 9% annual credit, provided for by the LIHTC legislation, when she does not plan on receiving other federal grant monies for construction of the project.²⁹ Otherwise, if the project relies on additional federal assistance, a developer will be eligible for credits worth 4% of the developer's eligible costs.³⁰

Assume that our developer is successful, but is awarded less than the full amount of credits, as is often the case. She receives an award worth \$800,000 in credits, distributed as \$80,000 each year for ten years, assuming that the project is in compliance with certain requirements for the entire period. A tax credit is akin to a voucher, redeemable to offset federal income taxes owed. If the developer has a tax liability of \$80,000 each year, then she may use all of the credit herself, to erase, dollar for dollar, the taxes she owes.³¹ More likely, however, she will sell her credits to corporations, partnerships or individuals with large tax liabilities as soon as she is awarded the credits. These entities or individuals become investors in the project and use the tax credits to offset their taxes owed. If the developer is a nonprofit organization, the entity must sell its credits; credits are of no use to tax-exempt organizations. A developer can sell credits through an intermediary that brokers the exchange and takes a percentage of the proceeds for fees.³² Assuming that the developer sells her tax credits for \$.80 on the dollar, this leaves the developer with

sis for a new building generally is the cost of construction, excluding the cost of land. The eligible basis for a rehabilitated building includes substantial rehabilitation expenditures.

29. *Id.* § 42(b)(1)(A).

30. *Id.* § 42(b)(1)(B). See also discussion *infra* Part III. These credit percentages are approximations; the actual credit percentages are adjusted monthly.

31. A for-profit corporation may apply the tax credits to the corporation's income tax liability and partners of a for-profit partnership may apply the tax credits to offset individual income tax liability. HERBERT STEVENS & THOMAS TRACY, DEVELOPER'S GUIDE TO THE LOW INCOME HOUSING TAX CREDIT 18, 81 (2000).

32. Developers usually turn tax credits into development capital by selling them to investors at a discount of approximately \$.80 on the dollar. *Id.* at 18. Thus, the developer receives the equity to complete the development and the investor receives the tax benefits of the credit for ten years after the units become occupied. Local and national syndicates broker the exchange of tax credits for capital. Syndicators typically pool a number of projects into an equity fund, then market the credits to investors. CUMMINGS & DiPASQUALE, *supra* note 24, at 3.

The buyer of the developer's tax credits must be involved in the project in order to use the credit. The buyers then become part owners of the development, usually as partners in a partnership or limited liability company (LLC). Experts suggest that a project should be owned by either a partnership or LLC because of the flexibility they allow. STEVENS & TRACY, *supra* note 31, at 79. The investors themselves often form an investor partnership with the investors serving as limited partners and the syndicator as the general partner. This investor partnership is the limited partner in the partnership that owns the tax credit project, with the general partner being an affiliate of the developer corporation.

\$640,000. She will need to secure financing to cover the remaining \$1,360,000 in costs, plus the cost of the land. Typically, a developer will turn to one or more conventional mortgages, grants and/or equity provided by the developer or limited partners to fill this gap.

Once the project is completed, tax credits begin to flow to the investors who purchased them. Assuming that the project continues to operate in compliance with habitability standards, tenant income requirements, and rent caps, credits will flow for ten years. If the project falls out of compliance, credits are subject to the recapture provisions of the Internal Revenue Code.³³

B. COMPETING VISIONS OF THE PROGRAM

Congress adopted the tax credit as a by-product of the political jockeying that took place surrounding the creation of the 1986 Tax Reform Act ("TRA"). It is from within this political process that the competition between for-profit and nonprofit developers first emerged. Profit-motivated real estate developers wanted the LIHTC program, in part, to compensate developers for the loss of tax advantages eliminated by the TRA. Nonprofit organizations conceptualized the LIHTC program as one that would allow nonprofit developers to supply very low- and moderate-income rental housing.

Beginning in the 1970s, the federal government provided tax incentives to private real estate developers in part to encourage investment in low-income housing.³⁴ Despite these incentives, the supply of affordable rental housing was at an all-time low by the early 1980s.³⁵ Concurrently, Americans' confidence in the fairness of the tax system also hit rock bottom.

The administration of President Ronald Reagan attempted to address both concerns. The answer to the housing shortage, and to other social crises, was to extract government from social spheres by transferring governmental functions to the private sector.³⁶ The answer to the

33. The state agencies administering the LIHTC program have responsibility for monitoring annually a developer's compliance with restrictions on rent and tenants' income requirements. 26 U.S.C. § 42(m)(1)(B)(iii). State agencies report violations to the IRS and the IRS has the authority to withhold tax credits for periods of noncompliance and to "recapture" prior tax credits already claimed. *Id.* § 42(j)(1).

34. STEVENS & TRACY, *supra* note 31, at vii (discussing incentives, including the deduction of construction period interest and taxes, rapid depreciation and amortization of building costs, in addition to the standard tax incentives offered to real estate investors).

35. 132 CONG. REC. S8148 (daily ed. June 23, 1986) (statement of Sen. Mitchell).

36. As early as 1982, President Reagan's Commission on Housing proposed that governmental involvement in housing subsidies should be privatized. Janet Stearns, *The Low-Income Housing Tax Credit: A Poor Solution to the Housing Crisis*, 6 YALE L. & POL'Y REV. 203, 205-06 (1988) (citing 1982 REP. OF THE PRESIDENT'S COMM'N ON HOUSING xviii (1982)).

complicated tax scheme was to simplify and minimize taxation and hope that the "trickle down" would prompt broad economic development.³⁷ These were among the goals of the TRA.

One of the objectives of the TRA was to eliminate tax shelters and close loopholes perceived as advantageous to the very rich.³⁸ The Democrat-controlled House of Representatives drafted and approved a tax reform measure in 1985 that proposed to eliminate certain tax provisions favorable to commercial real estate developers, homebuilders, and others.³⁹ It did not include a tax credit for low-income housing. The bill did, however, recognize the importance of low-income housing, by providing greater depreciation deductions for low-income rental housing.⁴⁰

After the House adopted this tax reform measure, lawmakers in the Republican-controlled Senate grew concerned over the effect such sweeping changes would have on real estate developers. As one Senator lamented, some of the House proposals "may put developers out of business."⁴¹ Concern seemed to be two-fold. Real estate developers would suffer losses, to which they testified vehemently during the committee hearings on the original House tax reform bill.⁴² In addition, some commentators suggested that production of at least one type of real estate they developed, low-income housing, would consequently be adversely affected.

Senators crafted an alternative tax reform bill in order to address both concerns.⁴³ The Senate's version still included measures that tended

37. 132 CONG. REC. S8145-46 (daily ed. June 23, 1986) (statement of Sen. Cohen).

38. See, e.g., *id.*

39. Tax Reform Act of 1985, H.R. 3838, 99th Cong. (1985). The bill proposed to eliminate accelerated depreciation for most assets, because of concern "about the significant inequities that result from the amount and concentration of these tax benefits." H.R. REP. NO. 99-426, at 145 (1985) (referring to the investment tax credit and accelerated depreciation deductions).

40. H.R. REP. NO. 99-426, at 152 (1985) (proposing that "depreciation deductions for [low-income rental housing] should be approximately 25 percent greater in present value terms than depreciation deductions for rental housing that does not qualify as low-income housing").

41. 132 CONG. REC. S8153 (daily ed. June 23, 1986) (statement of Sen. Dole).

42. After the House passed H.R. 3838, the Senate Committee on Banking, Housing, and Urban Affairs held hearings on February 4, 5, and 6, 1986, to explore the ramifications of the bill. A former president of the National Association of Home Builders testified that, under H.R. 3838, "Rental housing would not be an attractive investment without tax incentives." He maintained that "rents for newly constructed apartments could be over 20 percent higher than what they would have been without H.R. 3838." *Implications of H.R. 3838, The Tax Reform Act: Hearings on H.R. 3838 Before the Comm. on Banking, Housing, and Urban Affairs*, 99th Cong. 99-260, at 16 (1986) (Report of Senator Garn presenting a summary of the testimony of John Koelemij, past president, National Association of Home Builders). These comments were directed at the effect of the House's proposed TRA on all rental housing, not just low-income rental housing, that would have benefited from the proposed favorable depreciation rules.

43. See S. REP. NO. 99-313 (1986).

to penalize real estate developers.⁴⁴ But it also created the LIHTC which attempted both to ameliorate the impact on real estate developers of revisions eliminating other favorable tax treatment, and to ensure that these developers retained an incentive to produce low-income housing. In short, the legislative history indicates that the tax credit was developed in part to ameliorate the impact of tax reform on profit-motivated real estate developers.

Ironically, while the LIHTC serves to soften the blow to profit-oriented real estate developers from the loss of favorable tax provisions, the initial idea for the tax credit emerged from nonprofit affordable housing advocates. The original concept was to create a tax credit that would assist *nonprofit* organizations in providing low-income housing. This idea cropped up during Congressional hearings on the House's 1985 tax reform proposal. Two nonprofit organizations active in promoting affordable housing testified at Committee hearings on the bill.⁴⁵ Both organizations had used preexisting tax benefits for housing rehabilitation by partnering with tax-paying entities that purchased the nonprofits' tax benefits. Should those provisions have been axed by the new tax reform legislation, nonprofit housing advocates suggested that they be "replaced by a new *investment tax credit* for qualified projects," so long as the projects be "sponsored and managed by nonprofit community development organizations" and "serve low- and moderate-income persons," among other criteria.⁴⁶

C. LIHTC IN CONTEXT

The Low-Income Housing Tax Credit program garnered political support for a variety of reasons, some of which are better understood by locating the tax credit within the historical spectrum of subsidized housing. Traditionally, both for-profit and nonprofit private actors have been

44. The TRA eliminated accelerated depreciation schedules, imposed "at-risk" provisions for depreciation, and implemented the "line of business" and "passive investor" restrictions on the use of business losses to offset other income." O'Regan & Quigley, *supra* note 6, at 302. The legislation eliminated the investment tax credit for the purchase of depreciable assets. It also limited the circumstances under which a taxpayer could apply a loss from activities in which the taxpayer did not materially participate, to offset income.

45. Both of these entities, the Local Initiatives Support Corporation (LISC) and The Enterprise Foundation, remain active in LIHTC work.

46. *Comprehensive Tax Reform: Hearings Before the Comm'n on Ways & Means House of Representatives*, 99th Cong. 99-45, pt. 5 of 9, 3769 (1986) (statement of Mitchell Sviridoff, President, Local Initiative Support Corp.) (emphasis added).

James Rouse, Chairman of The Enterprise Foundation, posited a similar proposal. Rouse suggested that "existing low-income housing incentives be preserved for non-profit sponsored, low-income tenancy rehabilitation or new construction projects where syndication proceeds are used either in the project itself, or for new low-income rehabilitation or new construction projects." *Id.* at 3761-62 (report of James Rouse).

involved in the production and management of low-income housing, along with governmental entities that have owned and operated housing affordable to low-income families.⁴⁷ Much for-profit activity in affordable housing consists of small apartment buildings or houses owned by individuals or couples.⁴⁸ This supply of low-income housing is not very responsive to increases in demand for low-cost shelter.

Nonprofits have been involved in the production and management of subsidized housing for low-income families since the 1960s.⁴⁹ Observers view nonprofits as playing a key role in the provision of this affordable housing because they are willing to “serve poorer tenants, who live in poorer neighborhoods and [engage] in projects with less financial security in economic returns.”⁵⁰ A variety of federal programs have supported the participation of nonprofit organizations in housing initiatives.⁵¹ Major federal housing programs relying on nonprofit participation, in addition to LIHTC, include the Community Development Block Grant (CDBG), instituted in 1974,⁵² and the HOME program, created in 1992.⁵³ During the 1980s, when federal support for housing

47. Housing is affordable when a family spends no more than 30% of household income on housing. See *infra* note 82 and accompanying text.

48. For-profit individuals and entities own and operate most of the low-income housing units in the United States. STATE OF THE NATION'S HOUSING 2002, *supra* note 14, at 22 (reporting approximately 34 million rental units in the United States, of which about 6.2 million are units subsidized by governmental benefits, the remainder are unsubsidized.). Over half of the unsubsidized rental units are owned either by an individual or a married couple—necessarily “for-profit” individuals. *Id.*

49. O'Regan & Quigley, *supra* note 6, at 297.

50. *Id.* at 300 (citing URBAN INST., IMPLEMENTING BLOCK GRANTS FOR HOUSING: AN EVALUATION OF THE FIRST YEAR OF HOME, HC-5898 (U.S. Dept of Hous. and Urban Dev.) (1995); AVIS VIDAL, REBUILDING COMMUNITIES: A NATIONAL STUDY OF URBAN COMMUNITY DEVELOPMENT CORPORATIONS (1992)). Similarly, the author of a recent empirical analysis of for-profit and nonprofit hospitals argues that “not-for-profit firms very likely provide public and private goods that are both in the public interest, which for-profit firms fail to provide.” Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. REV. 1345, 1347 (2003). This is not to say that nonprofit organizations are flawless. Some nonprofits seem to exist largely to compete for grants and derive benefit from the poverty of others, aptly dubbed “poverty pimps,” by Professor Briggs. BRIGGS, *supra* note 3, at 13.

51. Significant federal support of nonprofits in the housing sector began with the 1959 Section 202 Housing Program, a low-interest loan program providing housing for the elderly designed exclusively for nonprofits. O'Regan & Quigley, *supra* note 6, at 297 n.1. From 1960 to 1990 the percent of funding received by nonprofits to provide affordable housing remained fairly constant. *Id.* at 304.

52. See 42 U.S.C. §§ 5301–5321 (2000). Initiated in 1974, the CDBG program became a major source of funding for nonprofit housing providers. O'Regan & Quigley, *supra* note 6, at 301 (citing VIDAL, *supra* note 50, at 53). Both the CDBG program and HOME encompass a broad array of objectives and are not restricted to the provision of housing.

53. The HOME program provides grants to state and local governments that can be used for creating affordable housing. A minimum of 15% of funds in each jurisdiction must be set aside for community housing development organizations—nonprofits that are engaged in producing affordable housing and that operate with the participation of low-income residents. 42 U.S.C. §§ 12771(a), 12704(6). See also Simon, *supra* note 4, at 396.

waned, nonprofits continued to provide housing and services to low-income people through the support of state and local governments and private foundations.⁵⁴

The government also has directly provided low-income rental housing in the form of public housing units, funded by the U.S. Department of Housing and Urban Development (HUD) and owned and operated by local public housing authorities (PHAs). Critics have faulted traditional public housing since the 1960s for producing large high-rise buildings, isolated in poverty-stricken areas. In addition to such design and planning missteps, some commentators suggest that PHAs have suffered from being overly bureaucratic and inefficient.⁵⁵

The LIHTC seems to be crafted to strike a balance between these models by recognizing the advantages that both for-profit and nonprofit developers bring to low-income housing, while at the same time extracting government from the role of directly providing housing. The idea is that for-profit corporations or partnerships, if given an appropriate incentive, will produce more units than for-profit individuals or families or nonprofit developers. Because LIHTC developers are dependent on investors who purchase their tax credits, advocates suggest that the program is more responsive to market forces than programs resting on direct federal subsidies. Accordingly, larger, for-profit developers could impose more market efficiency in the process of boosting the supply of low-income housing, producing rental housing in a more cost-effective manner than units produced by small, for-profit groups or nonprofit organizations.

In addition, supporters of the LIHTC program maintain that it is a more politically palatable alternative to traditional subsidized housing because the tax credits result in federal revenues foregone rather than a direct expenditure of limited federal dollars. Furthermore, Congress crafted the program within a revised and simplified tax code and placed it under the auspices of the Internal Revenue Service (IRS). Prior to the creation of the LIHTC, HUD funded most other federal programs housing the nation's poor.⁵⁶ Locating the tax credit program within the IRS

54. O'Regan & Quigley, *supra* note 6, at 301.

55. See, e.g., Simon, *supra* note 4, at 392 (Criticism of PHA-owned housing stems from the perspective that PHAs were monopolies "largely immune from market pressures and highly vulnerable to political pressures that compromise efficiency. They have been organized in a centralized fashion that concentrates discretion at the top among administrators with limited knowledge of conditions in the projects they manage.")

56. See, e.g., U.S. DEP'T OF HOUS. AND URBAN DEV., A PICTURE OF SUBSIDIZED HOUSEHOLDS, (1998) available at <http://www.huduser.org:80/datasets/assthsq/statedatag8/descript.html>.

clearly differentiated it from the often ill-fated public housing run by HUD.

Yet lawmakers chose not to throw their lot entirely with for-profit developers; legislators recognized the value of nonprofits in developing low-income housing when they enacted the TRA.⁵⁷ The legislation requires state agencies allocating tax credits to set aside at least 10% of their credits for projects sponsored by nonprofit developers.⁵⁸ To be sponsored by a nonprofit developer means that a nonprofit organization owns an interest in the development and "materially participate[s]" in the development and operation of the tax credit units.⁵⁹ In addition, the program provides incentives to allow nonprofits to acquire ownership of a tax credit project after the expiration of the compliance period.⁶⁰ Policymakers likely recognized that nonprofit housing avoids some of the drawbacks of the earlier government PHA-sponsored "projects" inasmuch as nonprofits are often more closely integrated into the community they serve and they are subject to market pressures.

Congress is not alone in valuing nonprofit contributions to affordable housing. State allocating agencies have devoted a substantial number of their credits to nonprofit-sponsored projects, far more than the required 10%. From 1992 through 1998, over 24% of the LIHTC units created were sponsored by nonprofit developers.⁶¹ This fact, however,

57. See, for example, the comments of Senator Mitchell related to his amendment of the tax credit provision to assist nonprofit developers, 132 CONG. REC. 14919 (1986) (statement of Sen. Mitchell). In discussing his proposal to provide a narrow exemption to the at-risk rules governing real estate investment, he stated: "This exemption is absolutely essential if the [tax credit] is to provide the necessary tools with which national nonprofit organizations . . . can continue their important work." *Id.*

58. 26 U.S.C. § 42(h)(5).

59. *Id.* § 42(h)(5)(B). The data regarding nonprofit tax credit performance in this Article relates to nonprofit-sponsored projects eligible for the 10% set-aside.

60. The LIHTC law allows nonprofits to negotiate below-market purchase options during the development of a project, options that would facilitate nonprofit acquisition of the housing project at the end of the fifteen-year compliance period, but would not compel a for-profit owner to sell at that time. This type of a right of first refusal agreement does not disqualify for-profit investors from claiming the credit during their ownership of the property. *Id.* § 42(i)(7)(A). This provision was added to the law in 1990, to encourage low-income occupancy beyond the fifteen-year compliance period. Pub. L. No. 101-508 Sec. 11407(b)(1), 104 Stat. 1388-474 (codified as amended at 26 U.S.C. § 42(i)(7) (1990)). See also REPORT OF THE MITCHELL-DANFORTH TASK FORCE ON THE LOW-INCOME HOUSING TAX CREDIT 19 (Jan. 1989) (recommending that this amendment would promote longer-term low-income occupancy of tax credit units).

61. ABT ASSOCS. INC., DEVELOPMENT AND ANALYSIS OF THE NATIONAL LOW-INCOME HOUSING TAX CREDIT DATABASE, at 3-4 exhibit 3-2 (July 1996) (reporting that nonprofit-sponsored developers accounted for 20.3% of all LIHTC projects and 23.2% of all LIHTC units from 1992 through 1994); NOLDEN ET AL., *supra* note 11, at 13 exhibit 3-2 (reporting that nonprofit-sponsored developers accounted for 28% of all LIHTC projects and 25% of all LIHTC units from 1995 through 1998). The Nolden report indicates that nonprofit projects are more likely to be new construction (54%) versus

does not indicate that nonprofit developers would hold their own in unregulated competition with for-profit developers. During all of this period, § 42 required states to give priority to projects sponsored by nonprofit developers.⁶² As Part II explains, for-profit developers recently succeeded in amending the legislation to omit this preference.

II. STILTED COMPETITION

Competition implies a dynamic in which the power of the actors competing is relevant. For-profit actors may have an advantage in the competition for limited governmental privatization incentives because they wield more political power than do traditional nonprofit providers of social services.⁶³ This advantage could operate to slant an incentive program to favor for-profit actors both from within the program's design and in the allocation of incentives. Indeed, for-profit real estate developers appear to have influenced the initial design of the LIHTC program, as the legislative history suggests.⁶⁴

The for-profit housing industry, led primarily by the National Association of Home Builders (NAHB), is very influential in policy-making circles, particularly given the significance of housing to the nation's economy. "[H]ousing is an engine of the national economy and crucial to its strength."⁶⁵ The housing sector generates more than 20% of the nation's gross domestic product.⁶⁶

By contrast, nonprofit entities exert less political or economic power. They account for less than 7% of national income and more than half of this amount is attributed to tax-exempt hospitals and other health care

rehabilitation (42%). *Id.* at 16 exhibit 3-4. However, an earlier report suggested that nonprofit developers "tended somewhat more than their counterparts to use tax credits for rehabilitation." MARTIN D. ABRAVANEL & JENNIFER E.H. JOHNSON, *THE LOW-INCOME HOUSING TAX CREDIT PROGRAM: A NATIONAL SURVEY OF PROPERTY OWNERS 19 (1999)*, available at <http://www.huduser.org/publications/affhsg/lihtcsurv.html>.

62. See *infra* notes 69-72.

63. In an article addressing the role of for-profit entities in a newly reformed welfare system, one author states: "These for-profit entities have different incentives, and more political power, than the nonprofit entities typically engaged in social service delivery in the past." Gilman, *supra* note 2, at 572.

64. While nonprofits also influenced the program's design, see, e.g., *supra* notes 45-46 and accompanying text, much of the substance of their proposals was ignored in the final legislation. Rather than being a program that facilitated nonprofits in meeting the housing needs of the very and the moderately poor, as The Enterprise Foundation and Local Initiatives Support Corporation (LISC) advocated, the LIHTC program became a vehicle through which for-profit developers attempt to meet the housing needs only of the moderately poor. Nonetheless, both The Enterprise Foundation and LISC are prominent nonprofit players in developing tax credit housing.

65. MILLENNIAL HOUS. COMM'N, *supra* note 15, at 12.

66. The housing sector includes residential investment, housing consumption and related spending. *Id.*

providers.⁶⁷ Moreover, the Internal Revenue Code prohibits nonprofit organizations from devoting a “substantial part” of their efforts to political lobbying and it completely proscribes campaigning on behalf of a candidate for public office.⁶⁸

The for-profit housing industry has been battling to reduce the influence of nonprofits in LIHTC developments since the inception of the program.⁶⁹ The NAHB has, in fact, made headway towards its goal. Congress recently amended the tax credit legislation in a manner potentially detrimental to nonprofit developers.

An extensive amendment to § 42 added the requirement in 1989 that state allocating agencies adopt selection criteria for ranking tax credit applications.⁷⁰ That legislation required states to consider the “participation of local tax-exempt organizations” in evaluating applications for tax credits.⁷¹ Congress eliminated this requirement in a 2000 tax bill.⁷² The NAHB prompted the 2000 amendment because it perceived that for-profit enterprises were disadvantaged in competing with nonprofits for tax credits.⁷³ The NAHB touted the amendment as “a provision to help level the playing field between nonprofit and tax-paying developers”⁷⁴ In other words, this amendment leaving nonprofit developers more vulnerable to competition in securing tax credits was, itself, a direct result of nonprofit-for-profit competition and the political power that for-profit developers wield.

In the long run, the extent to which this amendment will affect tenants of tax credit housing is unclear. State agencies administering the program are still free to include a preference for nonprofits in their stan-

67. Evelyn Brody, *Charities in Tax Reform, Threats to Subsidies, Overt and Covert*, 66 TENN. L. REV. 687, 696–97 (1998) (citing C. Eugene Steuerle & Virginia Ann Hodgkinson, *Meeting Social Needs: Comparing the Resources of the Independent Sector and Government*, in NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT 71, 80 fig.2.3 (Elizabeth T. Boris & C. Eugene Steuerle eds., 1999)).

68. 26 U.S.C. § 501(c)(3) (2000).

69. Nonprofit and for-profit LIHTC developers do not always operate as adversaries. For example, both supported a proposal by the Bush administration to create a home ownership tax credit. See, e.g., HOUSING COALITION PROPOSALS, Feb. 10, 2003, *supra* note 65 (recommending a homeownership tax credit from a coalition including The Enterprise Foundation and the Local Initiatives Support Corporation).

70. H.R. REP. NO. 101-247, pt. 2, at 1188 (1989).

71. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, Sec. 7108, 103 Stat. 2306, 2319.

72. Consolidated Appropriations Act, Pub. L. No. 106-554, Sec. 131, 114 Stat. 2763 A-611 (2000).

73. Allocating Agencies Preserve Nonprofit Preferences in 2001 QAPs Despite Statutory Change, 28 No. CD-42 HDR Cur. Dev. 11, Feb. 19, 2001 [hereinafter *Allocating Agencies*].

74. Press Release, NAHB, *Home Builders Support Expanded Funding For Affordable Housing Tax Credits* (Aug. 25, 1999), at http://www.nahb.net/press_releases/1999/ns1999_075.htm (last visited Feb. 8, 2003).

dards that govern decisions on how to distribute tax credits. Not all states, however, have opted to preserve the nonprofit preference.⁷⁵

The NAHB is now attacking the provision in § 42 that requires states to set aside 10% of their credits each year for nonprofit developers and is lobbying against the leeway that states have to allocate more than 10% of their credits to nonprofits.⁷⁶ Such allocations to nonprofit developers, in the eyes of the industry association, equates with “penalizing for-profit developers . . . [and] results in the allocation of tax credits to fewer projects and a reduction in the production of affordable rental housing.”⁷⁷ Accordingly, the NAHB supports legislation “to establish a level playing field for allocations of LIHTC to tax-exempt and taxpaying sponsors.”⁷⁸

It is doubtful that the NAHB opposes the 10% nonprofit set-aside and additional allocations to nonprofit developers simply because these allocations supposedly result in less affordable housing. If that were the case, any for-profit developer could partner with a nonprofit sponsor to propose a project that would be eligible for the 10% nonprofit set-aside. As long as a nonprofit “materially participates” in the partnership that owns and manages the tax credit property, the partnership will be eligible for the nonprofit set-aside.⁷⁹ The NAHB’s opposition to the set-aside is a further manifestation of the competition waged over limited tax credits.

Nonprofits would likely defend the 10% set-aside based on similarly competitive motives. Yet, with less influence in policy-making circles than for-profit developers, nonprofit representatives’ voices may fall on deaf ears.

This discussion thus far has focused on Congress and the way in which politically astute and powerful for-profit developers can influence LIHTC legislation. Yet actual tax credit allocation decisions are made on the state level, by state housing finance agencies. This is the level at which for-profit and nonprofit developers submit competing applications for tax credits. Congress has given these agencies significant latitude in crafting qualified allocation plans (QAPs).⁸⁰ As long as allocating agencies adhere to the minimum statutory set-asides and preferences, they are

75. Allocating Agencies, *supra* note 73.

76. Since its inception, § 42 has required states to set aside 10% of their credits for projects in which a nonprofit organization “materially participates.” Tax Reform Act of 1986, Pub. L. No. 99-514, § 252, 100 Stat. 2189, 2198 (codified as amended at 26 U.S.C. § 42(h)(5)(B) (2000)).

77. NAHB, *Low-Income Housing Tax Credit*, at <http://www.nahb.org/generic.aspx?genericContentID=3552> (Dec. 16, 2002).

78. *Id.*

79. 26 U.S.C. § 42(h)(5)(B).

80. See, e.g., *supra* note 25.

at liberty to value any other project characteristic that would serve to meet the state's housing priorities. Allocating agencies generally can change the selection criteria in their QAPs, or can opt to weight various criteria differently. They are, however, subject to political pressure in the formulation of their QAPs because they function as an arm of state government.⁸¹ Nonetheless, given the lack of transparency in an agency's development of its QAP, the effect of political pressure at the state level, if any, is hard to identify.

III. THE IMPACT OF COMPETITION ON TENANTS AND POSSIBLE SOLUTIONS

The fact that for-profit developers are more politically powerful does not, by itself, support this Article's premise that tenants of LIHTC rental units can be adversely affected by unregulated competition between for-profit and nonprofit actors. Nor does it necessarily lead to the ultimate conclusion that competition for tax credits should continue to be regulated. It simply means that the playing field for competition over tax credits is lopsided. To understand how tax credit tenants can be harmed by unregulated competition requires the consideration of other factors. Specifically, do nonprofit developers produce housing that is different from units constructed by for-profit entities, and if so, would tax credit tenants be harmed in the absence of that difference such that it should be preserved? If the answer to these questions is yes, does the preservation of nonprofit participation depend on legislative action, or might state agencies' qualified allocation plans serve this purpose?

Evaluating whether nonprofits add value to tax credit housing that is worthy of protection from competition is not simply a matter of considering the cost effectiveness of for-profit versus nonprofit housing. While it is important to consider per unit costs in evaluating tax expenditures, how cheaply a unit can be built is not the only factor that matters to the tenants of tax credit housing, nor should it be the only consideration valued by society. Granted, low production costs could result in an increase in the number of units constructed or rehabilitated, which would ultimately benefit tax credit tenants. But other factors, such as the cost of the unit to the tenant, the size and location of tax credit projects, the size of tax credit units, and the social services offered by the owners and managers of tax credit projects are also worth consideration. Finally, the question of whether nonprofit participation merits protection from com-

81. See, e.g., Jeremy Gustafson & J. Christopher Walker, *The Urban Institute, Analysis of State Qualified Allocation Plans for the Low-Income Housing Tax Credit Program* 44 (May 2002), available at <http://www.huduser.org/Publications/pdf/AnalysisQAP.pdf> (discussing political pressure to alter geographical preferences in state QAPs).

petition also implicates broader policy considerations related to the role of nonprofit organizations in civil society.

This Part analyzes these factors, illustrating how nonprofit tax credit housing lends value to the LIHTC program. Significantly, nonprofit tax credit units are more affordable to very low-income families than are for-profit units. While nonprofits' construction costs might be higher than for-profits' costs, other attributes of nonprofit housing tend to mitigate this potential cost differential. Nonprofit housing is different in a way that benefits tax credit tenants, and, as such, should be afforded legislative protection in a competitive field in which for-profit actors wield more power.

A. NONPROFIT LIHTC UNITS ARE MORE AFFORDABLE

There is a critical shortage of "affordable" housing in the United States, a measure that compares income to housing costs. Most federal programs subsidizing housing consider housing minimally "affordable" when a household devotes no more than 30% of its income to housing costs.⁸²

Renting households devote much of their income to housing. Approximately 14.7 million renting households spend 35% or more of their income on housing costs (rent plus utilities).⁸³ Twenty-five percent of renting households are considered to be extremely low income; these households receive less than 30% of the area median income (AMI).⁸⁴ There is a "critical shortage of affordable apartments for these extremely low-income households."⁸⁵ Compounding this problem is the fact that home prices and rents are increasing, as income of the nation's lowest-earning households is decreasing.⁸⁶

The LIHTC legislation incorporates extraordinarily little incentive for developers to rent to very poor people. Developers applying for tax credits must agree to dedicate at least 20% of the rental units in their project to low-income tenants with incomes at or below 50% of the AMI.⁸⁷ (This is known as the 20-50 test.) Alternatively, a developer may pledge to dedicate a larger share of its units to tenants with more resources—40% of its units to persons with incomes at or below 60% of

82. MILLENNIAL HOUS. COMM'N, *supra* note 15, at 15. Indeed, LIHTC rents are capped at 30% of a tenant's income. See 26 U.S.C. § 42(g)(2) and *infra* text accompanying note 89.

83. MILLENNIAL HOUS. COMM'N, *supra* note 15, at 17.

84. *Id.* at 15, 17. Of these, most tend to have incomes well below 30% of AMI. *Id.* at 16. The U.S. Department of Housing and Urban Development publishes AMIs on an annual basis.

85. *Id.* at 17.

86. STATE OF THE NATION'S HOUSING 2002, *supra* note 14, at 3.

87. 26 U.S.C. § 42(g)(1).

the AMI.⁸⁸ (This latter option is the 40-60 test.) Rents in tax credit units are limited to 30% of the applicable AMI percentage.⁸⁹ In other words, rent is capped at 30% of either 50% or 60% of AMI, depending on which “test” a developer chooses. Eighty-eight percent of developers choose the 40-60 test, meaning that they opt to apportion a larger number of units for higher-earning tenants, rather than fewer units for lower-income tenants.⁹⁰

The only incentive incorporated into § 42 to rent to families with incomes lower than 50% of the AMI derives from the geographic location of certain LIHTC projects.⁹¹ A developer locating a project in a difficult development area (DDA) or a qualified census tract (QCT) can claim an increase in eligible basis, and thus, secure additional tax credits.⁹² DDAs are areas in which construction, land, and utility costs are high relative to incomes earned in the area. QCTs are tracts where at least half of the households receive incomes less than 60% of the AMI.⁹³ Because rents

88. *Id.*

89. 26 U.S.C. § 42(g)(2).

90. U.S. GEN. ACC. OFF., TAX CREDITS: OPPORTUNITIES TO IMPROVE OVERSIGHT OF THE LOW-INCOME HOUSING PROGRAM GAO/GGD/RCED-97-55, at 38 (1997) [hereinafter OPPORTUNITIES TO IMPROVE OVERSIGHT], available at <http://www.gao.gov/archive/1997/g597055.pdf> (referring to units placed in service between 1992 and 1994). For example, assume that the AMI for a particular location is \$37,000 annually for a family of four. If a developer chooses the 20-50 test, rent will be based on 50% of this AMI, or \$18,500. A developer can charge a family of four with an income of \$18,500 rent no higher than 30% of this income. Accordingly, monthly rent for this family could not exceed \$463. Under the 20-50 test, a developer must promise to cap rent on at least 20% of the units in the project using this calculation of 50% of AMI. Rent for the remainder of the units in the project would be unrestricted. However, opting for the 40-60 test would raise the monthly rent cap for this same family to \$555 because the developer could charge rent based on 60% of AMI. (Sixty percent of \$37,000 is \$22,200, and 30% of this income would result in a rent ceiling of \$555.) Using this test, rent for 40% of the project's units would be similarly capped and the remaining units could be leased at the prevailing market rental rate. These AMIs do not reflect the actual percentages that HUD uses because HUD adjusts a percentage of AMI to address problems in low-income counties. STEVENS & TRACY, *supra* note 31, at 34-35. Investors in tax credit projects often require developers to select the 40-60 test in order to ensure a broader market of prospective tenants. Telephone interview with Thomas A. Bishop, Executive Director, Homestead Affordable Housing, Inc. (a nonprofit tax credit developer) (Sept. 12, 2003).

91. See generally 26 U.S.C. § 42(d)(5)(C). Despite the dearth of incentives in § 42 to develop tax credit housing for very low-income renters, state allocating agencies may encourage such production through their criteria for evaluating tax credit applications, or Qualified Allocation Plans (QAPs). Indeed, a study of state QAPs indicated that many state allocating agencies provide preferences to tax credit applications that target “very low-income” renters or “lowest income households.” GUSTAFSON & WALKER, *supra* note 81, at 10-11. However, this same study revealed that the existence of a QAP preference did not always impact the type of tax credit units actually built. *Id.* at 21-34. This research did not draw any correlation between very low-income preferences and the rents charged for units actually constructed.

92. 26 U.S.C. § 42(d)(5)(C). The developer's basis for qualifying units in DDAs or QCTs is 130% of the standard basis.

93. A census tract is a geographic area defined by the Census Bureau in which approximately 4,000 people reside.

for tax credit units are capped at 30% of either 50 or 60% of the AMI, in areas where incomes are low, rent also must be low. Accordingly, LIHTC units located in many DDAs or QCTs do tend to serve lower-income renters. Not surprisingly, nonprofits are more likely to construct tax credit projects in these high-poverty areas.⁹⁴

To be sure, § 42 does require states to give preference to proposals for developments “serving the lowest income tenants.”⁹⁵ But this factor is only one of several that state allocating agencies must consider in determining how to award credits.⁹⁶ Additionally, there is evidence to suggest that state allocating agencies do not adequately operationalize this preference.⁹⁷

Outside of these incentives for projects located in high-cost areas (DDAs and QCTs), and any incentives built into a state’s selection criteria, there is no financial benefit to a developer with an otherwise strong tax credit proposal to serve tenants earning less than 50% AMI. A developer, for example, who sets aside 20% of the units in a development for tenants with incomes at 30% of AMI will receive just as much tax benefit as a developer who sets aside the same percentage of units for residents with higher incomes of 50% AMI. Because a developer can charge the higher earning tenant more rent, thus generating more income for the developer, there is no legal or business reason to rent units to people earning incomes less than 50% of AMI.

Indeed, LIHTC tenants who receive no other federal housing subsidies earn an average of 47% of their area’s median income.⁹⁸ Many poorer tenants can afford to live in LIHTC units only because they receive direct rental subsidies to pay their rent,⁹⁹ such as Section 8 vouchers or certificates.¹⁰⁰

94. NOLDEN ET AL., *supra* note 12, at 25–26.

95. 26 U.S.C. § 42(m)(1)(B)(ii)(I). A state allocating agency often operationalizes a preference by allotting the preferred characteristic extra points in the process of scoring applications.

96. See *supra* note 25 (discussing the considerations states must incorporate into their QAPs).

97. See, e.g., Roisman, *supra* note 23, at 1015–16 (stating that the statutory preference for developments “serving the lowest income tenants . . . or the longest periods of time” is not honored).

98. OPPORTUNITIES TO IMPROVE OVERSIGHT, *supra* note 90, at 146.

99. *Id.* at 41, 146. Nearly 40% of the renters living in LIHTC properties placed in service between 1992 and 1994 relied on direct rental subsidies. See also Mbulu, *supra* note 23, at 423 (concluding that the LIHTC fails to meet the needs of low-income families).

100. Section 8, added in 1974 to the Housing Act of 1937, authorizes “tenant-based” housing subsidies under the aegis of the Department of Housing and Urban Development (HUD). HUD provides local and state governments with funds to pay private landlords in order to supplement the rent that low-income households pay. Section 8 certificates have a maximum rent established by HUD, which the rental unit may not exceed. Section 8 vouchers have no set maximum, but the low-income holders of the vouchers must pay the difference in rent between the rent charged and the voucher value. U.S. DEP’T OF HOUS. & URBAN DEV., *supra* note 56, at 1–2. In determining the maximum allowable rent for

Despite the legislation's lack of incentives to make LIHTC housing more affordable, nonprofit developers set rents low enough so that their tax credit units are more affordable to poorer families.¹⁰¹ Nonprofit developers tend to serve families with lower incomes than do for-profit developers. While no broad-based studies compare the rents that nonprofit developers charge with the rents that for-profit developers charge, a HUD survey concluded that "[r]ents in the nonprofit properties are substantially lower than in the for-profit properties."¹⁰² In addition, nonprofit developers are the most likely to locate LIHTC projects in tracts with high rates of poverty: QCTs and DDAs.¹⁰³ Rents in these poverty-stricken areas are lower than in areas with higher incomes.¹⁰⁴

Rents in for-profit LIHTC units might be higher because these developers need to derive income in excess of costs.¹⁰⁵ For-profit developers of affordable housing grapple with a potential contradiction. On the one hand, a for-profit entity exists in order to create a profit. On the other hand, a for-profit developer of tax credit housing is charged with provid-

tax credit units (30% of the applicable area median income), a developer cannot count rental assistance payments, such as Section 8 certificates or vouchers. 26 U.S.C. § 42(g)(2)(B)(i). In other words, a developer can set rents higher than the § 42 ceiling, as long as the tenant pays no more than that ceiling, leaving rental assistance payments to make up the difference between a tenant's § 42 ceiling and the rent a developer demands. *See, e.g., STEVENS & TRACY, supra* note 31, at 41.

101. Benson F. Roberts & F. Barton Harvey III, *Comment on Jean L. Cummings and Denise DiPasquale's "The Low-Income Housing Tax Credit: An Analysis of the First Ten Years,"* 10 HOUSING POL'Y DEBATE 309, 313 (1999) (reporting that nonprofit sponsors often set rents lower than the LIHTC ceiling to maximize affordability). Nonprofit developers are able to charge lower rents, not because they frequently direct their developer fees to reduce the project's expenses, but because they frequently direct their developer fees to reduce the project's debt, which, in turn, permits lower rents. Interview with Thomas A. Bishop, *supra* note 90.

102. LARRY BURON ET AL., U.S. DEP'T OF HOUS. & URBAN DEV., ASSESSMENT OF THE ECONOMIC AND SOCIAL CHARACTERISTICS OF LIHTC RESIDENTS AND NEIGHBORHOODS vii, 3-5 (2000), available at <http://www.huduser.org/publications/PDF/lihtc.pdf> [hereinafter HUD, CHARACTERISTICS] (surveying a sample of thirty-nine LIHTC properties placed in service between 1992 and 1994 and finding that 79% of nonprofit tax credit units serve tenants at or below 50% of AMI, while 70% of for-profit tax credit units serve tenants in this same income category).

103. NOLDEN ET AL., *supra* note 12, at 33.

104. *See, e.g., HUD CHARACTERISTICS, supra* note 102, at 3-13 (reporting that "for-profit properties are much more likely than nonprofits to be located in low-poverty and suburban neighborhoods where rents tend to be higher"). Similarly, according to the LIHTC program coordinator for North Dakota, "Nonprofits tend to serve lower-income tenants or special needs populations that for-profit developers aren't willing to target." Allocating Agencies, *supra* note 73.

105. Although perhaps not representative, anecdotal evidence indicates as much. Cornerstone of Topeka, Inc., a nonprofit affordable housing organization in Topeka, Kansas, has purchased for-profit tax credit properties at the end of their fifteen-year compliance period. Given the same operating costs, Cornerstone was able to lower the rent on each unit from \$390 per month charged by the for-profit owner to \$351 per month. Interview with Barry McMurphy, Executive Director of Cornerstone of Topeka, Inc., May 15, 2003.

ing housing for poor people who likely cannot afford to help for-profit developers generate excess income.

This inherent tension is common to needs-based social service programs outsourced by the government to for-profit private actors and further fuels competition between for-profit and nonprofit entities implementing social policy. The need threshold cannot be so low that the users who pay for services leave no room for profit, nor the cost of providing services so high that preserving a profit for the provider becomes impossible.¹⁰⁶

This tension permeates the foundation of the LIHTC program. The program strives to house poor people, but not ones so poor that they cannot pay rents sufficient to preserve a profit for the developers. Unless for-profit developers become even more efficient, their low-cost rental units cannot be geared towards otherwise unsubsidized very poor families or else no profit can be generated.

Nonprofit organizations providing privatized social services typically are not plagued by this tension. The Internal Revenue Code prohibits the payment of profits from a tax-exempt charity to shareholders, members, or individuals.¹⁰⁷ Accordingly, tax credit housing created by nonprofit organizations need not demand rents and developer fees high enough to generate a profit. In theory, if building costs are roughly equal to those of for-profit entities, nonprofits could consistently charge lower rents. In reality, however, building costs may not be equal, as is discussed below.

The trade-off for creating a program that fails to address directly the needs of the very poor is that large-scale for-profit involvement in low-income housing could dramatically increase the supply of housing affordable to the moderately poor.¹⁰⁸ If so, then the housing market might see a “trickle up” response, whereby the moderately poor vacate housing affordable to the very poor once LIHTC units create more rental options affordable to tenants with moderate incomes. If the LIHTC program is, indeed, operating to increase the overall supply in a way that eventually provides housing opportunities to the very poor, then perhaps there is no cause for concern with a competitive field in which for-profits hold political sway over the LIHTC program. This, however, is not the case.

106. See, e.g., Ellen Dannin, *supra* note 19, at 261–62 (pointing out that a private for-profit subcontractor of government functions is hard pressed to deliver projects and services at a lower cost than the government because of its need to add profit and its higher cost of borrowing).

107. 26 U.S.C. § 501(c)(3) (2000).

108. Indeed, the LIHTC program appears to be premised on the potential that for-profit involvement in affordable housing could increase the supply of low-income rental housing. See *supra* Part I.C.

B. BROADENING FOR-PROFIT INVOLVEMENT IN SUBSIDIZED HOUSING HAS NOT SUFFICIENTLY INCREASED THE PRODUCTION OF LOW-INCOME RENTAL UNITS

Not only are for-profits constructing housing that is not as affordable as many nonprofit units, but the increase in supply expected by for-profit involvement in low-income housing remains illusory. The overall supply of rental units for low-income tenants is diminishing.¹⁰⁹ The Bipartisan Millennial Housing Commission reports “a critical shortage of affordable apartments for extremely low-income households,” those households earning less than 30% of AMI.¹¹⁰

It is unclear how many projects and units the tax credit has actually produced to date. Estimates range from about 69,000 units per year¹¹¹ to approximately 100,000 low-income housing units annually.¹¹² From 1987 through 2001, state agencies have approved approximately 1.2 million tax credit units,¹¹³ but the number of approved units is larger than the number of units actually constructed.¹¹⁴ Despite the number of units attributable to the tax credit, these units may not represent a net increase in the supply of affordable housing. Studies evaluating the effect of subsidized housing on the overall supply of affordable housing suggest a high rate of substitution.¹¹⁵ Supply-side subsidies may simply replace low-income housing that otherwise would have been provided absent subsidies.

Some observers might condemn the LIHTC program in its entirety based on this data. To do so, however, would perpetuate a myopic perspective of the program based exclusively on quantitative output. Such short-sightedness not only ignores key qualitative benefits of tax credit projects, but also fails to consider the political feasibility of alternative subsidies for affordable housing.¹¹⁶ For example, it is conceivable that tax

109. See, e.g., STATE OF THE NATION'S HOUSING 2002, *supra* note 14, at 19.

110. MILLENNIAL HOUS. COMM'N, *supra* note 15, at 17.

111. Abt Associates, Inc., estimates that the tax credits produced nearly 88,000 units per year between 1995 and 2000. NOLDEN ET AL., *supra* note 12, at ii. The GAO estimated that an average of less than 58,000 units were placed in service each year from 1992 through 1994. OPPORTUNITIES TO IMPROVE OVERSIGHT, *supra* note 90, at 32. Of the total number of projects produced between 1995 and 2000 with tax credits, about 64% were new construction and about 35% were rehabilitated properties. NOLDEN ET AL., *supra* note 12, at 14.

112. The Enterprise Foundation, *Partnerships That Perform: The Low-Income Housing Tax Credit 2* (1997), available at <http://www.enterprisefoundation.org/policy/monographs/pubpol1.asp>.

113. Malpezzi & Vandell, *supra* note 13, at 362.

114. EVALUATING TAX EXPENDITURES, *supra* note 10, at 46–47.

115. Malpezzi & Vandell, *supra* note 13, at 378 (concluding that, although their study cannot prove that LIHTC units substitute one-for-one unsubsidized units, their finding of a relatively high rate of substitution is consistent with prior evaluations).

116. For example, while tenant-based subsidies, such as Section 8, might be a more efficient way to operate an affordable housing program, the housing stock to which tenants apply their subsidies might

credit housing is more habitable and sturdy than the housing that tax credit units are replacing. Nonetheless, evidence that the LIHTC may not cause a net increase in the overall supply of affordable housing tends to dilute one argument in support of for-profit developers in the competition over tax credits.

Even units that are created by virtue of the LIHTC may represent only a temporary boost in the supply of low-income housing. Section 42 dictates a minimum term of years during which a tax credit developer must stick to its agreement to dedicate units for low-income tenants.¹¹⁷ In addition, § 42 requires states to give preference in allocating tax credits to projects promising to serve low-income tenants for the “longest periods.”¹¹⁸ However, a developer that cannot find a buyer willing to adhere to the low-income use restriction can convert tax credit units to higher-rent units after the expiration of fifteen years, as long as no low-income tenants are evicted for an additional three years.¹¹⁹

Loss of some low-income tax credit units after fifteen years is possible, given that there is not much chance for a long-term gain in the management of affordable rental housing. Less than half of the for-profit owners of LIHTC properties envision that the properties will continue to be used for low-income housing after the termination of the compliance period.¹²⁰

Nonprofit tax credit projects, however, are more likely to keep their units affordable beyond the life span of the tax credit restrictions. Over 70% of nonprofit owners reported that they plan to retain low-income use of the properties.¹²¹ In addition, nonprofits—even those not involved in the development of a LIHTC program—are well situated to purchase

be only barely habitable. In addition, direct subsidies to developers to build more affordable housing might be more efficient in as much as they would eliminate the transaction costs involved in turning tax credits to capital, but cash payments to for-profit developers would not be a politically viable or wise option. *See, e.g., EVALUATING TAX EXPENDITURES, supra* note 10.

117. *See supra* note 26 and accompanying text.

118. 26 U.S.C. § 42(m)(1)(B)(ii). *But see supra* note 97.

119. *See supra* note 26. State allocating agencies may choose to allocate tax credits to projects that propose longer low-income use.

120. *See ABRAVANEL & JOHNSON, supra* note 61, at 54. This information stems from a limited telephone survey of 314 owners of tax credit developments. Almost 40% of for-profit owners reported that they either had no post-compliance plans for the property or they didn't know whether they had post-compliance plans. *Id.*

121. *Id.* A Colorado tax credit manager confirmed this trend, suggesting that “nonprofits are more likely to keep projects affordable beyond the expiration of affordability restrictions.” Allocating Agencies, *supra* note 73.

tax credit properties at the end of the compliance period, given the provisions in § 42 facilitating such nonprofit acquisition.¹²²

C. COST OF CONSTRUCTION VARIES BETWEEN FOR-PROFIT AND NONPROFIT DEVELOPERS

Nonprofits may well expend more resources to produce housing than do for-profit developers. The General Accounting Office initially estimated that the average cost to a nonprofit developing a LIHTC unit is about \$18,000 higher than the average cost of a for-profit developer's unit.¹²³ The GAO later concluded, however, that nonprofits' costs were not necessarily higher when one considered differences in the characteristics of nonprofit units. Significantly, nonprofits tended to: (1) locate LIHTC projects in areas with high poverty and unemployment rates; (2) site projects in areas where the costs of development are high compared to the incomes in the area; (3) build larger units to serve larger families;¹²⁴ and (4) construct units in the Northeast or Pacific regions where construction costs are higher than in other areas.¹²⁵

At least one subsequent study contradicted the GAO's conclusion that there was no statistically significant cost difference between for-profit and nonprofit tax credit housing. Two economists studied data on over 2,500 LIHTC projects to describe the characteristics and performance of the program's rental units. They published their findings in two reports, both of which posit that nonprofit units cost more to develop. One report asserts that units developed by nonprofit sponsors cost about \$15,000 more than the average unit built by for-profit sponsors, even when controlling for project size, construction type, location, region of the country, and neighborhood poverty rates.¹²⁶ Claiming a lack of data, the authors do not take into account the cost of project amenities or of space for providing social services, such as community centers and play-

122. See *supra* note 60 (discussing provisions relating to below-market purchase options for nonprofits).

123. U.S. GEN. ACC. OFF., TAX CREDITS: REASONS FOR COST DIFFERENCES IN HOUSING BUILT BY FOR-PROFIT AND NONPROFIT DEVELOPERS I (1999) [hereinafter COST DIFFERENCES].

124. A HUD survey found that approximately 44% of the nonprofit-sponsored units housed families with two or more children, compared to only 23% of for-profit sponsored units. HUD, CHARACTERISTICS, *supra* note 102, at 3-10.

125. COST DIFFERENCES, *supra* note 123, at 2.

126. BUILDING AFFORDABLE RENTAL HOUSING *supra* note 32, at 18. In a related report, Cummings and DiPasquale suggest that the GAO report may not accurately reflect the cost of nonprofit-built tax credit housing because its research oversampled large projects. Jean L. Cummings & Denise DiPasquale, *The Low-Income Housing Tax Credit: An Analysis of the First Ten Years*, 10 HOUSING POL'Y DEBATE 251, 265-66 (1999) [hereinafter *The First Ten Years*] (reporting on the same study as does their prior report, BUILDING AFFORDABLE RENTAL HOUSING). The NAHB relies on this distinction in arguing for the abolition of the 10% nonprofit set-aside. See *infra* note 77.

grounds. Nonprofits provide such space more often than do profit-motivated developers, which, in turn, increases nonprofits' development costs.¹²⁷

The authors recognize that their lack of information regarding social services represents a "major weakness" in their data.¹²⁸ Yet they conclude that "it is unlikely that these services could account for all of this cost difference between non-profit and for-profit developers."¹²⁹ Even if amenities and services offered by nonprofit developers do not fully account for nonprofits' supposed increased costs, there are other possible explanations for such cost differences.

First, financing for nonprofit projects can be complicated and costly. Nonprofits generally secure mortgages that cover a smaller portion of development costs than their for-profit counterparts.¹³⁰ This smaller mortgage leaves a larger gap to fill between mortgage proceeds and the equity raised from the sale of tax credits. Nonprofits must rely on more funding sources than do for-profit developers to fill this gap. The higher the number of funding sources, the higher the development costs are for a given project because of multiple negotiation and closing costs.¹³¹ Second, nonprofits may maintain higher operating reserves to support sustained low-income use and the provision of tenant services.¹³² Finally, nonprofits rely on other federal resources to cover development costs more than for-profit developers do. Because of these resources, the

127. Roberts & Harvey, *supra* note 101, at 318 (concluding that "nonprofit sponsors more often build space for social service provision into their properties"). *But see* HUD CHARACTERISTICS, *supra* note 102, at 5-7 (finding, based on a limited survey, that nonprofit and for-profit developers tend to offer community rooms at about the same rate, while nonprofits' developments more frequently include playgrounds). One nonprofit tax credit developer reported designing low-income family housing with communal spaces for use as computer rooms or meeting areas for after school tutoring or credit counseling and suggested that nonprofits more frequently provide such space in their developments. *See* interview with Thomas A. Bishop, *supra* note 90. Not only do nonprofits more often provide space for social services, they also provide services that do not rely on space. *See, e.g.*, Allocating Agencies, *supra* note 73 (citing a state housing authority official who communicated that "nonprofits are more attentive to tenant needs than for-profit developers"). Space allocated for social services is more relevant to this discussion because such an area increases construction costs which, in turn, affects the amount of tax credits a project might usurp. The provision of social services that are not related to a building's space might well increase operational costs, a factor state allocating agencies consider in evaluating whether to award a project tax credits, but not related to the amount of tax credits eventually awarded.

128. *The First Ten Years*, *supra* note 126, at 260.

129. BUILDING AFFORDABLE RENTAL HOUSING, *supra* note 32, at 18.

130. *Id.* (reporting that "[t]he first mortgage covers just over half of total per-unit costs in for-profit units, compared to 38% for non-profits."). Nonprofit projects are smaller in size, making lending a mortgage not as profitable because lenders' fees are based on the amount of the mortgage.

131. EVALUATING TAX EXPENDITURES, *supra* note 10, at 53.

132. Roberts & Harvey, *supra* note 101, at 318.

Davis-Bacon Act may require some nonprofits to pay higher wages to construction workers.¹³³

Standing alone, this supposed cost difference could hurt nonprofits competing for tax credits. Several state QAPs restrict total development costs, particularly by limiting the amount of credits that a project is entitled to receive.¹³⁴

In addition to this potential cost difference, nonprofit LIHTC housing tends to usurp more governmental resources in meeting construction costs. Nonprofits essentially use federal dollars by virtue of their tax-exempt status; by operating with no tax liability, they deprive federal coffers of revenue. Nonprofits also rely more on federal subsidies to finance construction costs than do for-profit developers. Early data suggest that nonprofits use public sources to secure gap financing, depending more than profit-oriented developers do on HOME funds and CDBGs to meet their development costs.¹³⁵

Section 42 penalizes developers who rely on certain federal subsidies for construction or rehabilitation of LIHTC projects. The program generally awards a 9% annual credit for the cost of a new building or substantial rehabilitation of an existing building when the developer does not rely on a federal subsidy.¹³⁶ If a federal subsidy is involved in the construction or rehabilitation of a project, the developer may apply only for a 4% annual credit.¹³⁷

The rules to determine whether a developer is eligible to apply for 9% or 4% credits are complex and riddled with exceptions. For example, projects financed with loans from the CDBG program, the HOME Investment Partnership Act, or the Federal Home Loan Bank are not treated as being "federally subsidized," and are thus eligible for the higher credit amount.¹³⁸ Likewise, a tax credit project is still eligible for the 9% credit even if it rents units to tenants with federal Section 8 rental certificates or vouchers.

While nonprofits' reliance on federal subsidies for construction and permanent financing may seem to be a strike against the efficiency of nonprofit developers in their competition with for-profit developers, for-

133. *Id.*

134. GUSTAFSON & WALKER, *supra* note 81, at 17.

135. *See supra* note 61, at 39.

136. 26 U.S.C. § 42(b)(1)(A) (2000). In other words, a developer eligible for the 9% credit can receive credits totaling 9% of the developer's eligible basis. *See, e.g., supra* note 29 and accompanying text.

137. These percentages are "annual" because a developer receives the credit for ten years; approximately 4 or 9% of the developer's costs (excluding land) for each of the ten years following the year in which the project becomes occupied.

138. For an explanation of CDBG and HOME, *see supra* notes 52-53.

profits also rely on federal subsidies, but more so during the operation of a tax credit project. As established earlier, many tax credit tenants can meet rent requirements only by relying on Section 8 vouchers or certificates.¹³⁹ At least one study suggests that a higher percentage of for-profit LIHTC units rely on Section 8 subsidies than units in nonprofit developments.¹⁴⁰ Without further empirical data, it is difficult to know whether nonprofits' reliance on subsidies during development outweighs for-profit reliance on subsidies during operation.¹⁴¹

Research on tax credit properties indicates that nonprofits add significantly to the LIHTC program in ways that benefit tax credit tenants. While one study suggests that housing constructed by nonprofits may cost more to develop than housing by for-profits, the value added to the LIHTC by nonprofit housing may well offset any additional costs.¹⁴² The most severe need for affordable housing stems from very low-income households; nonprofit tax credit housing is more affordable to these families than housing constructed by profit-oriented entities.¹⁴³ Nonprofit developers offer more services to tenants, provide smaller, community-oriented housing,¹⁴⁴ and tend to meet the needs of larger families better.

139. See *supra* note 100 and accompanying text.

140. HUD CHARACTERISTICS, *supra* note 102, at 2-3, 2-5 (reporting that 55% of for-profit units included in the survey relied on either Section 8 project- or tenant-based subsidies, while only 33% of nonprofit units relied on those subsidies). These data alone does not conclusively establish that for-profit developments usurp more Section 8 funds, but if per unit Section 8 expenditures are roughly equal for nonprofit and for-profit units, for-profit developments would, indeed, be relying more heavily on Section 8 subsidies.

141. To determine the relative reliance on public resources, the nature of the resources must be considered. For example, low-interest loans would impose less on federal coffers than would outright grants. In addition, evidence suggests that for-profit developers have relied significantly on the Section 515 Rural Rental Housing program, originally under the auspices of the Farmers Home Administration (FmHA) and now administered by the Rural Housing Service (RHS). BUILDING AFFORDABLE RENTAL HOUSING, *supra* note 32, at 18. Congress, however, has significantly cut back on Section 515 funding so it is no longer a significant source of tax credit housing funds.

142. This Article highlights some of the most salient differences between for-profit and nonprofit tax credit housing. Additional differences not explored here likely exist.

143. For-profit developers might dispute the conclusion that the lower rents in nonprofits' units represent an advantage in the tax credit program. The argument would be that Congress did not create § 42 to serve very poor families, so the fact that nonprofit developers tend to provide housing to these families is beyond the scope of the program. Nonetheless, while the LIHTC program may not target the very poor as its central beneficiaries, § 42 does require states to give preference to proposed developments that would house the "lowest income tenants." 26 U.S.C. § 42(m)(1)(B)(ii)(I) (2000). In addition, there are no other federal subsidies that specifically aim to provide rental assistance to the very poor. While a program geared towards the housing needs of very poor families would be advantageous, the fact that nonprofit developers help meet this need through the LIHTC program is, indeed, a benefit to the tax credit program and to poor families.

144. Most nonprofit tax credit developments comprise thirty-six or fewer units, whereas most for-profit developments include 100 or more units. BUILDING AFFORDABLE RENTAL HOUSING, *supra* note 32, at 18 ("[F]or-profits comprise over 80% of the units in projects of 100 or more units. Non-

Nonprofit developers will likely dedicate tax credit housing to low-income use for longer periods of time than will for-profits developers.¹⁴⁵ In addition, for-profit involvement in low-income housing has not increased the overall supply of affordable housing as much as some founders of the tax credit program had envisioned.¹⁴⁶ If for-profit developers use their power to narrow the space in which nonprofits can compete for tax credits, then the tenants who benefit from nonprofits' contributions would suffer the loss.

Congress should legislatively protect the participation of nonprofit developers in the LIHTC program. The 10% set-aside is a reasonable protection and should be preserved. The set-aside ensures that at least some tax credit projects will continue to embody the favorable features of nonprofit housing. In addition, the set-aside ensures that some nonprofits are involved in the inception of tax credit properties and are thus in a better position to maintain operations of these and other low-income rental units beyond their tax credit life expectancy.

In addition to maintaining the 10% set-aside, policymakers must be vigilant in evaluating the impact that any proposed § 42 amendments might have on nonprofit developers. Other provisions in the LIHTC somewhat favorable to nonprofits might come under attack from for-profit lobbyists. For example, recall the general rule that a developer garners more credits if her project does not rely on a federal subsidy for meeting construction costs.¹⁴⁷ Nonprofit developers benefit from exceptions allowing the higher rate of credits for projects built with support from federal HOME funds and CDBGs. Nonprofits rely on these sources of funding to a greater extent than do profit-oriented developers. Should there not be an exception for HOME and CDBG funds, developers utilizing these programs would be eligible only for the lower 4% credit. Likewise, § 42 gives nonprofits an advantage in acquiring for-profit-produced LIHTC properties at the end of the compliance period. Finally, for-profit developers could attempt to make inroads in the DDA and QCT niche currently occupied largely by nonprofits. Developers building in these poverty-stricken areas can garner more credits, often in exchange for accepting lower rents. For-profits may attempt to increase the rent ceiling in these areas so that they can also take advantage of in-

profits . . . are responsible for 70% of the units in projects with 36 or fewer units.") While increasing the number of units of a project takes advantage of economies of scale, the trade off results in enormous developments that hark back to the discredited "project" housing built by public housing authorities.

145. See *supra* note 121 and accompanying text.

146. See *supra* note 115 and accompanying text.

147. See *supra* notes 136-37 and accompanying text.

creased credits, while securing more rent at the same time. Should Congress contemplate amendments to these provisions, lawmakers would be wise to consider the competitive dynamic between for-profit and non-profit participants in the LIHTC program and the adverse effects on tax credit tenants that could result from eliminating protections for nonprofit developers.

For-profit developers would maintain that the value nonprofits bring to tax credit housing can be preserved within the competitive process absent statutory protection. If nonprofits bring an important difference to tax credit housing, state allocating agencies will recognize those contributions and award credits to their projects or attempt to protect nonprofit participation with preferences.¹⁴⁸ In other words, unfettered competition at the state level would appropriately protect nonprofit participation to the extent that nonprofits' tax credit applications propose projects that fit with local housing needs in light of project costs.

But state allocating agencies may not adequately protect the involvement of nonprofit participants in an unregulated competitive field dominated by politically powerful for-profit developers. State allocating agencies, particularly in a time of depleted state budgets, may have an incentive to value an efficiency approach to housing that discounts qualitative features offered by nonprofits. States make hard choices when faced with revenue shortfalls, and it is reasonable to expect a narrower focus on efficiency. Despite apparent fiscal sense, it would be short-sighted for states to discount nonprofit participation, should statutory protections be eliminated. Extra costs, if any, that may result from allocating even a small amount of credits to nonprofits could easily preserve resources that would otherwise be spent if families that cannot afford the higher rents in for-profit tax credit units fall into homelessness. Housing gives low-income families a chance to maintain jobs, educational opportunities, health care, community ties, and more. When families lose housing, public expenditures increase in the short term for emergency support services, and likely in the long term as the collateral effects of homelessness mount.

More importantly, allocating agencies are not immune to the political pressures exerted by for-profit developers. Just as for-profit developers have been successful in attempts to eradicate legislative provisions favorable to nonprofits, they may also succeed in altering state-imposed

148. Many states do, in fact, include in their qualified allocation plans preferences for 'specialized' nonprofit developers, those that are community based, for example, or that focus their projects on a particular activity. Ironically, states that included this preference between 1987 to 1993 developed fewer nonprofit units than did states that had no such preference. GUSTAFSON & WALKER, *supra* note 81, at 27.

preferences or set-asides in QAPs that appear to favor nonprofits.¹⁴⁹ Even if state agencies continue to include provisions in their QAPs that seem to favor nonprofit developers, such nominal protection does not necessarily translate into increased awards of tax credits to nonprofits. A preference for a particular characteristic expressed in a state's QAP does not always impact the actual LIHTC units developed.¹⁵⁰

The fact that states have allocated credits sufficient for nonprofits to have constructed over 24% of all tax credit units from 1992 through 1998 does not indicate that QAPs alone can preserve nonprofit LIHTC participation. Section 42 still required states to give preference to nonprofit projects during this period.¹⁵¹ Furthermore, respondents to the survey that generated this percentage omitted information on nonprofit versus for-profit sponsorship at a fairly high rate.¹⁵²

In addition, state QAPs cannot adequately or uniformly reflect the importance of nonprofit organizations to civil society. Income generated from nonprofit tax credit developments reinforces the charitable work of nonprofit agencies. For example, income from a tax credit project may allow an agency to maintain a non-tax credit homeless shelter or operate a credit counseling program, or other community service consistent with the nonprofit's charitable status. If for-profits succeed in pushing nonprofits out of most tax credit development, some nonprofits may lose a source of revenue supporting other community work.

149. An example of conspiracy and fraud, rather than political pressure, is found in the 2000 conviction of two real estate developers and a member of the Texas Department of Housing and Community Affairs Board, the body that allocates tax credits in that state. The board member was given an interest in a contracting company owned by the developers in exchange for the board member's influence in securing an award of \$10 million in tax credits to a project sponsored by the developers' corporation. See, e.g., U.S. Attorney's Office, Southern District of Texas, *News Release: Business Associate of Former Texas Department of Housing and Community Affairs Board Member Sentenced* (Apr. 12, 2001), available at <http://www.usdoj.gov/usao/txs/releases/april2001/010412-walker.htm>.

150. GUSTAFSON & WALKER, *supra* note 81, at 27-28 (finding "no relationship between non-profit set-asides and the percentages of non-profit units developed" and "no apparent correlation between the weight of non-profit preferences and the share of units developed by non-profits," but discovering a correlation between set-asides for specialized non-profits and the share of LIHTC units developed by those entities).

151. See *supra* note 81.

152. From data collected on units placed in service between 1992 and 1994, whether a nonprofit was involved is missing from 23.7% of the units responding. NOLDEN ET AL., *supra* note 12, at 9 exhibit 2-2. From data collected on units placed in service between 1995 and 2000, whether a nonprofit developed a unit is missing from 12.2% of the units responding. *Id.* Data collected after 1998 indicate that nonprofit LIHTC participation is declining. *Id.* at 12 exhibit 3-2. A recent report (December 2002) presents figures on the percentage of LIHTC projects sponsored by nonprofits, rather than the percentage of units. *Id.* In 1998, 35.1% of LIHTC projects were sponsored by a nonprofit developer and in 2000, that figure decreased to 31.7%. *Id.*

Congress provides tax benefits for nonprofit organizations because they contribute to the welfare of society by performing services that the government would otherwise provide.¹⁵³ The fact that nonprofits, standing alone, function largely as a surrogate for government in the provision of social services is sufficient rationale for protecting a certain degree of nonprofit involvement in the LIHTC program through statutory measures. Statutory protection for nonprofit participation becomes an even more logical and advisable solution when this rationale is coupled with the premise that for-profit–nonprofit competition, if played out on an unregulated field slanted by for-profit political power, could result in the loss of nonprofit participation and the benefit that nonprofits bring to tax credit tenants.

CONCLUSION

When government retreats from its traditional role as a provider of social services and relies on the private sector to fill the gap, nonprofit organizations will compete with for-profit actors for the benefits associated with implementing social programs. In crafting programs to outsource social services, policy makers must recognize the potential for this competitive dynamic and keep in mind the users of social services, whose needs stand to be impaired by unregulated competition.

Tax credits for low-income rental housing represent significant benefits over which powerful for-profit developers vie with less powerful nonprofit developers. Nonprofits lend value to tax credit housing that benefits low-income tenants. Although there are other factors one could consider in comparing the relative contributions to the program of different types of developers, nonprofit units tend to be cheaper for tenants (albeit possibly more expensive to build) and may better meet the needs of tenants by being more closely tied to communities, built for larger families, and constructed in smaller projects. In addition, participation in LIHTC programs may help keep tax credit properties dedicated to low-income use longer and may help advance broader charitable goals of nonprofit developers. These advantages that nonprofit developers bring to LIHTC housing and its tenants justify statutory protection, given a field of competition for tax credits otherwise lopsided with for-profit political power.

153. H.R. REP. No. 99-841, at 687 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4775 (discussing the tax exemption of private activity bonds for 501(c)(3) organizations). Scholars frequently debate the theories underlying tax exemptions for nonprofit corporations. See, e.g., Horwitz, *supra* note 50, at 1382; Barbara K. Bucholtz, *Reflections on the Role of Nonprofit Associations in a Representative Democracy*, 7 CORNELL J.L. & PUB. POL'Y 555, 564 (1998).

During economic downturns, lawmakers will likely be more supportive of for-profit housing developers because of the importance of housing to national economic health. At the same time, however, low-income families harmed by an anemic economy are all the more in need of the affordable housing that nonprofits develop. Ironically, a deteriorating economy is one of the reasons why an enhanced role for nonprofits is crucial, yet it is also a primary factor threatening to undermine the political feasibility of protecting nonprofit participation.