

**OUR HOUSE: CROWDFUNDING AFFORDABLE HOMES
WITH TAX CREDIT INVESTMENT PARTNERSHIPS**

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Abstract

The Low-Income Housing Tax Credit (“LIHTC”) creates a channel for private investment in affordable housing. Investors partner with developers to build low-income housing projects: they provide the up-front capital needed for construction and receive a ten-year stream of tax credits generated by the property. Today, banks are the largest investors in LIHTCs, motivated primarily by the Community Reinvestment Act (“CRA”). The homogeneity of the investor pool renders the affordable housing market susceptible to shifts in investor demand. The financial crisis slashed revenues across the country, reducing demand for the tax credits. While the market has begun to recover, communities outside of CRA assessment areas still receive less LIHTC financing.

This article proposes that individual investment in LIHTCs could diversify the market and funnel funds into areas that struggle to finance affordable housing projects. Mirroring the role of statutorily-motivated banks, socially-motivated investors may increase stability in these markets. An online crowdfunding platform could aggregate individual contributions in order to raise sufficient equity financing. While there are certain legal and administrative obstacles to this method, individuals may provide an exciting new foundation for low-income housing investment.

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Introduction

The Low-Income Housing Tax Credit (“LIHTC”) is the primary mechanism by which the United States government finances affordable housing.¹ The LIHTC creates a financial incentive to develop low-cost rental housing by providing a tax credit to developers of affordable housing projects.² While developers are the initial recipients of the credit, they ultimately transfer these credits to investors in exchange for the capital needed to complete the housing projects.³ Since 1987, the LIHTC program has helped place over 2.3 million housing units in service.⁴

Large banks and government-sponsored enterprises (“GSEs”) have traditionally filled the role of the investor, motivated by the tax benefits as well as the opportunity to satisfy the Community Reinvestment Act (“CRA”) and their charter purposes, respectively.⁵ According to a paper by the Joint Center for Housing Studies of Harvard University, the LIHTC market changed dramatically in 2008.⁶ The financial crisis reduced the income tax liabilities of banks, lowering demand for the tax credit.⁷ Consequently, developers were not able to sell their tax credits, or

¹ *The LIHTC Database*, U.S. DEP’T OF HOUS. & URBAN DEV., <http://www.huduser.org/portal/datasets/lihtc.html> (last updated Sept. 5, 2013).

² See 26 U.S.C. § 42(a)–(b) (2012) (providing rules to attain the low-income housing credit).

³ *How Do Housing Tax Credits Work?*, U.S. DEP’T OF HOUS. & URBAN DEV., http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/affordablehousing/training/web/lihtc/basics/work (last visited Apr. 16, 2014) [hereinafter *How Do Housing Tax Credits Work?*].

⁴ U.S. DEP’T OF HOUS. & URBAN DEV., *supra* note 1 (“The LIHTC database, created by HUD and available to the public since 1997, contains information on 37,506 projects and almost 2,318,000 housing units placed in service between 1987 and 2011.”).

⁵ Denise DiPasquale, *Rental Housing: Current Market Conditions and the Role of Federal Policy*, 13 CITYSCAPE: J. POL’Y DEV. & RES. 57, 62 (2011).

⁶ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM: CAUSES, CONSEQUENCES, RESPONSES, AND PROPOSED CORRECTIVES* 15–16 (2009), <http://www.urban.org/uploadedpdf/1001383-disruption-of-the-low-income.pdf> [hereinafter *THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM*].

⁷ *Id.*; Buzz Roberts, *Modifying CRA to Attract LIHTC Investments*, in *INNOVATING IDEAS FOR REVITALIZING THE LIHTC MARKET* 13, 13 (2009), <http://federalreserve.gov/newsevents/press/other/other20091110a1.pdf>.

had to do so at significant mark-downs, creating “financing gaps” that suspended thousands of affordable housing projects.⁸ The market has started to recover, but the LIHTC program only recently achieved the levels of success it had prior to the financial crisis,⁹ and these levels may not be permanent.¹⁰ A follow-up paper by the Joint Center for Housing Studies suggests that the market’s narrow investor pool continues to render it vulnerable to financially-driven decreases in demand.¹¹

Individual participation in the LIHTC market would broaden and diversify the investor base and stabilize the affordable housing program in periods of decreased demand.¹² Individual investors have not represented a large portion of the LIHTC market thus far, dissuaded by the risk and expense of the investment, the credit’s complexity and illiquidity, and unfavorable tax treatment as compared to corporations.¹³ In the past decade, however, the growing popularity and success of crowdfunding and socially-responsible

⁸ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 16.

⁹ Compare U.S. DEPT. OF HOUS. AND URBAN DEV., CHARACTERISTICS OF LIHTC PROJECTS, 1995–2011 (2013), <http://www.huduser.org/portal/Datasets/lihtc/tables9511.pdf> (showing an average of 982.5 projects and 73,608 units per year for years 2008–2011, as compared to an average of 1,555.5 projects and 123,990 units per year for years 2000–2007), with Bendix Anderson, *Credit Cloudy*, APARTMENT FIN. TODAY (Mar. 1, 2012), <http://www.housingfinance.com/economic-development/credit-cloudy.aspx> (observing that “pricing is similar to [what it was] before the downturn”) (alteration in original) (internal quotations omitted).

¹⁰ Anderson, *supra* note 9 (“Pressure from such [economic] investors may drive LIHTC prices down by 2 cents to 5 cents over the next year, experts predict.”).

¹¹ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS 17 (2010), <http://www.urban.org/uploadedpdf/1001483-Housing-Tax-Credit.pdf> [hereinafter LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS] (“[A] narrow, specialized investor pool limited to a small number of firms in a single sector is too fragile and too subject to market volatility.”).

¹² Ian Galloway, *Create a More Robust LIHTC Market by Attracting Individual Investors*, in INNOVATING IDEAS FOR REVITALIZING THE LIHTC MARKET 25, 25 (2009), <http://federalreserve.gov/newsevents/press/other/other20091110a1.pdf>.

¹³ *Id.*

forms of investing¹⁴ suggests that individual investors could be an important untapped resource for affordable housing.¹⁵ This article explores how individual investors can play a role in the future of the LIHTC program. Part I reviews the history of the LIHTC and how the tax credit is used to finance affordable housing. Part II discusses the relationship between the LIHTC and affordable housing in the United States today, and points out certain weaknesses in the current system. Part III examines the feasibility of attracting individual investors to the LIHTC market through an online financing platform. Finally, Part IV identifies and discusses potential legal and tax hurdles facing this innovative fund raising approach.

I. Background

A. Tax Reform Act of 1986

The LIHTC program's reliance on private sector developers and investors is integral to its history¹⁶ and to how the program continues to keep rental costs low.¹⁷ The LIHTC is described in section 42 of the Internal Revenue Code ("Code").¹⁸ Its enactment as part of the Tax Reform Act of 1986¹⁹ was part of a governmental

¹⁴ See Anita Hamilton, *Crowdfunding Soared to \$2.7 Billion in 2012, But Equity Funding Is Still On Ice*, TIME (Apr. 8, 2013), <http://business.time.com/2013/04/08/crowdfunding-soared-to-2-7-billion-in-2012-but-equity-funding-is-still-on-ice> ("[I]ndividual donors pledged \$2.7 billion to more than a million crowdfunding campaigns across the globe in 2012—an 81% increase from 2011."); *SRI Basics*, US SIF, <http://www.ussif.org/sribasics> (last visited Apr. 16, 2014) ("[S]ustainable and responsible investing enjoyed a growth rate of more than 22 percent, increasing from \$3.07 trillion in 2010.").

¹⁵ See US SIF, EXECUTIVE SUMMARY: REPORT ON SUSTAINABLE AND RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES 11 (2012), http://ussif.org/files/Publications/12_Trends_Exec_Summary.pdf ("The assets engaged in sustainable and responsible investing practice currently represent 11.3 percent of the \$33.3 trillion in total assets under management tracked by Thomson Reuters Nelson.").

¹⁶ See *infra* notes 20–23 and accompanying text (explaining the history of affordable housing and the roles of private sector developers and investors).

¹⁷ See *infra* notes 31–36 and accompanying text (explaining how private capital reduces the rental rates of affordable housing).

¹⁸ 26 U.S.C. § 42 (2012).

¹⁹ Tax Reform Act of 1986, Pub. L. No. 99-514, § 252, 100 Stat. 2085, 2189 (1986).

effort to privatize affordable housing.²⁰ In the early 20th century, affordable housing was synonymous with public housing: “subsidized by public funds” and “managed by local public housing authorities.”²¹ Starting in the 1960s, however, Congress began to replace public funding with private sector “incentives.”²² In reality, Congress only shifted administrative costs, since the LIHTC, like many of the housing investment incentives that preceded it, is a federal subsidy in the form of a tax expenditure.²³

Enacting policy through the Code is controversial.²⁴ Critics argue such policies are not always effective;²⁵ in fact, the LIHTC itself replaced several “uncoordinated” low-income housing tax provisions that “failed to guarantee that affordable housing would be

²⁰ 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) (“In 1982, President Ronald Reagan’s Commission on Housing argued that governmental functions should be ‘privatized,’ or transferred to the private sector.” (citing PRESIDENT’S COMM’N ON HOUS., REPORT OF THE PRESIDENT’S COMMISSION ON HOUSING xvii (1982), available at <http://www.huduser.org/Publications/pdf/HUD-2460.pdf>)).

²¹ David Phillip Cohen, *Improving the Supply of Affordable Housing: The Role of the Low-Income Housing Tax Credit*, 6 J.L. & POL’Y 537, 537–38 (1998).

²² *Id.* at 538; Tracey A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 VILL. L. REV. 872, 877 n.28 (1993) (“[I]t is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families.” (quoting Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 901, 82 Stat. 476, 547 (1968))).

²³ Stearns, *supra* note 20, at 206.

²⁴ See Lawrence Zelenak, *Choosing Between Tax and Nontax Delivery Mechanisms for Health Insurance Subsidies*, 65 TAX L. REV. 723, 723–24 (2012) (“Ever since Stanley Surrey introduced the concept of tax expenditures and explained that ‘for any given program involving federal monetary assistance, the program may be structured to use the tax system to provide that assistance . . . or structured to use a direct Government expenditure,’ legislators and tax policy analysts have debated—in any number of contexts—the relative merits of tax and nontax subsidy-delivery systems.” (quoting STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 6 (1973))).

²⁵ Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1155 (1988) (“In some cases, repealed tax expenditures could be replaced by direct subsidy programs that would furnish government assistance more effectively” (citing SURREY, *supra* note 24 at 204-07)).

provided to the most needy low-income individuals.”²⁶ Additionally, creating policy through tax incentives may cause inefficiencies, both in the economic sense by creating unnecessary costs,²⁷ and in the tax sense by distorting taxpayer behavior.²⁸ The Senate Finance Committee believed that high-income taxpayers were using earlier versions of affordable housing investment credits to shelter income.²⁹ Congress hoped that the LIHTC would be more narrowly-tailored to only benefit low-income housing residents.³⁰

Private developers and investors require subsidies or other incentives in order to provide affordable housing.³¹ Unlike other real estate investments, affordable housing cannot offer a strong return since owners must keep rents low.³² The LIHTC program

²⁶ STAFF OF JOINT COMM. ON TAX’N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 152 (Comm. Print 1987). Contemporary commentators have also suggested the LIHTC is not as effective as it could be at reaching the very lowest income households. *See* LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 9 (“To reach these households, project sponsors usually need multiple layers of subsidy, which can be complex to arrange.”).

²⁷ *See* Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 992 (1986) (“[T]echnical inefficiency” is “a means of viewing tax incentives from the perspective of the government as purchaser of economic behavior: what is the cheapest way the government can induce additional production of a particular good or encourage increased consumption of a specific service?”).

²⁸ Jason S. Oh, *The Social Cost of Tax Expenditure Reform*, 66 TAX L. REV. 63, 68–69 (2012); *see also* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 28 (7th ed. 2008) (“The efficiency criterion requires that a tax interfere as little as possible with people’s economic behavior.”).

²⁹ Stearns, *supra* note 20, at 208.

³⁰ *See* STAFF OF JOINT COMM. ON TAX’N, *supra* note 26, at 153.

³¹ Kaye, *supra* note 22, at 877 (“Absent the tax credit or other government subsidy, the private sector has little economic incentive to provide low-income housing.”); *see also* Stearns, *supra* note 20, at 206–07 (“These incentives, or tax expenditures, entice investment and development by creating tax benefits that supplement or replace profits lost to the developer as a result of developing units with below-market rents. Low-income housing requires these subsidies because affordable tenant rents usually cannot cover the owner’s costs of construction, maintenance, and management.”).

³² Kaye, *supra* note 22, at 899.

creates value for investors by providing a “dollar-for-dollar” reduction in income tax liability for less than a dollar per credit.³³ Investor capital, in turn, reduces the amount that developers must borrow to finance affordable housing projects.³⁴ Since developers use residents’ rent to offset their loan payments,³⁵ the presence of private investors actually lowers the cost of rent, as it lowers the borrowing costs incurred by the developer.³⁶

B. How the LIHTC Program Finances Affordable Housing

The LIHTC provides a generous subsidy to affordable housing developers.³⁷ By structuring the subsidy as a ten-year stream of tax credits,³⁸ Congress was able to encourage long-term private investment in low-income housing.³⁹ The LIHTC program relies on partnerships between developers and investors.⁴⁰ In exchange for providing the necessary capital to develop affordable homes, investors receive a share of the property’s tax credits.⁴¹ The investors’ initial contribution to the partnership is based on the amount of credits they expect to receive, discounted by the risk that they will not be able to use the credits, due to recapture or

³³ *How Do Housing Tax Credits Work?*, *supra* note 3; U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-869R, COMMUNITY REINVESTMENT ACT: CHALLENGES IN QUANTIFYING ITS EFFECT ON LOW-INCOME HOUSING TAX CREDIT INVESTMENT 13 (2012).

³⁴ *How Do Housing Tax Credits Work?*, *supra* note 3 (“Developers then sell these credits to investors to raise capital (or equity) for their projects, which reduces the debt that the developer would otherwise have to borrow.”).

³⁵ *See* Kaye, *supra* note 22, at 899.

³⁶ Sherrie L. W. Rhine et al., *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks*, COMMUNITY DEV. INSIGHTS (Office of the Comptroller of the Currency, Washington, D.C.), Feb. 2008, at 1, <http://www.occ.gov/topics/community-affairs/publications/insights/insights-low-income-housing-tax-credits.pdf>.

³⁷ *See infra* notes 55–65 and accompanying text (explaining how Congress structured LIHTCs to cover 70% of a developer’s costs).

³⁸ 26 U.S.C. § 42(f)(1) (2012).

³⁹ KHADDURI ET AL., WHAT HAPPENS TO LOW-INCOME HOUSING TAX CREDIT PROPERTIES AT YEAR 15 AND BEYOND? 5 (2012), http://www.huduser.org/publications/pdf/what_happens_lihtc.pdf.

⁴⁰ *How Do Housing Tax Credits Work?*, *supra* note 3; *see also infra* Part I.B.4 (describing the partnership structure of LIHTC investments).

⁴¹ Rhine et al., *supra* note 36, at 2.

insufficient future income.⁴² An investor's yield is the spread between the capital contributed and the credits' face value on future tax returns.⁴³

1. State Allocations

Developers must first apply for the credits by proposing affordable housing projects to state housing credit agencies ("HCAs").⁴⁴ Each state is granted a certain number of LIHTCs based on its population.⁴⁵ HCAs award LIHTCs to developers in accordance with a Qualified Allocation Plan ("QAP"), which must adhere to strict federal guidelines.⁴⁶ For example, QAPs must follow specific criteria⁴⁷ and give preference to developers who propose projects that last the longest time⁴⁸ and serve the lowest-income tenants.⁴⁹ HCAs have two years to distribute their LIHTCs because credits that are not assigned to projects in one year roll over to the next year.⁵⁰ After two years, any credits that are still not used are returned to the national pool of LIHTCs.⁵¹

⁴² THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4.

⁴³ Terry Pristin, *Who Invests in Low-Income Housing? Google, for One*, N.Y. TIMES, Jan. 26, 2011, at B8 (describing the "return on investment" a LIHTC investor receives in buying "\$1 worth of tax credit for 59 cents").

⁴⁴ 26 U.S.C. § 42(h)(1)(A) (2012).

⁴⁵ § 42(h)(3)(C)(ii). Starting in 2003, a state's per capita amount is adjusted for inflation. § 42(h)(3)(H).

⁴⁶ § 42(m)(1)(A).

⁴⁷ § 42(m)(1)(C) (including "project location," "housing needs characteristics," "project characteristics," "sponsor characteristics," "tenant populations with special housing needs," "public housing waiting lists," "tenant populations of individuals with children," "projects intended for eventual tenant ownership," "energy efficiency," and "historic nature of the project").

⁴⁸ § 42(m)(1)(B)(ii)(I).

⁴⁹ § 42(m)(1)(B)(ii)(II).

⁵⁰ § 42(h)(3)(C)(i).

⁵¹ § 42(h)(3)(D).

2. Use of the Credit in Financing and the Role of Investors

Once a project is approved, a formula determines how many credits the state HCA will award the developer.⁵² The annual credit amount is equal to the developer's "qualified basis"—or costs—in the building,⁵³ multiplied by the appropriate "applicable percentage"—one of two rates published by the Internal Revenue Service ("IRS"), depending on the type of project.⁵⁴ For properties without any other form of federal subsidy, Congress intended the present value of the ten-year stream of credits to equal 70% of a developer's qualified costs.⁵⁵ The government does not cover this portion of the costs directly; rather, the developer finances the project by transferring the property (and its associated tax credits) to a partnership with investors, whose initial contribution to the partnership provides the capital necessary to build the affordable housing.⁵⁶ Over the next ten years, these investors receive the majority of the annual credits generated by the property.⁵⁷ By spreading the tax credits over ten years the government is able to

⁵² § 42(a). The annual amount of credits so determined applies to a project for the ten years over which credits may be taken, but is deducted from the state allocation only in the first year. § 42(h)(2).

⁵³ The qualified basis is the portion of the developer's cost properly attributable to providing affordable housing. It is calculated by multiplying the developer's eligible basis in the building (generally, his cost) by the ratio of low-income space to non-low-income space in the building. § 42(c)(1), (d).

⁵⁴ § 42(b). The IRS publishes the applicable percentages monthly in a revenue ruling. *See, e.g.*, Rev. Rul. 2014-12, 2014-15 I.R.B. 923.

⁵⁵ § 42(b)(1)(B). For acquisitions, and projects with other federal subsidies, Congress intended to cover 30% of the developer's qualified costs. *Id.* ("The percentages prescribed by the Secretary for any month shall be percentages which will yield over a ten year period amounts of credit . . . which have a present value equal to . . . (i) 70 percent of the qualified basis of a new building which is not federally subsidized for the taxable year, and . . . (ii) 30 percent of the qualified basis of a building not described in clause (i).").

⁵⁶ *How Do Housing Tax Credits Work?*, *supra* note 3.

⁵⁷ Rhine et al., *supra* note 36, at 2.

condition its subsidy on the property's continued compliance with affordable housing standards.⁵⁸

The applicable percentage is used to calculate the annual credit amount,⁵⁹ but does not determine the investor's actual capital contribution to the partnership. In order to cover 70% of the developer's costs, the investors' capital contribution would also have to equal the credit stream's present value.⁶⁰ This is often not the case, since economic investors base their investment not only on how much they expect to receive, but also on the risks involved.⁶¹ Accordingly, investors' contributions usually represent less than a dollar per credit.⁶² When the financial crisis caused investors to further discount their contributions,⁶³ Congress stepped in to create a 9% floor for the applicable percentage used in projects without any other federal subsidies.⁶⁴ This floor yields a ten-year stream of credits, whose present value exceeds 70% of a developer's costs, but which practically functions to ensure that the investors' capital contributions ultimately cover roughly the same percentage of costs.⁶⁵

Table 1 calculates the credit award for a \$4 million affordable housing project with no other federal subsidies, where 100% of the costs are incurred for qualified, low-income

⁵⁸ See THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 3 (“[A] key reason for the LIHTC program’s success was that private investors had significant capital at risk.”).

⁵⁹ § 42(a).

⁶⁰ See *supra* notes 55–56 (explaining how the government uses LIHTCs to cover a generous portion of the developer’s costs).

⁶¹ See THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4 (“[I]nvestors were clearly discounting both real estate risk and tax liability risk . . .”).

⁶² U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 33 at 13.

⁶³ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4.

⁶⁴ Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3002(a), 122 Stat. 2879, 2879 (2008); see also § 42(b)(2) (setting the temporary rate for “non-federally subsidized new buildings” at 9%). For affordable housing acquisitions and projects that benefit from additional federal subsidies, the applicable rate for determining the annual credit amount continues to be the one calculated monthly by the IRS. See *infra* Appendix.

⁶⁵ See *infra* Table 1.

residences.⁶⁶ The annual credits total 90% of the developer's costs. The present value of this credit stream at a 1.85% discount rate⁶⁷ still exceeds 70% of the developer's costs. However, as investors further discount for risk—contributing \$0.85 per dollar of tax credit—their actual investment covers closer to 70% of the costs.

Table 1 Projects without Other Federal Subsidies (9% Credit)	
Qualified basis (100% of cost)	\$ 4,000,000.00
Annual credits (9%)	\$ 360,000.00
Total credit award (over 10 years)	\$ 3,600,000.00 (90% of cost)
Present value (using 1.85% discount rate)	\$ 3,319,553.37 (83% of cost)
Equity (\$0.85 per credit)	\$ 3,060,000.00 (76.5% of cost)

3. Compliance and Recapture

The investors' capital contribution to a LIHTC partnership is less than the present value of the tax credit stream because investors discount for risk.⁶⁸ The "threat of tax credit recapture" poses one such risk to a LIHTC investment.⁶⁹ In order to be eligible for the credits, a building must be a "qualified low-income housing project,"⁷⁰ meaning it not only provides a certain number of rent-restricted units, but also ensures that it is occupied by low-income tenants.⁷¹ A building must qualify under either the "20-50" or "40-60" test: either 20% of the residential units must be rent-restricted and occupied by tenants with income that is 50% or less than the

⁶⁶ See *infra* Table 2 for an example in which only 70% of the building is set aside as affordable housing.

⁶⁷ Section 42 instructs the IRS to discount using a rate that is based on the applicable federal rate (AFR) for mid- and long-term debt instruments. § 42(b)(1)(C)(ii); see also Appendix. The AFRs are published monthly in a revenue ruling. See Rev. Rul. 2014-12, 2014-15 I.R.B. 923.

⁶⁸ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4.

⁶⁹ KHADDURI ET AL., *supra* note 39, at 6.

⁷⁰ See § 42(a)(2).

⁷¹ § 42(g)(1). The taxpayer's election is irrevocable. *Id.*

area's median,⁷² or 40% of the residential units must be rent-restricted and occupied by tenants with income 60% or less than the area's median.⁷³ The income limitations apply directly to a four-person household and are adjusted for differently sized households.⁷⁴ The annual rent for a rent-restricted apartment cannot exceed 30% of the maximum income level permitted, based on the unit's expected occupancy.⁷⁵

Despite these threshold requirements, many low-income housing projects contain higher numbers of rent-restricted units in order to receive more tax credits.⁷⁶ Table 2 shows that the same \$4 million housing project from Table 1 will receive fewer LIHTCs from a state HCA if only 70% of its units are rent-restricted. This in turn reduces the amount of capital a developer will be able to raise from investors to cover the initial costs of the project.

⁷² § 42(g)(1)(A).

⁷³ § 42(g)(1)(B).

⁷⁴ *Eligibility*, U.S. DEP'T OF HOUS. & URBAN DEV., http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/affordablehousing/training/web/lihtc/basics/eligibility (last visited Apr. 16, 2014); *see also How are LIHTC Rents determined?* DANTER CO., <http://www.danter.com/taxcredit/rents.htm> (last visited Apr. 16, 2014) (listing the adjustment factors for different sized households).

⁷⁵ § 42(g)(2)(A), (C). Thirty percent of income is the current standard for rental affordability. MARY SCHWARTZ & ELLEN WILSON, WHO CAN AFFORD TO LIVE IN A HOME? A LOOK AT DATA FROM THE 2006 AMERICAN COMMUNITY SURVEY 1-2 (2008), *available at* <http://www.census.gov/housing/census/publications/who-can-afford.pdf> (tracing the history of affordability standards from the United States Housing Act of 1937 to the present).

⁷⁶ *Eligibility*, U.S. DEP'T OF HOUS. & URBAN DEV., http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/affordablehousing/training/web/lihtc/basics/eligibility (last visited Apr. 16, 2014); *see also supra* note 53 and accompanying text (explaining that a developer's qualified basis is based on the percentage of affordable housing in the building)

Table 2	
Seventy-Percent of Units Rent-Restricted	
Total cost	\$ 4,000,000.00
Qualified basis (70% of Cost)	\$ 2,800,000.00
Annual credit (9%)	\$ 252,000.00
Total credit award (over 10 years)	\$ 2,520,000.00 (63% of cost)
Equity (\$0.85 per credit)	\$ 2,142,000.00 (53.6% of cost)

In Boston—where the area median income for 2014 is \$94,100⁷⁷—in order to satisfy the 40-60 test, the owner of the above building could not lease its rent-restricted units to a three-person household that earns over \$50,820 in income.⁷⁸ For a two-bedroom unit, the maximum rent would be \$1,270.50.⁷⁹

LIHTCs are subject to recapture if they do not continue to comply with the rent and tenant income requirements.⁸⁰ This risk of recapture extends for a fifteen-year “compliance period,”⁸¹ after which the IRS cannot reclaim the credits’ value.⁸² After the compliance period, federal law mandates an additional fifteen-year “extended-use period,” for which the building must remain

⁷⁷ *LIHTC Maximum Rents and Incomes – New England Areas*, DANTER CO., <http://www.danter.com/taxcredit/getrentsNE.html> (enter “MA” for State, “Suffolk” for County name, and “Boston city” for Town/City/Village) (last visited Apr. 16, 2014).

⁷⁸ Sixty percent of \$94,100 is \$56,460, but because it is a three-person household, the income limitation is adjusted by 90% to equal \$50,820. *Id.*

⁷⁹ Thirty percent of \$50,820, divided by twelve months, is \$1,270.50. *Id.* For purposes of calculating maximum rent, section 42 assumes 1.5 individuals live in a unit for every separate bedroom. § 42(g)(2)(C).

⁸⁰ See § 42(j)(1) (“If . . . as of the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than . . . the amount of such basis as of the close of the preceding taxable year, then the taxpayer’s tax under this chapter for the taxable year shall be increased by the credit recapture amount.”). A decrease in a building’s qualified basis indicates a decrease in the building’s qualified affordable housing. See *supra* note 53 and accompanying text (explaining the calculation of qualified basis).

⁸¹ § 42(i)(1).

⁸² KHADDURI ET AL., *supra* note 39, at xii (2012).

affordable.⁸³ LIHTC property developers must enter into an agreement with a state HCA that provides for an extended-use period in order to receive any tax credits.⁸⁴ While there are no federal tax penalties for failing to comply during the extended-use period, there are still be consequences: state HCAs and low-income tenants may enforce the extended-use agreement in court.⁸⁵ Non-legal pressures also encourage compliance. Like many industries, the tax credit industry is built on business reputations and relationships. Developers who breach their extended-use agreements may find it difficult to find investors, or to obtain credits from state HCAs in the future.⁸⁶ States may also lengthen the extended-use period and prescribe additional consequences for violations.⁸⁷ For this reason, investors usually dispose of their partnership interest after the first fifteen-year compliance period, often by transferring it back to the developer, who continues to manage the property.⁸⁸

4. Entity Choice

LIHTCs are inextricably tied to the underlying affordable housing projects that generate them, and investors can only receive LIHTCs by holding an ownership interest in LIHTC property.⁸⁹ Thus, the “sale” and “purchase” terminology sometimes applied to

⁸³ § 42(h)(6)(A)–(B), (D).

⁸⁴ § 42(h)(6)(A)–(B).

⁸⁵ See § 42(h)(6)(B)(i)–(ii), (iv) (requiring the agreement to be “recorded pursuant to State law as a restrictive covenant” and “allow[ing] individuals who meet the income limitation . . . whether prospective, present, or former occupants of the building . . . the right to enforce in any State court the requirement and prohibitions of [the extended low-income housing commitment]”). Thus, both HCAs, who are party to the extended-use agreement, and the tenants, who are not, may sue to enforce the affordability commitment. *Id.*

⁸⁶ See *Affordable Housing Investment Opportunities for Banks*, *supra* note 36, at 17 (“[A] bank investor will also need to evaluate the experience, strength, and reputation of the general contractor who will be responsible for completing the project on-time and on-budget.”); § 42(m)(1)(C)(iv) (requiring state HCAs to consider the “sponsor characteristics” of any affordable housing project).

⁸⁷ KHADDURI ET AL., *supra* note 39, at 7.

⁸⁸ *Id.* at 29.

⁸⁹ Kenneth N. Alford & David C. Wellsandt, *Appraising Low-Income Housing Tax Credit Real Estate*, APPRAISAL J. 350, 352 (2010).

LIHTC transfers is somewhat misleading.⁹⁰ Rather, developers transfer LIHTCs to investors by means of a limited partnership (“LP”) or limited liability company (“LLC”).⁹¹ These structures are ideal since they limit investors’ downside exposure, and their pass-through treatment facilitates the transfer of tax benefits.⁹² The entity owns the LIHTC property⁹³ and is usually divided into a 1% managing interest and a 99% equity interest, permitting the majority of tax benefits to flow to the investors.⁹⁴ The equity interest itself may also be organized as an LP or LLC in order to accommodate multiple investors.⁹⁵ Because the property and the investors’ capital are transferred to the partnership, instead of being directly exchanged between the investors and developer, these initial transfers are considered non-taxable capital contributions.⁹⁶

⁹⁰ *Id.* (“Although market participants often talk casually about ‘selling’ the tax credits, they are actually referring to selling a partial ownership interest in the entity that owns the real estate.”).

⁹¹ Rhine et al., *supra* note 36, at 2.

⁹² JEROME OSTROV, TAX AND ESTATE PLANNING WITH REAL ESTATE, PARTNERSHIPS AND LLCs, §§ 2:1.2, at 2-15 to -16 & 3:3 at 3-11 (Practising Law Institute, 2nd ed. 2011).

⁹³ Alford & Wellsandt, *supra* note 8989, at 354 (“[T]he whole limited partnership, which is a legal entity, actually owns the real estate, and not the individual partners.”).

⁹⁴ Sherrie L. W. Rhine et al., *supra* note 3636, at 2–3 (describing the one percent and ninety-nine percent division of the respective interests); JASON KORB, THE LOW-INCOME HOUSING TAX CREDIT: HERA, ARRA AND BEYOND 25–26 (2009), <http://dspace.mit.edu/bitstream/handle/1721.1/54857/609666820.pdf> (“Interests in the owner LLC are in turn owned by two or more entities, typically a second LLC that is the manager or managing member and the equity investor that is a non-managing member.”) (emphasis omitted).

⁹⁵ See Sherrie L. W. Rhine et al., *supra* note 3636, at 3 (depicting a two-tier partnership in which a fund partners with developers in the lower-tier and multiple investors in the upper-tier).

⁹⁶ See 26 U.S.C. § 721(a) (2012) (“No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.”).

II. *The LIHTC Today*

A. **An Affordable Housing Crisis**

The country's need for the LIHTC program has never been more pressing.⁹⁷ The financial crisis dramatically increased the number of Americans renting homes.⁹⁸ The collapse of the housing market bubble challenged the government's policy of promoting home ownership over renting.⁹⁹ Unprecedented numbers of foreclosures pushed millions of mortgagees into the rental market.¹⁰⁰ The financial crisis thus exacerbated a growing affordability crisis in which the cost of providing low-income housing is prohibitively greater than the rent low-income individuals can afford.¹⁰¹

Renters are more likely to have low incomes.¹⁰² Many renters view renting as a temporary living situation and commonly cite financial reasons as an obstacle to owning a home.¹⁰³ While

⁹⁷ See *infra* notes 98–101 and accompanying text (citing findings from recent studies on the affordable housing crisis).

⁹⁸ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS 1 (2013), www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs_americas_rental_housing_2013_1_0.pdf [hereinafter AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS].

⁹⁹ See THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT xxvii (2011), www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (“As a nation, we set aggressive homeownership goals with the desire to extend credit to families previously denied access to the financial markets. Yet the government failed to ensure that the philosophy of opportunity was being matched by the practical realities on the ground.”).

¹⁰⁰ AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 1.

¹⁰¹ NAT'L LOW INCOME HOUS. COAL., OUT OF REACH 3 (2013), http://nlihc.org/sites/default/files/oor/2013_OOR.pdf (“The 2013 Housing Wage is \$18.79, exceeding the \$14.32 hourly wage earned by the average renter by almost \$4.50 an hour, and greatly exceeding wages earned by low income renter households.”).

¹⁰² AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 3.

¹⁰³ See FANNIE MAE, NATIONAL HOUSING SURVEY, RENTERS: SATISFIED, BUT REACHING FOR HOMEOWNERSHIP 16 (June 2013), <http://www.fanniemae.com/resources/file/research/housingsurvey/pdf/nhsq32012presentation.pdf> (“Compared to the owners that they aspire to become, renters are

renting is still less of a financial commitment than home ownership,¹⁰⁴ it is becoming less affordable for a growing number of Americans.¹⁰⁵ One measure of affordability is the percentage of one's income spent on rent.¹⁰⁶ "Affordable" housing is generally considered to constitute 30% or less of one's income.¹⁰⁷ In 2011, 20.6 million households—over half of the renting population—spent over 30% of their income on rent.¹⁰⁸ Of these, 11.3 million had "severe" cost burdens, spending over half of their income on rent.¹⁰⁹ The affordability crisis has implications beyond housing: as more income is spent on rent, less is available for food, transportation, health insurance, and savings.¹¹⁰

The low supply of adequate low-income housing is responsible for many renters' extreme cost-burdens.¹¹¹ The costs of building and maintaining real estate create a strong financial incentive against developing affordable housing.¹¹² In 2011, the "median monthly cost" of providing housing exceeded \$1,000.¹¹³ Renters would have to earn a yearly salary of over \$40,000 in order to make such rent "affordable" at 30% of their income.¹¹⁴ However,

more likely to have fewer assets and higher debt stress—and they doubt their ability to get a mortgage.”).

¹⁰⁴ AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 9.

¹⁰⁵ *Id.* at 6 (“[T]he share of renters paying more than 30 percent of income for housing, the traditional measure of affordability, rose 12 percentage points over the decade, reaching 50 percent in 2010.”).

¹⁰⁶ SCHWARTZ & WILSON, *supra* note 75, at 1.

¹⁰⁷ *Id.*

¹⁰⁸ AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 6.

¹⁰⁹ *Id.* at 28. This number is 2.5 million higher than the year before the financial crisis. *Id.*

¹¹⁰ *Id.* at 32.

¹¹¹ *Id.* at 30.

¹¹² See *supra* notes 31–32 and accompanying text (explaining that affordable housing projects require subsidies to attract investors and developers since the low rent limits return on investment).

¹¹³ AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 6.

¹¹⁴ If renters paid \$1,000 per month, for twelve months, dividing their annual total by the aforementioned 30% affordability standard would yield a yearly salary of \$40,000.

46% percent of renters earn less than \$30,000.¹¹⁵ Providing affordable housing to low-income residents often means that the rents may not cover costs of upkeep.¹¹⁶ This puts low-income rental properties at a disproportionately high risk of falling into disrepair.¹¹⁷

Under section 42, the maximum rent limitations are based on the maximum income levels permitted for low-income tenants.¹¹⁸ Thus, if the owner of a building charges the maximum rent, any residents who earn less than the maximum income level will spend over 30% of their income on rent.¹¹⁹ The LIHTC program helps keep rents low by reducing the amount a developer must borrow to finance the construction of an affordable housing project.¹²⁰ The LIHTC program enables developers to replace a portion of their debt financing with equity.¹²¹ The resulting lower mortgage payments enable owners of low-income housing to charge more affordable rents.¹²²

Table 3 demonstrates the potential impact of debt financing on rent price. Assume that the \$4 million affordable housing project from Table 2 is comprised of 40 two-bedroom units: 28 are rent-restricted and 12 are rented at market price: \$2,000 per month.¹²³

¹¹⁵ AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 12.

¹¹⁶ Kaye, *supra* note 22, at 899.

¹¹⁷ AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 21 ("The deterioration and loss of low-cost rental housing are grave concerns."); NAT'L COUNCIL OF STATE HOUS. AGENCIES, 2011 PRESERVATION REFORM FACT SHEET (Mar. 2, 2011), https://ncsha.org/system/files/resources/Preservation+Reform+Fact+Sheet_2011.pdf ("The loss of affordable housing properties due to demolition, abandonment, or conversion to more expensive housing has reduced further the options available to low-income renters.").

¹¹⁸ See 26 U.S.C. § 42(g)(2)(A) (2012) ("[A] residential unit is rent-restricted if the gross rent with respect to such unit does not exceed 30 percent of the imputed income limitation applicable to such unit.").

¹¹⁹ *How are LIHTC Rents determined?* DANTER CO., <http://www.danter.com/taxcredit/rents.htm> (last visited Apr. 16, 2014); see also *supra* note 75 (explaining how rent is determined for rent-restricted apartments in LIHTC properties).

¹²⁰ *How Do Housing Tax Credits Work?*, *supra* note 3.

¹²¹ Rhine et al., *supra* note 36, at 1.

¹²² *Id.*

¹²³ Market rent for a two-bedroom apartment is set at this number for convenience purposes, but the amount was informed both by the U.S. Department of Housing and Urban Development's measure of fair market

Assume further that the building owner has a twenty-year mortgage with 5.5% annual interest, in addition to operating costs that average \$600 per month, per apartment.¹²⁴

Under these circumstances, the presence of LIHTC investors enables the developer to halve its debt burden and mortgage payments.¹²⁵ As a result, the building owner does not need to charge the maximum rent permitted for rent-restricted units, simply to meet monthly costs.¹²⁶ Instead, owners can offer the units to tenants with a wider range of income levels while still maintaining affordability, which eases the compliance burden.¹²⁷

rent for a two-bedroom apartment in Boston (\$1,454) and the average actual rental price for all apartments in Boston (\$2,693). *Compare FY2014 Final Fair Market Rents Documentation System*, U.S. DEP'T OF HOUS. & URBAN DEV., <http://www.huduser.org/portal/datasets/fmr/fmrs/docsys.html&data=fmr14> (last visited Apr. 16, 2014) (listing \$1,454 as the fair market rent for a two-bedroom apartment in Boston), *with Mapping Boston's Rents*, BOSTON.COM, http://www.boston.com/yourtown/boston/average_rent_neighborhood (last visited Apr. 16, 2014) (listing average rents for all apartment sizes by neighborhood).

¹²⁴ In 2011, the "median monthly cost" of providing housing was over \$1,000. AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 6. In this example, monthly mortgage payments of \$875 and monthly operating costs of \$600 total \$1,475.

¹²⁵ See *infra* Table 3.

¹²⁶ In Boston, the maximum rent for a two-bedroom apartment in a building that satisfies the 40-60 test, is \$1,270.50. See *supra* notes 77-79 (calculating the income and rent limitations for a Boston LIHTC property). Under Table 2, the owner of a LIHTC-financed property meets all monthly expenses by charging \$580.63 in rent.

¹²⁷ See *supra* Part I.B.3 (describing the strict income and rent limitations for LIHTC properties).

Financing	Debt-Financed	LIHTC- Financed (Debt & Equity)
Total costs	\$4,000,000.00	\$ 4,000,000.00
Total credit award	--	\$ 2,520,000.00
Equity (\$0.85 per credit)	--	\$ 2,142,000.00
Debt	\$ 4,000,000.00	\$ 1,858,000.00
Mortgage payments	\$ 420,000.00	\$ 195,090.00
Operating costs	\$ 288,000.00	\$ 288,000.00
Revenue from market price units ¹²⁸	\$ 288,000.00	\$ 288,000.00
Revenue from restricted-rent units needed to meet monthly expenses	\$ 420,000.00	\$ 195,090.00
<i>Expressed as monthly rent</i>	\$ 1,250.00	\$ 580.63
<i>Expressed as salary required to afford rent</i>	\$ 50,000.00	\$ 23,225.00

Subsidy programs are therefore necessary to provide comprehensive affordable housing.¹²⁹ In some ways, the LIHTC program has fared better than direct government subsidies: even

¹²⁸ This example was structured so that the annual revenue from the market price units equals the annual operating costs of renting all the units. This is not intended to imply a direct relationship between these two variables, but is solely for the purposes of highlighting how debt and mortgage payments can create pressure for owners to charge more for rent-restricted units. Consequently, the more market price unit revenue exceeds operating costs, the less revenue owners would require from rent-restricted units, in order to meet all monthly expenses.

¹²⁹ See AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS, *supra* note 98, at 7 (advocating "more generous tax breaks for maintenance and improvements" as "incentives to invest in existing affordable housing" and observing that "for households with incomes too low to cover the costs of operating even lower-quality units in less desirable markets public subsidies are essential.").

though it ultimately reflects a federal government expenditure, it is not subject to budget cuts and does not rely on annual appropriations as part of the Code.¹³⁰ Nevertheless, one potential downside to the LIHTC's privatization of affordable housing is that it leaves the market vulnerable to shifts in investor demand.¹³¹ Since the LIHTC program relies on the private sector for start-up capital,¹³² these investors effectively determine the amount of funds available for LIHTC-financed affordable housing.¹³³ If investor demand for the LIHTC drops, low-income tenants ultimately bear the cost.¹³⁴

B. Tax Credit Pricing and Demand

In a particular market, demand for LIHTCs can be measured by the capital contributions investors are willing to make when partnering with developers.¹³⁵ Various factors influence how investors "price" LIHTCs.¹³⁶ In addition to discounting for real estate and compliance risk, investors also discount for tax liability risk.¹³⁷ On the other hand, certain financial institutions are statutorily incentivized to pay a premium for the tax credits.¹³⁸

1. Tax Liability Risk

Tax liability risk is "the risk that a firm will not have enough income . . . to derive value from the tax credits" during the ten-year

¹³⁰ *Id.* at 8.

¹³¹ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 20.

¹³² *See How Do Housing Tax Credits Work?*, *supra* note 3 ("Developers then sell these credits to investors to raise capital (or equity) for their projects . . .").

¹³³ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 20.

¹³⁴ *See infra* notes 186–92 (describing how the financial crisis decreased the availability of LIHTC funds).

¹³⁵ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 33, at 6.

¹³⁶ *Id.* (defining "LIHTC price" as "the ratio of investors' equity contribution to the total amount of LIHTCs in nominal dollars").

¹³⁷ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4; *see supra* Part I.B.4.

¹³⁸ *See infra* Parts II.B.2–3.

credit period.¹³⁹ Compared to compliance risk, tax liability risk is harder to mitigate.¹⁴⁰ Investors contain the risk of credit recapture stemming from non-compliance by remaining invested and involved in the property through year fifteen.¹⁴¹ Tax liability risk, on the other hand, is contingent on investors' future income and therefore difficult to predict and insure.¹⁴²

Tax liability risk is unique to tax credit investments, which experience returns in the form of reduced taxes instead of outright cash flows.¹⁴³ Since the LIHTC is a credit, and not a deduction, its value does not vary with a taxpayer's bracket.¹⁴⁴ However, since it is a non-refundable credit, its value is only recognized to the extent a taxpayer actually owes income tax.¹⁴⁵ The widespread reduction in earnings caused by the 2008 financial crisis dramatically reduced the income tax liabilities of LIHTC investors,¹⁴⁶ and continues to affect

¹³⁹ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 30.

¹⁴⁰ *See infra* notes 141–42 and accompanying text (comparing the risk of credit recapture with tax liability risk).

¹⁴¹ *See* KHADDURI ET AL., *supra* note 39, at 29 (“[After ten years of tax credits], the next five years of ownership oversight allows investors to minimize the risk that the credits already taken will be subject to Internal Revenue Service (IRS) recapture for noncompliance.”).

¹⁴² *See* LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11 at 19 (“[M]ost potential investors new to the LIHTC program are reluctant to project their tax liability more than three to five years into the future.”).

¹⁴³ EMERGING ISSUES TASK FORCE, ISSUE 13- B, SUMMARY NO. 1, SUPP. NO. 1, ACCOUNTING FOR INVESTMENTS IN QUALIFIED AFFORDABLE HOUSING PROJECTS 11 (Aug. 30, 2013).

¹⁴⁴ *How Do Housing Tax Credits Work?*, *supra* note 3; *cf.* Benjamin H. Harris & Amanda Eng, *The Benefits of Mortgage Interest And Property Tax Deductions*, 140 TAX NOTES 947, 947 (2013) (explaining how the tax benefits of home ownership—mortgages interest and property tax deductions—“reduce[] taxes more for households in higher tax brackets”).

¹⁴⁵ *See* THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 9 (“The most powerful option [to restore the investor base] would be to make the LIHTC refundable so that owners of LIHTCs could submit for a dollar for dollar tax refund even if they do not have tax liability in that year.”).

¹⁴⁶ *See infra* notes 186–87 and accompanying text (discussing the impact of the financial crisis on banks and GSEs, historically, two of the largest investors in LIHTCs).

demand for LIHTCs today.¹⁴⁷ When investors do not have sufficient income tax liabilities to use the credits, demand for the credit falls and prices drop.¹⁴⁸ This directly impacts the amount of equity financing available for affordable housing projects.¹⁴⁹

2. Banks and the GSEs

Prior to the financial crisis, large banks and two housing GSEs—the Federal National Mortgage Association (“Fannie Mae” or “Fannie”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac” or “Freddie”)—had become the leading purchasers of LIHTCs.¹⁵⁰ A 2003 study by Ernst & Young suggested that as many as 43% of LIHTC purchasers are evaluated under the CRA,¹⁵¹ which applies to “bank[s] or savings association[s]” whose deposits are insured by the FDIC.¹⁵² Fannie and Freddie made up another 40% of the LIHTC market.¹⁵³ Banks and the GSEs dominated the LIHTC market due to their familiarity with real estate transactions, as well as their ability to handle long-term, illiquid investments.¹⁵⁴ The United States system of fractional reserve banking relies on banks being able to use short-term deposits to effectively finance

¹⁴⁷ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 20–21.

¹⁴⁸ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 16.

¹⁴⁹ See *supra* notes 131–33 and accompanying text (explaining that developers rely on LIHTC investors to supply the capital for construction).

¹⁵⁰ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 16.

¹⁵¹ ERNST & YOUNG, THE IMPACT OF THE DIVIDEND EXCLUSION PROPOSAL ON THE PRODUCTION OF AFFORDABLE HOUSING 4 (2003), available at http://www.novoco.com/low_income_housing/resource_files/advocacy/E&Y_DividendReport.pdf.

¹⁵² Community Reinvestment Act, 12 U.S.C. §§ 2901(a)(1), 2902(2) (2012) (regulating “insured depository institutions”); 12 U.S.C. § 1813(c)(2) (defining “insured depository institution” as “any bank or savings association the deposits of which are insured by the [Federal Deposit Insurance] Corporation”).

¹⁵³ INGRID GOULD ELLEN, JOHN NAPIER TYE & MARK A. WILLIS, URBAN INST., IMPROVING U.S. HOUS. FIN. THROUGH REFORM OF FANNIE MAE AND FREDDIE MAC: ASSESSING THE OPTIONS 6 (2010), <http://www.urban.org/uploadedpdf/1001382-fannie-mae-freddie-mac-reform.pdf>.

¹⁵⁴ Roberts, *supra* note 7, at 13.

long-term investments.¹⁵⁵ The ten-year credit period of LIHTCs readily made them one such investment opportunity.¹⁵⁶ Fannie and Freddie, limited in the type of investments they could make,¹⁵⁷ were similarly drawn to LIHTCs for profit.¹⁵⁸

More important than their profit motive, however, was the fact that these financial institutions had additional statutory incentives to purchase LIHTCs.¹⁵⁹ Fannie and Freddie's financial interest in LIHTCs satisfied the GSEs' regulatory purpose.¹⁶⁰ For

¹⁵⁵ See RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFERY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 37 (4th ed. 2009) ("By making loans, banks can . . . convert their borrowers' illiquid assets into liquid ones.").

¹⁵⁶ See Galloway, *supra* note 12, at 26 ("The 15-year compliance period, coupled with restrictions placed on the reselling of credits, makes purchasing LIHTCs a relatively illiquid investment. This tends to favor investors with long investment time horizons."). LIHTCs differ from a more notorious long-term investment of banks: mortgages. Purchasing LIHTCs puts banks in an equity position, as opposed to creating a debt relationship. See *supra* notes 91–95 and accompanying text (describing how investors receive an equity interest in a LIHTC partnership). *But see* LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 20–21 ("[A] housing credit investment in some ways behaves more like subordinate debt than equity . . ."). Moreover, the 15-year recapture period ensures that a bank, or any other private investor, has sufficient "skin in the game," which decreases the likelihood of moral hazard scenarios. See THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 3 (suggesting that the recapture provision "encourages investors to underwrite carefully and step in to support properties in temporary trouble").

¹⁵⁷ See *infra* notes 164–68 and accompanying text (discussing the GSEs' "affirmative obligation" and "duty" to ensure that their lending activities benefit the affordable housing market).

¹⁵⁸ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 19–20. See Federal National Mortgage Association Charter Act, 12 U.S.C. §§ 1717(b), 1723b (2012) (describing approved mortgage purchases and limiting the investment of funds); Federal Home Loan Mortgage Corporation Act, 12 U.S.C. §§ 1452(d), 1454 (2012) (describing approved mortgage purchases and limiting the investment of funds).

¹⁵⁹ See DiPasquale, *supra* note 5, at 62 ("Banks could use the tax credit investments to meet Community Reinvestment Act requirements. Fannie Mae and Freddie Mac could use the tax credits to meet growing affordable housing requirements under their charters.").

¹⁶⁰ Shekar Narasimhan, *LIHTC: The Dilemma and a Secondary Market Solution*, in INNOVATING IDEAS FOR REVITALIZING THE LIHTC

banks, purchasing LIHTCs generated favorable treatment under the CRA.¹⁶¹ The fact that these “mission-motivated” financial institutions were willing to pay more for LIHTCs than other investors may explain the LIHTC’s program’s historical stability through different market conditions.¹⁶² Positive statutory recognition led banks to pay a consistent premium on the credits, above what a purely economic investor would pay.¹⁶³

In the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (“FHEFSSA”), Congress codified Fannie and Freddie’s “affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families.”¹⁶⁴ The Housing and Economic Recovery Act of 2008 reaffirmed and amended Fannie and Freddie’s affordable housing goals, and established the Federal Housing Finance Agency (“FHFA”) to oversee the GSEs.¹⁶⁵ Although the GSEs’ statutory “duty to serve underserved markets” was phrased in terms of “developing loan products and flexible underwriting guidelines,”¹⁶⁶ regulators also looked favorably on their LIHTC investments.¹⁶⁷ Providing equity

MARKET 31, 31 (2009), <http://federalreserve.gov/newsevents/press/other/other20091110a1.pdf>.

¹⁶¹ Roberts, *supra* note 7, at 13. *See infra* Part II.B.3.

¹⁶² THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 20, 22 (suggesting that institutional investors supported the LIHTC program through “elevated rental vacancy rates in the late 1980s, a period of real rent deflation in the early 1990s, and rising rental vacancy rates and soft rents following the 2001 recession and so-called jobless recovery period”).

¹⁶³ Anderson, *supra* note 9.

¹⁶⁴ Federal Housing Enterprises Financial Safety and Soundness Act, 12 U.S.C. § 4501(7) (2012).

¹⁶⁵ Housing and Economic Recovery Act of 2008, 12 U.S.C. § 4511 (2012).

¹⁶⁶ § 4565(a)(1).

¹⁶⁷ The U.S. Department of Housing and Urban Development—the agency previously responsible for GSE affordable housing goals under the FHEFSSA—refused to grant “goals credit” for LIHTC investment, although it recognized “that the GSEs’ participation in LIHTCs plays a vital role in the development of affordable housing.” HUD’s Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), 65 Fed. Reg. 65,044, 65,078 (Oct. 31, 2000). The FHFA has adopted a similar position. 2010–2011 Enterprise Housing Goals; Enterprise Book-entry Procedures, 75 Fed. Reg. 55,892, 55,923–24 (Sept. 14, 2010).

capital to low-income housing projects likely fell within the GSE's broader commitment to affordable housing.¹⁶⁸

3. The Community Reinvestment Act

Under the CRA, supervisory agencies evaluate banks on the basis of how well they “meet the needs of the local communities in which they are chartered.”¹⁶⁹ The resulting CRA score is important for banks because the agencies consider such ratings when deciding on bank applications for new branches, relocations, mergers, and acquisitions.¹⁷⁰ Banks are evaluated on their activities within an

¹⁶⁸ See LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 17 (explaining that “Fannie Mae and Freddie Mac . . . were not subject to the same incentives as banks . . . but were under regulatory pressure to meet the nation’s affordable housing needs.”). The more traditional lending and purchasing activities of the GSEs also had positive effects on the LIHTC market and affordable housing. See ELLEN, TYE & WILLIS, *supra* note 153, at 20 (“Through creating a set of standard products that lenders can offer to tax credit developments, they have brought a more stable and less expensive supply of loan funds to multifamily projects that rely on the LIHTC for part of their funding.”); MORTG. FIN. WORKING GROUP’S MULTIFAMILY SUBCOMM., A RESPONSIBLE MKT. FOR RENTAL HOUS. FIN.: ENVISIONING THE FUTURE OF THE U.S. SECONDARY MKT. FOR MULTIFAMILY RESIDENTIAL RENTAL MORTGGS. 29 (2010), <http://www.americanprogress.org/wp-content/uploads/issues/2010/10/pdf/multifamilyhousingreport.pdf> (“Fannie and Freddie continue to facilitate, through their loan purchases, 15-year fixed-rate mortgages, which are essential for these tax credits to be attractive to LIHTC investors.”).

¹⁶⁹ Community Reinvestment Act, 12 U.S.C. § 2901(b) (2012). The supervisory agency for national banks is the Comptroller of the Currency. § 2902(1).

¹⁷⁰ § 2903(a). See, e.g., 12 C.F.R. § 25.29(a) (2013) (“Among other factors, the OCC takes into account the record of performance under the CRA of each applicant bank in considering an application for: (1) The establishment of a domestic branch; (2) The relocation of the main office or a branch; (3) Under the Bank Merger Act (12 U.S.C. 1828(c)), the merger or consolidation with or the acquisition of assets or assumption of liabilities of an insured depository institution; and (4) The conversion of an insured depository institution to a national bank charter.”). Other bank regulators have adopted parallel regulations for state chartered banks that are members and non-members of the Federal Reserve System. See 12 C.F.R. § 228.29(a) (2013) (evaluating state chartered banks that are members of the Federal Reserve System under the CRA); 12 C.F.R. § 345.29(a) (2013) (the FDIC,

“assessment area,”¹⁷¹ and are subject to one to three tests depending on the size of their assets.¹⁷² Only the largest banks are subject to the “investment test,”¹⁷³ which takes into account both the quantity and quality of a bank’s community development investments.¹⁷⁴ Specifically, the investment test measures:

- (1) the dollar amount of qualified investments;
- (2) the innovativeness or complexity of qualified investments;
- (3) the responsiveness of qualified investments to credit and community development needs; and
- (4) the degree to which the qualified investments are not routinely provided by private investors.¹⁷⁵

Considering its qualitative criteria, particularly the “innovativeness or complexity” factor,¹⁷⁶ the investment test would appear to favor LIHTC investments. However, as a recent report from the U.S. Government Accountability Office (“GAO”) noted, “it is difficult to determine in a systematic way the extent to which certain qualified investments, such as LIHTC investments, were

evaluating state chartered banks that are not members of the Federal Reserve System under the CRA).

¹⁷¹ Banks designate their own assessment area, which must adhere to several regulatory standards. 12 C.F.R. § 25.41(a), (e) (2013).

¹⁷² 12 C.F.R. §§ 25.21, 25.26, 25.12(u) (2013).

¹⁷³ 12 C.F.R. § 25.23 (2013). Large banks are subject to lending, service, and investment tests. 12 C.F.R. § 25.21(a)(1). Small banks are only subject to a lending test and intermediate small banks are subject to lending and community development tests. 12 C.F.R. § 25.26(a)–(c).

¹⁷⁴ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 33, at 8. By comparison, the intermediate small bank community development test also assesses investments, but only in terms of “number and amount.” 12 C.F.R. § 25.26(c).

¹⁷⁵ 12 C.F.R. § 25.23(e). A “qualified investment” is “a lawful investment, deposit, membership share, or grant that has as its primary purpose community development.” 12 C.F.R. § 25.12(t). “Community development” includes “affordable housing (including multifamily rental housing) for low- or moderate-income individuals.” 12 C.F.R. § 25.12(g)(1).

¹⁷⁶ 12 C.F.R. § 25.23(e).

considered as part of a bank's CRA performance evaluations."¹⁷⁷ Nevertheless, extensive anecdotal evidence supports the idea that banks invest in LIHTCs primarily to increase their ratings under the CRA: the same GAO report surveyed fifty-six state HCAs and found that the "CRA was widely cited as one factor that increases bank demand for LIHTC investments."¹⁷⁸ Thus, the investment test provides a persuasive rationale as to why national banks have comprised such a large percentage of LIHTC investors.¹⁷⁹

The LIHTC market began with a broad and diversified pool of investors, which included individuals, corporations from various industries, as well as financial institutions.¹⁸⁰ However, banks and GSEs were motivated by statutory incentives, as well as profit, and accordingly offered larger capital contributions to developers.¹⁸¹ Increasingly, developers partnered with these financial institutions in order to receive the most funds for affordable housing projects.¹⁸² As a result, individual and corporate investors were gradually shut out of the market.¹⁸³ The overwhelming market share of banks and the GSEs made the LIHTC market appear robust and healthy: the financial institutions drove up LIHTC prices and poured funds into developer's affordable housing projects.¹⁸⁴ However, the narrow investor pool was concentrated almost entirely in the financial services industry, leaving the market susceptible to adverse changes in the economy.¹⁸⁵

¹⁷⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 33, at 8.

¹⁷⁸ *Id.* at 14.

¹⁷⁹ See COHNREZNICK LLP, THE COMMUNITY REINVESTMENT ACT AND ITS EFFECT ON HOUSING TAX CREDIT PRICING 1, 14–15 (2012) ("Committing equity to a housing tax credit property means that the investment will automatically be treated as a qualified community development investment under the CRA's investment test requirements Clearly, the largest banks have the greatest incentive to pursue outstanding CRA ratings.").

¹⁸⁰ DiPasquale, *supra* note 5, at 62.

¹⁸¹ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 33, at 12; THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4.

¹⁸² THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 15.

¹⁸³ See Roberts, *supra* note 7, at 13 ("[Y]ields dipped unsustainably low and large investors crowded out smaller ones.").

¹⁸⁴ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 16.

¹⁸⁵ *Id.* at 17.

4. Impact of Financial Crisis

The financial crisis had a tremendous impact on U.S. businesses,¹⁸⁶ and banks and the GSEs were not immune from heavy losses.¹⁸⁷ As these primary LIHTC investors realized the extent of their tax liability risk,¹⁸⁸ the impact on affordable housing was devastating.¹⁸⁹ Developers who had secured a stream of tax credits from state HCAs prior to the crisis anticipated a certain amount of investor capital contributions to fund their low-income housing projects—an amount that was based on pre-crisis LIHTC pricing.¹⁹⁰ Faced with dramatically reduced income, investors found they could no longer use the tax credits, and prices fell with demand.¹⁹¹ Developers were left with substantially less capital to finance the up-front costs of their project: once healthy projects were “effectively stranded” due to these “financing gaps.”¹⁹²

Table 4 illustrates how financings gaps may occur. The developer of the \$4 million affordable housing project in Table 2 secured \$2.52 million in credits from the state HCA. The developer obtained debt financing based on the assumption that investors would contribute capital to the investment partnership at \$0.85 per LIHTC. If investors instead were only willing to purchase LIHTCs at \$0.65 per credit—due to uncertainty about future income tax liability—the developers would require \$504,000 in additional financing to complete the affordable housing project.

¹⁸⁶ See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-180, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT 15 (2013) (“Research suggests that U.S. output losses associated with the 2007–2009 financial crisis could range from several trillion to over \$10 trillion.”).

¹⁸⁷ See THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 5 (observing that banks and the GSEs will be able to offset their tax liability for “years to come” with losses from the financial crisis).

¹⁸⁸ See *supra* note 139 (defining tax liability risk as the risk that investors would not have sufficient income to benefit from the tax credits).

¹⁸⁹ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 18.

¹⁹⁰ COHNREZNICK LLP, *supra* note 179, at 28.

¹⁹¹ Galloway, *supra* note 12, at 25.

¹⁹² THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 16.

LITHC market price	\$0.85 per credit	\$0.65 per credit
Total cost	\$ 4,000,000.00	\$ 4,000,000.00
Total credit award	\$ 2,520,000.00	\$ 2,520,000.00
Investor equity	\$ 2,142,000.00	\$ 1,638,000.00
Debt	\$ 1,858,000.00	\$ 1,858,000.00
Financing gap	--	\$ 504,000.00

Even as the economy began to recover, it was clear that the composition of the LIHTC market had been permanently altered. While banks remain key players, commentators noted that bank LIHTC investments were “scaled back” after the financial crisis,¹⁹³ and some have suggested that banks’ continued participation in the market is solely to maintain ratings under the CRA.¹⁹⁴ In comparison, it is unlikely that the GSEs will return to the LIHTC market.¹⁹⁵ The consequences of the financial crisis will continue to affect demand for LIHTCs.¹⁹⁶ Not only did the crisis actually produce sufficient losses to “offset future taxes for many years to

¹⁹³ Roberts, *supra* note 7, at 13.

¹⁹⁴ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 5; *see also supra* Part II.B.3 (describing community investment incentives for banks under the CRA).

¹⁹⁵ This is primarily due to the size of their current LIHTC holdings, given their previous 40% market share. *See* ELLEN, TYE & WILLIS, *supra* note 153 at 6–7 (“Indeed, given their large holdings, they are unlikely to need the level of tax shelter being provided by these investments for some time, even if they become profitable again.”). In 2009, the Treasury Department blocked Fannie’s attempt to sell half of its \$5.2 billion worth of tax credits, finding that “it would have resulted in a loss of tax revenues greater than the savings to the federal government had it allowed the sale.” Nick Timiraos, *Treasury Blocks the Sale Of Tax Credits by Fannie*, WALL ST. J., Nov. 7, 2009, at B1. As a result, Fannie and Freddie wrote off their LIHTC investments in 2009, which accounted for the majority of their \$9 billion and \$3 billion losses, respectively, that year. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-849, MORTGAGE FINANCING: FANNIE MAE AND FREDDIE MAC’S MULTIFAMILY HOUSING ACTIVITIES HAVE INCREASED 33 (2012).

¹⁹⁶ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 18.

come,”¹⁹⁷ but it also “sensitized” investors to tax liability risk and lowered expectations about future incomes.¹⁹⁸

Despite these long-lasting effects of the financial crisis, the LIHTC market has started to recover in recent years, benefitting in part from the entry of non-bank corporate investors.¹⁹⁹ Low LIHTC prices, which were so devastating to affordable housing projects in the months immediately following the crisis,²⁰⁰ ultimately signaled high yields for a variety of new corporate investors.²⁰¹ These investors have joined banks to replace the GSEs’ abandoned market share.²⁰²

C. Room for Improvement

While many are optimistic about the recent improvement in LIHTC pricing, there are still ways to strengthen the market itself.²⁰³ Financially-driven corporate investors may not stay in the market if yields decrease.²⁰⁴ Comparatively, the banks’ consistent interest in LIHTCs also has shortcomings: namely, the geographic limitations of the CRA.²⁰⁵ The financial crisis exposed affordable housing’s

¹⁹⁷ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 5.

¹⁹⁸ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 19. Markets are forward-looking, and thus changes in expectations drive prices. *See* STEPHAN A. ROSS, NEOCCLASSICAL FINANCE 16–17 (2005) (explaining that returns are based on “innovations” or changes in “state variables,” that such “factors exogenous to the market move returns and that pricing depends on them”).

¹⁹⁹ Pristin, *supra* note 43.

²⁰⁰ *See supra* notes 186–92 and accompanying text (discussing how the financial crisis threatened to collapse the tax credit market).

²⁰¹ Pristin, *supra* note 43.

²⁰² *See* Anderson, *supra*, note 9 (“Companies ranging from insurance companies to Google have filled in the gap left by large investors, such as Fannie Mae and Freddie Mac, that left the tax-credit market during the crash.”).

²⁰³ *See infra* Parts II.C.3 & III (discussing proposals to amend the Internal Revenue Code and CRA, and a potential role for individual investors in the LIHTC market).

²⁰⁴ Pristin, *supra* note 43.

²⁰⁵ Buzz Roberts, *Strengthening the Low Income Housing Tax Credit Investment Market*, COMMUNITY REINVESTMENTS, Winter 2009/2010, at 12.

precarious dependence on the homogenous LIHTC investor pool,²⁰⁶ yet Congress has not taken action to broaden or diversify this market.²⁰⁷ While proposals exist to revitalize the LIHTC market by amending the Code and the CRA, such legislative changes are unlikely and would be time-consuming to implement.²⁰⁸

1. Non-Diversified, Profit-Driven Investors

Even though corporate interest has helped restore the LIHTC market, it may only be a temporary solution.²⁰⁹ The presence of new corporate investors has helped stabilize the market and driven up LIHTC prices.²¹⁰ As yields decrease accordingly, proponents of affordable housing have questioned whether the corporate participation in LIHTC investments is permanent or reliable.²¹¹ Company management insists that LIHTC investing activities are both profit- and mission-driven.²¹² Commentators are understandably skeptical: unlike banks, these corporations have no statutory incentive to purchase LIHTCs at low yields.²¹³ Nevertheless, it is possible that these companies see the mission component of their LIHTC investment as increasing a firm's reputational value.²¹⁴

²⁰⁶ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 17.

²⁰⁷ Congress did enact two “stopgap” measures in 2009: the Tax Credit Assistance Program, which was “intended to provide gap financing for projects,” and the Tax Credit Exchange Program, which was “designed to offset the drop in tax credit demand and pricing.” THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 1. However, neither of these programs was “intended to revive demand or improve the market price of tax credits.” *Id.*

²⁰⁸ See *infra* Part II.C.3 (suggesting that making changes to the LIHTC program takes time because the federal government and more than fifty agencies must interpret and implement the changes).

²⁰⁹ Anderson, *supra* note 9.

²¹⁰ Pristin, *supra* note 43.

²¹¹ Anderson, *supra* note 9.

²¹² Pristin, *supra* note 43 (“Brent Callinicos, a Google vice president, took note in a statement of the ‘void in affordable housing investment’ and said the tax credit investments ‘allows us to further our goal of providing relief to people who otherwise may not have access to quality housing.’”).

²¹³ Anderson, *supra* note 9.

²¹⁴ See, e.g., Joseph Pereira, *Doing Good and Doing Well: Timberland Cultivates a Corporate Culture of Altruism to Attract Valuable Employees*, WALL ST. J., Sept. 9, 2003, at B1 (“Timberland’s generosity isn’t entirely

Whether that value is worth sacrificing financial yields remains to be seen, however, since corporations are ultimately responsible to their shareholders, a permanent preference for societal reputation at the expense of company returns seems unlikely.

2. CRA Gaps

The CRA has motivated banks to continue investing in LIHTCs even without a present need for the credits.²¹⁵ However, the statutory incentive has inadvertently limited the geographic scope of bank LIHTC investments.²¹⁶ Under the CRA, agencies evaluate the bank's community reinvestment activities only within its surrounding assessment area.²¹⁷ LIHTC projects located outside of these areas draw substantially less attention from banks and struggle to receive sufficient equity financing.²¹⁸ The lack of CRA-regulated institutions in these areas indicates that projects may have difficulty accessing debt financing as well.²¹⁹

The connection between the CRA and the LIHTC market is the subject of some debate.²²⁰ The two are not linked statutorily,²²¹ and thus, any evidence of the CRA's impact must be extracted from surveys, interviews, and databases.²²² The GAO report discussed above suggested that the CRA's investment test may have an effect on LIHTC demand and pricing,²²³ but did not exhaustively conclude that the CRA is the primary determinant for LIHTC prices.²²⁴ On the

altruistic. Company officials say offering its employees a chance to be good Samaritans helps it attract and retain valuable talent.”)

²¹⁵ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 30.

²¹⁶ Roberts, *supra* note 7, at 13.

²¹⁷ *Id.*

²¹⁸ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 37.

²¹⁹ *See id.* at 43 (observing that “permanent debt financing for tax credit properties is becoming harder to come by and with tighter terms”).

²²⁰ COHNREZNICK LLP, *supra* note 179, at 18.

²²¹ *Id.* at 14.

²²² *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 33, at 15 (utilizing interviews and empirical models); COHNREZNICK LLP, *supra* note 179, at 35 (analyzing LIHTC pricing in metropolitan and non-metropolitan markets).

²²³ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 33, at 14.

²²⁴ *Id.*

other hand, a recent study by accounting firm CohnReznick attempted to establish a correlation between high LIHTC pricing and areas with a high concentration of CRA-regulated banks.²²⁵ In a 2011 interview, Frederick H. Copeman—now a director at CohnReznick’s Tax Credit Investment Services Practice—described LIHTC pricing differences as “unintended, perverse consequences” of the CRA, since banks do not invest in LIHTC housing “in places where they have no depositors.”²²⁶ The CohnReznick study echoes this sentiment, suggesting that banks are only incentivized to make community investments in “densely populated cities,” because CRA evaluations are roughly “based on where the deposits are located.”²²⁷ Because LIHTCs are distributed based on housing needs, the affordable housing program and the CRA are “virtually guaranteed to conflict with one another.”²²⁸ As a result of this mismatch, the study found that “tax credit prices are highest in states dominated by . . . the top five banks.”²²⁹ Although this study is based on anecdotal evidence, the pricing spreads were dramatic: “\$0.35 per \$1.00 of tax credit at the extreme ends of the pricing spectrum between “CRA-hot” and “CRA-not” locations.”²³⁰ The lower credit prices in “CRA-not” areas make it harder for developers to finance affordable housing projects.²³¹

3. Existing Recommendations and Proposals

The above circumstances reflect two current weaknesses in the LIHTC market: investor sensitivity to financial incentives,²³² and a limited geographic scope even where statutory incentives exist.²³³

²²⁵ COHNREZNICK LLP, *supra* note 179, at 18.

²²⁶ Pristin, *supra* note 43.

²²⁷ COHNREZNICK LLP, *supra* note 179, at 17.

²²⁸ *Id.* at 18.

²²⁹ *Id.* at 32.

²³⁰ *Id.* at 45. “CRA-hot” refers to areas with high levels of bank investment activity and “CRA-not” refers to area with less such activity. *Id.* at 18.

²³¹ *See id.* at 28 (explaining how lower capital contributions “require the developer to fill the financing gap by applying for a larger mortgage or by seeking additional ‘soft’ financing from a state or local government agency”).

²³² *See supra* Part II.C.1 (explaining how investors’ capital contributions depend in part on the financial return they expect to achieve).

²³³ *See supra* Part II.C.2 (explaining how CRA-motivated banks generally do not invest in second-tier metros and states where they had no depositors).

These issues join broader concerns about the still largely homogenous investor pool,²³⁴ and have prompted various proposals for reform. Tax-related reforms would permit a five-year carryback for the credits,²³⁵ and amend the passive loss restrictions for individuals and small corporations to encourage the participation of a more diverse group of investors.²³⁶ CRA-related proposals would expand the assessment areas in which banks are evaluated,²³⁷ and apply the CRA to non-bank financial institutions such as mutual funds.²³⁸ These reforms would take extensive legislative time and effort.²³⁹ The ideal solution, rather, should come from the private sector and highlight the strengths of both diversified corporate investors and statutorily-motivated financial entities.

III. Individual Investment in LIHTCs

Encouraging individuals to participate in the LIHTC market would broaden and diversify the investor pool, and has the potential to create a committed investor pool that is not driven solely by financial gain.²⁴⁰ The rise of socially-responsible investing (“SRI”) suggests that significant numbers of individuals are interested in investments with a positive social impact.²⁴¹ LIHTC investment would be a suitable avenue for such investors given the demonstrated need for affordable housing in the United States.²⁴² While passive loss rules currently limit LIHTC benefits for individuals, this ultimately decreases tax liability risk and may actually bring more

²³⁴ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 16.

²³⁵ *Id.* at 19.

²³⁶ Narasimhan, *supra* note 160, at 32; *see infra* Part III.B.

²³⁷ Roberts, *supra* note 7, at 15.

²³⁸ LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 23.

²³⁹ *See* THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 11, at 5 (“Making changes to the LIHTC program takes time because the federal government and more than 50 allocating and administering agencies must interpret and implement rule changes.”).

²⁴⁰ Galloway, *supra* note 12, at 25.

²⁴¹ *See SRI Basics*, US SIF, <http://www.ussif.org/sribasics> (last visited Apr. 16, 2014). Socially-responsible investing is also known as “sustainable and responsible investing.” *Id.*

²⁴² *See supra* Part II.A.

stability to the LIHTC market.²⁴³ Moreover, aggregating individual LIHTC purchases through an online financing platform would effectively utilize economies of scale to achieve sizeable equity investments for affordable housing projects.²⁴⁴

A. Socially Responsible Investing

SRI is a form of investing that takes into account “factors beyond the typical risk and return analysis,”²⁴⁵ often “social or ethical issues.”²⁴⁶ Also known as values-based finance,²⁴⁷ or mission investing,²⁴⁸ SRI became popular in the 1970s,²⁴⁹ although the principles on which it is based have existed for much longer.²⁵⁰ SRI may be divided into three basic strategies: screening investments, shareholder advocacy, and community investment.²⁵¹ However, SRI often implements non-traditional approaches and structures to achieve investors’ desired social impact.²⁵² Developing innovative methods to benefit affordable housing through individual investment in LIHTCs could provide a model for future tax credit investments.

One early example of a groundbreaking SRI model is that of the Domini Money Market Fund (“DMMF”).²⁵³ In 1995, Domini Social Investments, an investment firm led by Andrea Domini,

²⁴³ See *infra* Part III.B.

²⁴⁴ See *infra* Part III.C.

²⁴⁵ Susan N. Gary, *Is It Prudent to be Responsible? The Legal Rules for Charities That Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J.L. & SOC. POL’Y 106, 107 (2011).

²⁴⁶ *Id.* at 110.

²⁴⁷ Elizabeth Ferruelo, *Why Socially Responsible Investing and Islamic Finance Is on the Rise*, FORBES (Nov. 1, 2012, 11:59 AM), <http://forbes.com/sites/ashoka/2012/11/01/why-there-is-high-growth-potential-in-the-nexus-between-socially-responsible-investing-and-islamic-finance>.

²⁴⁸ Gary, *supra* note 245, at 108.

²⁴⁹ *Id.* at 106.

²⁵⁰ For example, some commentators have drawn parallels between SRI and Islamic finance. See, e.g., Ferruelo, *supra* note 247 (“Governed by religious principles, Islamic finance forbids the charging or receiving of interest. Transactions are guided by ethical, moral, and social considerations and the belief that money should be used to create social value, rather than just wealth.”).

²⁵¹ Gary, *supra* note 245, at 111.

²⁵² See, e.g., *infra* text accompanying notes 253–58 (discussing the Domini Money Market Fund) and notes 332–37 (discussing Mosaic, Inc.).

²⁵³ SANDRA A. WADDOK, *DIFFERENCE MAKERS* 86 (2008).

established an arrangement with the South Shore Bank of Chicago that defied traditional financing definitions.²⁵⁴ The DMMF raised \$56 million from investors, which was then converted into deposits at South Shore Bank.²⁵⁵ The bank then used the deposits to finance projects in underserved Chicago communities.²⁵⁶ The DMMF was not a true money market fund: its assets were not short-term debt and it was not included on any money market lists.²⁵⁷ Rather, Domini created a fund in which investors could “sell [their interest in the] funds, but stay with the social investing criteria.”²⁵⁸ In other words, she captured the short-term liquidity appeal of a money market fund, but gave investors the option of a longer-term relationship with community development, in order to best meet their needs.²⁵⁹ Domini’s model has much in common with modern SRI websites. Kiva Microfund (“Kiva”) members, for example, have the option of re-lending invested funds once the principal is returned.²⁶⁰ These examples suggest that SRI individuals are not solely motivated by short-term gain, but rather, seek a longer-term commitment to communities in need.²⁶¹ The LIHTC presents an ideal opportunity for this kind of investor.

²⁵⁴ *Id.*

²⁵⁵ Dominique Blanc & Samer Hobeika, *The Challenges Facing SRI Money Market Funds* 10 (Novethic SRI Res. Ctr., Working Paper No. 1, Feb. 2009), available at http://www.novethic.fr/novethic/upload/etudes/SRI_Money_Market.pdf.

²⁵⁶ *Id.* at 11 (explaining that the deposits were used “to finance local development projects”).

²⁵⁷ WADDOK, *supra* note 253, at 86; see Blanc & Hobeika, *supra* note 255, at 3 (“Money market funds, also known as cash funds, are comprised of short-term debt.”).

²⁵⁸ WADDOK, *supra* note 253, at 86.

²⁵⁹ See *id.* (“I had felt that if people think the market is going to go down, they’re going to have to sell the fund and go away.”).

²⁶⁰ *How Kiva Works, The Long Version*, KIVA, <http://www.kiva.org/about/how/even-more> (last visited Apr. 16, 2014).

²⁶¹ See US SIF, *THE IMPACT OF SUSTAINABLE AND RESPONSIBLE INVESTMENT* 11 (2013), http://www.ussif.org/Files/Publications/USSIF_ImpactofSRI_Aug2013_FINAL.pdf (suggesting that real estate investment is “a natural outgrowth of *SRI interest in long-term wealth creation*” since it “entails tangible social and environmental impacts that investors can measure, and those impacts are material to *long-term performance* and risk assessment”) (emphasis added).

A common question in SRI literature is whether focusing on social impact entails sacrificing financial return.²⁶² Limiting investments based on non-financial factors could lead a portfolio to underperform,²⁶³ but the “responsible” character of SRI could also serve to limit investor exposure.²⁶⁴ It is difficult to make generalizations about such a broad market, comprised of investments that vary extensively in both structure and amount.²⁶⁵ Nevertheless, there is evidence that certain forms of SRI may outperform traditional investments in periods of financial crisis.²⁶⁶ Much in the same way that the conservative lending practices of smaller financial institutions insulated their losses in the most recent financial crisis,²⁶⁷ SRI also experiences stability in economic downturns.²⁶⁸ This stability could be due to the fact that the investments themselves are less risky,²⁶⁹ but a wealthy investors base also contributed: SRI continued to grow throughout the most recent financial crisis.²⁷⁰

²⁶² EMMA SJÖSTRÖM, THE PERFORMANCE OF SOCIALLY RESPONSIBLE INVESTMENT 6 (2011), <http://ap7.se/PageFiles/1095/The%20Performance%20of%20SRI.pdf>.

²⁶³ *Id.*

²⁶⁴ See JOHN NOFSINGER & ABHISHEK VARMA, SOCIALLY RESPONSIBLE FUNDS AND MARKET CRISES 3 (Dec. 24, 2012), <http://www.geneva-summit-on-sustainable-finance.ch/wp-content/uploads/2013/03/nofsinger.pdf> (“[T]he nature of SRI and ESG dampens the downside risk. Companies that exhibit environment, social, and governance responsibility are less likely to suffer large, negative events in [these] areas during both bull and bear market periods.”).

²⁶⁵ SJÖSTRÖM, *supra* note 262, at 9.

²⁶⁶ NOFSINGER & VARMA, *supra* note 264, at 3.

²⁶⁷ See R. Anton Gilbert, Andrew P. Meyer & James W. Fuchs, *The Future of Community Banks: Lessons from Banks That Thrived During the Recent Financial Crisis*, 95 FED. RES. BANK ST. LOUIS REV. 115, 127 (Mar./Apr. 2013) (citing “conservative lending principles” as “key to [the] success” of community banks during the financial crisis).

²⁶⁸ Ioannis Oikonomou, Chris Brooks & Stephen Pavelin, *The Impact of Corporate Social Performance on Financial Risk and Utility: A Longitudinal Analysis*, 41 FIN. MGMT. 483, 512.

²⁶⁹ See, e.g., NOFSINGER & VARMA, *supra* note 264, at 3 (“[D]isastrous pollution events are less likely in firms with strong environmental green programs. Firms with high social concerns are less likely to undergo employee-related lawsuits.”).

²⁷⁰ Geoff Nairn, *Wise Ethical Investment Seeks Profit*, WALL ST. J. (Dec. 12, 2011), <http://online.wsj.com/news/articles/SB10001424052970204630904577055663749586298>.

Moreover, such socially-motivated investors are more likely to be involved in specialized investments,²⁷¹ and the resulting oversight and commitment can help the underlying projects succeed.

In the LIHTC program, compliance is directly related to an investment's success.²⁷² One of the most frequently cited reasons for the LIHTC program's longevity is that private investors have sufficient "skin in the game."²⁷³ The risk of recapture keeps investors involved in affordable housing projects through year fifteen.²⁷⁴ The downside to this involvement is that investors often discount for the risk that credits will be recaptured,²⁷⁵ or, seen preventatively, for the risk that they will need to "step in" and supplement their contribution in order to maintain the housing's affordability.²⁷⁶ Investors that care about providing affordable housing, however, should recognize that compliance is both a risk for equity partners and a guarantee for low-income residents.²⁷⁷ Because such individuals are motivated in part by the social impact of their investment, they may assign a higher value to LIHTCs in their capital contributions—and accept lower financial yields—similar to CRA-regulated financial institutions.²⁷⁸

Where the motivation is personal, and not based on statutory incentives, the scope of individual investment can reach areas that

²⁷¹ See *id.* (“[High-net-worth investors] are more likely to use smaller specialist vehicles that invest away from the main markets and focus on one particular theme.”).

²⁷² See *supra* Part I.B.4 (explaining how investors previous years' tax credits are recaptured if a LIHTC property does not comply with low-income housing standards).

²⁷³ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 3.

²⁷⁴ KHADDURI ET AL., *supra* note 39, at 6.

²⁷⁵ See THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 4 (“[I]nvestors were clearly discounting . . . real estate risk . . .”); Narasimhan, *supra* note 160, at 31 (“While real estate investments traditionally include risk of default, LIHTC investments also include compliance risk . . .”).

²⁷⁶ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 3.

²⁷⁷ See KHADDURI ET AL., *supra* note 39, at 6 (describing “tax credit recapture” as a “powerful enforcement mechanism”).

²⁷⁸ See Nairn, *supra* note 270 (“Impact investors are often—but not always—prepared to sacrifice some financial returns to help boost the social impact of their investments.”).

are overlooked by banks.²⁷⁹ Yields in these areas will most likely be high, at least at first.²⁸⁰ For corporations, accountability to shareholders may operate as an incentive to abandon these areas as yields decrease.²⁸¹ In contrast, SRI individuals lack this external pressure and are more likely to remain, even if the potential LIHTC profit decreases.²⁸² Indeed, in order to serve the areas most in need of affordable housing financing, as well as their own social impact goals, SRI individuals may be motivated to invest specifically in communities that are ignored by CRA-regulated institutions.²⁸³

Table 5 places the \$4 million affordable housing project from Table 2 in three different markets and predicts the investor capital contributions a developer could receive in each. Market A is a CRA assessment area where banks contribute capital at \$0.95 per LIHTC. Market B is a CRA-gap area, ignored by banks, but occupied by several economic investors who hope to profit from the less competitive LIHTC environment by making capital contributions at \$0.70 per credit. Market C is also a CRA-gap area, but in addition to economic investors, SRI individuals have also partnered with the developer for half of the credits (\$1,260,000), and contribute capital to the partnership at \$0.90 per credit. The presence of these socially-motivated individual investors helps the developer cover more of his costs.

²⁷⁹ See Galloway, *supra* note 12, at 25 (“[I]ndividual investors would also help round out the LIHTC market’s financing of smaller projects and underserved geographies.”).

²⁸⁰ Anderson, *supra* note 9.

²⁸¹ *Id.*

²⁸² Nairn, *supra* note 270.

²⁸³ Many SRI individuals not only want to “know[] their money is helping make the world a better place” in the abstract, but are also drawn to causes that “focus on one particular theme.” *Id.*

Market	A	B	C	<u>IRR</u> ²⁸⁴	
Total cost	\$ 4,000,000.00	\$ 4,000,000.00	\$ 4,000,000.00		
Total credit award	\$ 2,520,000.00	\$ 2,520,000.00	\$ 2,520,000.00		
Equity					
<i>Banks</i>	\$ 2,394,000.00	--	--		0.94%
<i>Economic investors</i>	--	\$ 1,764,000.00	\$ 882,000.00		7.07%
<i>Individuals</i>	--	--	\$ 1,134,000.00		1.96%
Total capital contribution	\$ 2,394,000.00	\$ 1,764,000.00	\$ 2,016,000.00		
Percentage of costs	60%	44%	50%		

B. Passive Loss Rules

The same act of Congress that created the LIHTC also enacted passive loss rules to curtail the perceived abuse of tax shelters.²⁸⁵ These rules, found in section 469 of the Code, limit individuals' ability to benefit from certain passive investing activities.²⁸⁶ Section 469 broadly prohibits individuals from using passive activity losses or credits against ordinary income.²⁸⁷ However, an exception permits "natural persons" to

²⁸⁴ The internal rate of return ("IRR") of an investment is the "discount rate which equates the present value of the opportunity to the initial investment required." Herbert Kierulff, *MIRR: A Better Measure*, 51 BUS. HORIZONS 321, 322 (2008). Here, it is used to compare the different expectations of investors given their capital contributions at different LIHTC prices.

²⁸⁵ ARTHUR B. WILLIS, JOHN S. PENNELL & PHILLIP F. POSTLEWAITE, *PARTNERSHIP TAXATION* § 8.01.

²⁸⁶ *Id.* § 8.01[2].

²⁸⁷ See 26 U.S.C. § 469(a) (2012) ("[N]either . . . the passive activity loss, nor . . . the passive activity credit, for the taxable year shall be allowed."). The Community Revitalization Tax Act of 1989 included a proposal to limit section 469's application to passive activity losses, and not credits, in order

utilize up to a \$25,000 “deduction equivalent” of credits earned from “rental real estate activities.”²⁸⁸ Normally, this permitted amount would decrease if the investor’s adjusted gross income rose above \$100,000,²⁸⁹ however, low-income housing tax credits are explicitly exempt from this “phase-out.”²⁹⁰ The annual LIHTC amount available to an investor is thus \$25,000 multiplied by the individual’s tax bracket.²⁹¹ While the dollar-for-dollar nature of the investment remains, this calculation effectively creates a ceiling on the amount of LIHTCs a rational individual would be willing to purchase, and that ceiling varies with the individual’s bracket.²⁹² For example, an individual in the 39.6% bracket could use up to \$9,900 in credits per year, but an individual in the 28% bracket would only have \$7,000 available per year.²⁹³

The investors’ initial contribution to a LIHTC partnership reflects the fact that the credits are taken over a ten year period.²⁹⁴ Thus, if investors can only use \$7,000 in credits per year, they will only purchase a maximum of 70,000 credits, which, at \$0.90 per credit, would be a capital contribution of \$63,000.²⁹⁵ Thus, due to the passive loss rules, individual contributions are much smaller than a corporate LIHTC investment.²⁹⁶ On the other hand, because

to “increase the pool of investors eligible to use the [LIHTC],” but the proposal was not successful. Kaye, *supra* note 22, at 875–76.

²⁸⁸ § 469(i).

²⁸⁹ § 469(i)(3).

²⁹⁰ § 469(i)(3)(D).

²⁹¹ § 469(j)(5) (“The deduction equivalent of credits from a passive activity for any taxable year is the amount which (if allowed as a deduction) would reduce the tax liability for such taxable year by an amount equal to such credits.”).

²⁹² See *How Do Housing Tax Credits Work?*, *supra* note 3 (“Credits reduce tax liability dollar-for-dollar Deductions reduce tax liability by the amount of the deduction times the tax rate.”). The deduction equivalent calculation does not convert tax credits into deductions, but merely limits the amount of credits an investor may take in a year. See Forrest David Milder & Ronald S. Borod, *Rehabilitation Tax Credit and Low-Income Housing Tax Credit*, 584 TAX MGMT. (BNA) U.S. INCOME A-129 (2012) (“[A] taxpayer may use the credit—up to a deduction equivalent amount of \$25,000 per year”).

²⁹³ Thirty-nine point six percent of \$25,000 is \$9,900. Twenty-eight percent of \$25,000 is \$7,000.

²⁹⁴ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 33, at 13.

²⁹⁵ Ten years of \$7,000 in credits is \$70,000, multiplied by \$0.90 per credit is \$63,000.

²⁹⁶ See Galloway, *supra* note 12, at 26 (“Tax-credit-financed deals can be multimillion dollar projects. New construction financed by LIHTCs can require raising tax credit equity of 70 percent of eligible construction costs.”).

individuals' tax savings are limited, they have much less tax liability risk.²⁹⁷ Individual investors would need to predict a smaller annual tax burden, compared to the much larger, and therefore riskier, anticipated tax liabilities of corporations.²⁹⁸

Table 5 envisioned a scenario in which individual investors made a capital contribution of \$1.134 million and received \$1.26 million in tax credits over ten years. Table 6 establishes that for each investor to fully enjoy the use of these credits under the passive loss rules, the award would need to be split evenly among at least thirteen investors at the 39.6% tax bracket.²⁹⁹ However, Table 7 demonstrates that as more investors are added, the passive loss rules present less of a limitation on investment.³⁰⁰

Table 6				
Minimum Number of Investors to Avoid Cap under Section 469				
Total credits	\$ 1,260,000.00			
Capital contribution (\$0.90 per credit)	\$1,134,00.00			
<i>Investor Brackets</i>	39.6%	35%	33%	28%
Maximum annual credits per investor (\$25,000 deduction equivalent)	\$ 9,900	\$8,750	\$8,250	\$7,000
Maximum total credits per investor	\$ 99,000	\$ 87,500	\$82,500	\$70,000
Minimum number of investors	13	14	15	18

²⁹⁷ See *supra* note 139 (defining tax liability risk as the risk that investors would not have sufficient income to benefit from the tax credits).

²⁹⁸ See *id.* at 3 (“Most corporate investors are reluctant to make such a long-term investment because they cannot dependably forecast their tax liability that far in advance.”).

²⁹⁹ See *infra* Table 6 (calculating the minimum number of investors for each tax bracket if each investor uses the maximum number of credits).

³⁰⁰ See *infra* Table 7 (demonstrating that only a small percentage of the permitted deduction equivalent amount is used up if 150 investors participate in the initial capital contribution.)

Table 7 \$1.26 Million in Credits Split Evenly Among 150 Investors				
Individual total credits	\$ 8,400			
Individual capital contribution (\$0.90 per credit)	\$7,560			
Individual annual credits	\$ 840			
<i>Investor Brackets</i>	39.6%	35%	33%	28%
Percentage of \$25,000 deduction equivalent	8%	10%	10%	12%

Modification of the passive loss rules is a frequent component of LIHTC reform proposals.³⁰¹ A wide-scale relaxation of the passive loss rules would almost certainly increase individual LIHTC investments.³⁰² Commentators disagree, however, as to whether individual investor participation in the market is possible without amending the passive loss rules.³⁰³ Many feel that the administrative hurdle is too great: the limited return necessitated by the passive loss rules would require hundreds of individuals to pool their investments in order to create an equity contribution large enough to finance a typical affordable housing project.³⁰⁴ The per capita transaction costs could grow to “prohibitive” levels.³⁰⁵ On the other hand, it may be possible to limit costs by utilizing “economies of scale.”³⁰⁶ If one accepts that transaction costs could be kept low,

³⁰¹ See, e.g., LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at 22 (“Of the consensus proposals put forward by the industry, the proposal to relax passive loss rules for some subchapter S and C corporations is the one most focused on bringing in new investors and improving demand outside of major metros.”); Narasimhan, *supra* note 160, at 32 (“For example, changes to passive loss rules that limit investment by closely held C, sub-S and LLC corporations would allow greater involvement from community banks and other potential investors.”).

³⁰² Galloway, *supra* note 12, at 26.

³⁰³ See *infra* notes 304–06 and accompanying text (discussing conflicting opinions on whether the administrative hurdles of individual investment may be surmounted with economies of scale).

³⁰⁴ KORB, *supra* note 42, at 23.

³⁰⁵ Galloway, *supra* note 12, at 26.

³⁰⁶ *Id.* at 27.

the remaining question is what form individual LIHTC investment should take.³⁰⁷

C. Online Models: Crowdfunding, Peer-to-Peer Lending, and Microfinance

Although passive loss rules effectively curb the amounts individuals invest in LIHTCs, aggregating the relatively small investments through a website could successfully incorporate individual wealth into the LIHTC market.³⁰⁸ Models already exist for this kind of financing.³⁰⁹ Pooling together capital from many individual investors shares much in common with crowdfunding, which has historically been used for political campaigns and disaster relief, and has more recently expanded to support a variety of artistic and entrepreneurial initiatives.³¹⁰ A LIHTC investment website could also be viewed as the equity version of peer-to-peer lending, in which borrowers receive loans from other individuals without relying on banks.³¹¹ Using individual wealth to support affordable housing projects especially resembles a subset of peer-to-peer lending—microfinance—where lenders make loans to low-income individuals who cannot use traditional credit.³¹² This concept aligns with the idea that individuals could restore the LIHTC markets in areas ignored by CRA-regulated banks.³¹³ By following in the tradition of these successful web-based models, developers could connect with large numbers of individual investors, whose combined capital contribution would help cover affordable housing start-up costs.³¹⁴

³⁰⁷ See *infra* Part III.C.

³⁰⁸ Galloway, *supra* note 12, at 26.

³⁰⁹ See *infra* notes 310–12.

³¹⁰ *Microfinance, Crowdfunding, and Peer-to-Peer Lending Explained*, LENDING CLUB BLOG (Oct. 22, 2010, 4:00 AM), <http://blog.lendingclub.com/2010/10/22/microfinance-crowdfunding-and-peer-to-peer-lending-explained>.

³¹¹ *Id.*

³¹² *Id.*

³¹³ See *supra* notes 279–83 and accompanying text (suggesting that socially-motivated individuals could fill an important investing role in CRA gap areas).

³¹⁴ See Lisa T. Alexander, *Cyberfinancing for Economic Justice*, 4 WM. & MARY BUS. L. REV. 309, 312 (2013) (“These crowdfunding websites help entrepreneurs connect with large numbers of people at once, across the globe, to seek financing.”).

At least one author has recognized the peer-to-peer lending model's suitability for LIHTC-financed affordable housing.³¹⁵ Observing the success of platforms like Kiva and LendingClub, Ian Galloway—an Investment Associate at the Federal Reserve Bank of San Francisco—suggests that “the same technology could be adapted” for arranging LIHTC investments over the Internet.³¹⁶ Galloway emphasizes the “tradeoff between complexity and cost.”³¹⁷ The simplest and least expensive way for individuals to participate in the LIHTC market would be to connect with developers directly.³¹⁸ However, the complexity of a typical LIHTC transaction may ward off individual investors.³¹⁹ Purchasing LIHTCs through a syndicator or fund may be more user-friendly and attract greater numbers of diverse investors.³²⁰ The syndicator model would likely be most effective at funding deals, though more costly than the direct investment model.³²¹

The complexity and costs of either model are adjustable.³²² In the simplest model Galloway describes, developers “promote the project’s financial and social merits as well as set the initial price for the credits,” leaving investors with a sizeable due diligence burden.³²³ However, the website could also serve as an intermediary between developers and individual investors in order to shift some of the information costs.³²⁴ A site like Kiva, for example, enlists “field partners” to vet borrowers.³²⁵ Importantly however, Kiva does not guarantee or insure the risks its members experience as

³¹⁵ Galloway, *supra* note 1213, at 26.

³¹⁶ *Id.*

³¹⁷ *Id.* at 27.

³¹⁸ *Id.* at 26.

³¹⁹ *Id.*

³²⁰ *Id.* at 27.

³²¹ *Id.*

³²² See *infra* notes 324–31 and accompanying text (proposing modifications to reduce the complexity of the direct investment model and reduce the costs of the syndicator model).

³²³ Galloway, *supra* note 12, at 26.

³²⁴ See Alexander, *supra* note 314, at 338 (“Thus, users on P2P lending platforms may not know each other before meeting and connecting online, but they come to know a bit more about each other, in this cyberspace, through the information that the P2P lending platforms collect and publish.”).

³²⁵ *Field Partner’s Role*, KIVA, <http://www.kiva.org/about/risk/field-partner-role> (last visited Apr. 16, 2014).

microlenders.³²⁶ Instead, it encourages members to “diversify [their] Kiva portfolio, thus reducing [their] exposure to any one borrower.”³²⁷

Diversification is a major benefit of the syndicator model, as the syndicator could “create limited liability investment funds that invest in a range of tax credit deals on behalf of” investors.³²⁸ The syndicator’s expertise in investment and diversification generates most of this model’s high fees, as would any guarantees it provides.³²⁹ However, the design of the fund also affects costs: for example, a fund that allowed individuals to invest in tranches of credits separated by their remaining compliance period would be more complex and costly.³³⁰ Additionally, the identity of the syndicator matters: a for-profit intermediary would charge higher fees and interest rates than a 501(c)(3) non-profit organization.³³¹

Mosaic, Inc. (“Mosaic”) is a new company that merges crowdfunding with tax credit equity to finance solar energy projects.³³² Developers use energy investment tax credits (“ITCs”)³³³ to fund solar energy projects much in the same way they use LIHTCs to fund affordable housing projects.³³⁴ However, energy ITC equity

³²⁶ *Risk and Due Diligence*, KIVA, <http://www.kiva.org/about/risk> (last visited Apr. 16, 2014).

³²⁷ *Id.*

³²⁸ Galloway, *supra* note 12, at 27.

³²⁹ *See id.* (“While the syndicator model would likely make tax credit investments more manageable, syndicator fees would reduce investor yield.”).

³³⁰ Narasimhan, *supra* note 160, at 32.

³³¹ *Compare, e.g., Lending Money Is Easy with SoMoLend!*, SOMOLEND, <https://www.somolend.com/Lend/LenderInfo.aspx> (last visited Apr. 16, 2014) (“Upon accepting a loan offer, SoMoLend charges a 4% origination fee . . . Upon completion of a loan transaction, SoMoLend charges a 1.8% portfolio management fee.”), with *How Kiva Works, The Long Version*, KIVA, <http://www.kiva.org/about/how/even-more> (last visited Apr. 16, 2014) (“Interest rates are set by the Field Partner, and that interest is used to cover the Field Partner's operating costs. Kiva doesn't charge interest to its Field Partners and does not provide interest to lenders.”). Kiva, unlike SoMoLend, is a 501(c)(3) non-profit organization. KIVA, <http://www.kiva.org> (last visited Apr. 16, 2014).

³³² Jesse Morris, *How Crowdfunding Lowers the Cost of Solar Energy*, GREENBIZ.COM (Feb. 27, 2013), <http://www.greenbiz.com/blog/2013/02/27/how-crowdfunding-lowers-cost-solar-energy>.

³³³ 26 U.S.C. § 48 (2012).

³³⁴ US PARTNERSHIP FOR RENEWABLE ENERGY FINANCE, TAX CREDITS, TAX EQUITY AND ALTERNATIVES TO SPUR CLEAN ENERGY FINANCING I

is more expensive than LIHTC equity, as commercial investors in this field demand a greater return.³³⁵ Mosaic sought loans from individuals as a means of decreasing its cost of capital.³³⁶ Thus, while the individual investors did not purchase energy ITCs, their capital investment lowered the amount that developers had to raise from commercial tax credit purchasers, reducing the costs of solar energy in general.³³⁷

Like the ideal LIHTC investor, these individuals were socially-motivated.³³⁸ While the company's most recent projects have annual returns between 4.4% and 7%,³³⁹ the social commitment of their investor base was evidenced by a willingness to front solar energy costs for no initial return on their investment.³⁴⁰ Mosaic,

(Sept. 2011), available at <http://uspref.org/wp-content/uploads/2011/09/Tax-Credits-Tax-Equity-for-Clean-Energy-Financing.pdf>.

³³⁵ Compare Morris, *supra* note 332 (“Currently, capital for commercial solar projects comes from two main sources: tax equity providers (at about 18% interest) and solar developers (at about 17% interest).”), with THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 20 (“At pricing between 90 cents and a dollar, these investors were essentially accepting four to six percent returns . . .”).

³³⁶ Morris, *supra* note 332. Mosaic's model does not offer individuals an opportunity to purchase energy ITCs, but this may be due to the future of energy ITCs being more uncertain than that of LIHTCs. See Uclia Wang, *Mosaic: Making Money from Solar and Beyond*, RENEWABLEENERGYWORLD.COM (Apr. 29, 2013), <http://renewableenergyworld.com/rea/news/article/2013/04/mosaic-making-money-from-solar-and-beyond> (“How well Mosaic could draw investors will partly depend on the availability of public subsidies, which still play an important role in making solar an attractive investment. One of the key subsidies is a 30 percent federal investment tax credit that is due to expire by the end of 2016.”).

³³⁷ Morris, *supra* note 332.

³³⁸ *Why Impact Investing?*, MOSAIC, <https://joinmosaic.com/impact-investing> (last visited Apr. 16, 2014).

³³⁹ *Return on Investment*, MOSAIC, <https://joinmosaic.com/return-on-investment> (last visited Apr. 16, 2014).

³⁴⁰ See Peter Kelly-Detwiler, *Solar Crowd-Funding: Assembling the Mosaic*, FORBES (Jan. 7, 2013, 3:51 PM), www.forbes.com/sites/peterdetwiler/2013/01/07/solar-crowd-funding-assembling-the-mosaic (“Until recently, the organization was able to provide an avenue for people to fund solar projects, but not to receive a positive return on investment. That's right. If you invested \$1,000, you got your capital back and no more. Who would be interested in that? As it turned out, 400 individuals anted up \$350,000 to fund 5 projects totaling 73 kW. These included community

having already raised over \$5.6 million for twenty solar projects, demonstrates SRI's high potential for success.³⁴¹ Although the scale of the projects is "dwarfed" by the size of the market, Mosaic shows that individual investment can "co-exist" with larger commercial enterprises.³⁴² Affordable housing could benefit similarly from the participation of motivated individual investors in the LIHTC market.

IV. Legal and Tax Hurdles to Individual Investment

Brokering LIHTC deals through a website implicates developing areas of the Code and securities laws.³⁴³ Ideally, the IRS should treat the initial investments in a LIHTC partnership as non-taxable capital contributions.³⁴⁴ However, in two recent cases involving historical rehabilitation tax credits ("HRTCs"), the IRS has challenged these partnership transactions and won, resulting in unfavorable tax treatment to the investors³⁴⁵ and generating uncertainty throughout the larger tax credit industry.³⁴⁶ Additionally, one potential difference between the peer-to-peer lending platforms Galloway mentions,³⁴⁷ as well as the Domini³⁴⁸ and Mosaic³⁴⁹ examples described above, is that LIHTC investors have an equity share in the affordable housing project instead of a debt interest.³⁵⁰

centers and other non-profits, and the projects generated 2700 job-hours of local employment.").

³⁴¹ *Browse Investments*, MOSAIC, <https://joinmosaic.com/browse-investments> (last visited Apr. 16, 2014); *Prospectuses*, MOSAIC, <https://joinmosaic.com/prospectuses> (last visited Apr. 16, 2014).

³⁴² Kelly-Detwiler, *supra* note 340.

³⁴³ See discussion *infra* Parts IV.A–B.

³⁴⁴ Capital contributions are a non-recognition event for partnerships and do not create taxable gain or loss. 26 U.S.C. § 721(a) (2012).

³⁴⁵ *Historic Boardwalk Hall, LLC v. Comm'r*, 694 F.3d 425, 463 (3d Cir. 2012); *Virginia Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129, 146 (4th Cir. 2011).

³⁴⁶ Janet A. Meade, *IRS Wins Again on Appeal of Rehabilitation Credit*, 214 J. ACCT. 64, 64 (Nov. 2012).

³⁴⁷ See *supra* notes 316–22 and accompanying text (discussing Kiva and LendingClub).

³⁴⁸ See *supra* notes 254–59 and accompanying text (discussing Domini).

³⁴⁹ See *supra* notes 332–42 and accompanying text (discussing Mosaic).

³⁵⁰ See *supra* notes 91–95 and accompanying text (describing how investors receive an equity interest in a LIHTC partnership). *But see* LONG-TERM LOW INCOME HOUSING TAX CREDIT POLICY QUESTIONS, *supra* note 11, at

Thus, pending regulation on crowdsourcing equity may also impact how the platform is regulated and whether the LIHTCs are securities.³⁵¹ If LIHTCs are securities, the partnerships that offer them may face steep compliance costs under the securities laws' regulatory scheme.³⁵²

A. Failed Partnerships

LIHTC investments are usually structured as partnerships or limited liability companies.³⁵³ This ensures that transferring the tax credits to the investors in exchange for the financing produces no initial tax consequences.³⁵⁴ However, if the IRS treats the exchange as a disguised sale instead of a capital contribution, the partnership can end up owing taxes on the gain.³⁵⁵ Similarly, the IRS may also determine that a partnership is not bona fide and reverse the transfer of credits.³⁵⁶ In 2011 and 2012, the IRS used these rationales to successfully challenge two partnerships that invested in HRTCs.³⁵⁷

The HRTC is a tax credit much like the LIHTC, except it is granted for historical rehabilitation projects instead of low-income housing.³⁵⁸ The HRTC covers 10% to 20% of the project's qualified costs,³⁵⁹ and has a shorter compliance period—five years³⁶⁰—instead

20–21 (“[A] housing credit investment in some ways behaves more like subordinate debt than equity . . .”).

³⁵¹ Crowdfunding, 78 Fed. Reg. 66,428, 66,429 (Nov. 5, 2013).

³⁵² Cf. George A. Burke, Jr., *Limited Liability Companies and the Federal Securities Laws: Congress Should Amend the Securities Laws to Avoid Coverage*, 76 IND. L.J. 749, 759 (2001) (“The uncertainty of the judicial analysis of LLC interests as securities also creates significant compliance costs [T]he risks of securities law violations often force firms into costly compliance with securities regulation, even when they eventually would be held not covered by the securities laws.”) (internal quotations omitted).

³⁵³ See *supra* Part I.B.1.

³⁵⁴ 26 U.S.C. § 721(a) (2012).

³⁵⁵ Jerold A. Friedland, “*Disguised Sales*” in *Partnership Transactions: Precepts and Recent Cases*, EMERGING ISSUES 5058, 1 (May 24, 2010).

³⁵⁶ 1 TAXPAYER ADVOCATE SERV., NAT’L. TAXPAYER ADVOCATE: 2013 ANNUAL REPORT TO CONGRESS 328–29 (2013).

³⁵⁷ *Historic Boardwalk Hall, LLC v. Comm’r*, 694 F.3d 425, 463 (3d Cir. 2012); *Virginia Historic Tax Credit Fund 2001 LP v. Comm’r*, 639 F.3d 129, 146 (4th Cir. 2011).

³⁵⁸ 26 U.S.C. § 47 (2012).

³⁵⁹ *Id.* § 47(a).

of the LIHTC's fifteen.³⁶¹ In addition to the federal HRTC, many states have created parallel incentives in their tax codes.³⁶²

1. *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner and Disguised Sales*

In *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*,³⁶³ investors partnered with a series of LLCs and LPs (the "Funds"), which in turn partnered with developers to obtain Virginia state HRTCs.³⁶⁴ Investors contributed \$6.99 million into the Funds in exchange for a 0.01% interest in the partnership.³⁶⁵ The investors' partnership agreements stipulated that investors would receive \$1 of HRTCs for every \$0.74-\$0.80 they contributed.³⁶⁶ More importantly, the partnership agreements stated that the Funds would only purchase HRTCs after "receiv[ing] certification from the [Virginia's Department of Historic Resources] that the rehabilitation constitutes a qualified rehabilitation."³⁶⁷ The agreements also "promised a refund of capital to the investor" if the Funds could not obtain sufficient tax credits.³⁶⁸ The partnership reported a loss on its tax return,³⁶⁹ but the IRS found the investors' initial investments were not capital contributions, and that the partnership instead owed taxes on \$1.53 million of income.³⁷⁰ The tax court agreed with the partnership,³⁷¹ but the Fourth Circuit reversed, siding with the IRS and construing the transaction as a "disguised sale."³⁷²

The Circuit Court analyzed the transfers under section 707 of the Code, which addresses situations where "a partner engages in a

³⁶⁰ *Id.* § 50(a).

³⁶¹ *See supra* notes 80–82 and accompanying text (describing the LIHTC's recapture period).

³⁶² DAVID MILL, NAT'L PARK SERV., FEDERAL TAX INCENTIVES FOR REHABILITATING HISTORIC BUILDINGS: ANNUAL REPORT FOR FISCAL YEAR 2012, 3 (Dec. 2012).

³⁶³ 639 F.3d 129 (4th Cir. 2011).

³⁶⁴ *Id.* at 133.

³⁶⁵ *Id.* at 134–35.

³⁶⁶ *Id.* at 134.

³⁶⁷ *Id.*

³⁶⁸ *Id.*

³⁶⁹ *Id.* at 135.

³⁷⁰ *Id.* at 135–36.

³⁷¹ *Id.* at 132.

³⁷² *Id.* at 146.

transaction with a partnership other than in his capacity as a member of such partnership.”³⁷³ Specifically, section 707 anticipates that certain “transfer[s] of money or property” between a partner and a partnership may be “properly characterized as a sale or exchange of property.”³⁷⁴ The Treasury Regulations, favoring a totality-of-the-circumstances approach, offers a two-prong test for determining whether a transfer constitutes a sale: whether the investor’s “transfer of money . . . would not have been made but for the transfer of” tax credits, and whether the latter transfer of credits was “dependent on the entrepreneurial risks of partnership operations.”³⁷⁵

Both the tax court and the Fourth Circuit found the “but for” test satisfied,³⁷⁶ but the circuit court called the investors’ risk “speculative and circumscribed.”³⁷⁷ The circuit court characterized the investors risk as unlike that of a true entrepreneur and more akin to that of “any advance purchaser who pays for an item with a promise of later delivery,”³⁷⁸ emphasizing their “fixed rate of return,”³⁷⁹ their isolation from “partnership items of income, gain, loss or deduction,”³⁸⁰ and the guarantee “of a refund from the Funds if tax credits could not be delivered or were revoked,”³⁸¹ which the Funds further insured by making “contributions . . . only to completed projects.”³⁸² The Fourth Circuit additionally found five other factors that weighed in favor of finding a disguised sale: (1) the exchange’s “reasonable certainty”; (2) the investor’s “legally enforceable right” to the credits; (3) the security of investing in pre-approved projects; (4) the disproportionate amount of tax credits received for the investors’ comparatively minimal interests; and (5) the lack of an “obligation to return [the credits] to the partnership.”³⁸³ The holding required the partnership to treat the investments as taxable income instead of as non-taxable capital contributions.³⁸⁴ The

³⁷³ 26 U.S.C. § 707(a)(1) (2012).

³⁷⁴ *Id.* § 707(a)(2)(B).

³⁷⁵ 26 C.F.R. § 1.707-3(b)(1) (2013); 26 C.F.R. § 1.707-6(a).

³⁷⁶ *Virginia Historic*, 639 F.3d at 145.

³⁷⁷ *Id.*

³⁷⁸ *Id.* at 145–46.

³⁷⁹ *Id.* at 145.

³⁸⁰ *Id.*

³⁸¹ *Id.*

³⁸² *Id.*

³⁸³ *Id.* at 139, 143–44

³⁸⁴ *Id.* at 146.

resulting tax burden would have substantially reduced the amount of capital available to finance the historical rehabilitation project.³⁸⁵

2. *Historic Boardwalk Hall, LLC v. Commissioner and Non-Bona Fide Partners*

The court in *Historic Boardwalk Hall, LLC v. Commissioner*³⁸⁶ reversed the transfer of federal HRTCs on the grounds that the investment structure was not a bona fide partnership.³⁸⁷ Although the *Virginia Historic* court undertook its “disguised sale” analysis after “[a]ssuming, without deciding, that a ‘bona fide’ partnership existed,”³⁸⁸ the two cases effectively speak to the same issue: the extent to which an investor has exposed himself to risk in a partnership venture.³⁸⁹ In the events leading up to *Historic Boardwalk*, the New Jersey Sports and Exposition Authority (“NJSEA”) was tasked with restoring the East Hall venue located on the boardwalk in Atlantic City.³⁹⁰ After it had secured sufficient financing for the restoration,³⁹¹ a consulting firm contacted NJSEA and recommended selling the HRTCs generated from the project to a corporate investor because, as a tax-exempt entity, NJSEA would have no use for the credits.³⁹² Taking this advice, NJSEA formed a partnership with a wholly-owned subsidiary of Pitney Bowes, Inc. (“Pitney”).³⁹³

Pitney received a 99.9% interest that, unlike the *Virginia Historic* investors’ interest, corresponded to a 99.9% allocation of partnership profits, losses, and tax credits, as well as a 99.9% interest in residual cash flows from the completed project.³⁹⁴ Similar to the

³⁸⁵ A \$1.53 million tax liability on \$6.99 million in contributions would have reduced the Fund’s budget by nearly a quarter (22%).

³⁸⁶ 694 F.3d 425 (3d Cir. 2012).

³⁸⁷ *Id.* at 429.

³⁸⁸ *Virginia Historic*, 639 F.3d at 137.

³⁸⁹ *Historic Boardwalk*, 694 F.3d at 454 n.54.

³⁹⁰ *Id.* at 432.

³⁹¹ *Id.* at 433.

³⁹² *Id.*

³⁹³ *Id.* at 429, 436.

³⁹⁴ *Id.* at 436; *cf. Virginia Historic*, 639 F.3d at 144 (“The investors had essentially *no* interest in partnership profits under their arrangement with the Funds. According to their subscription agreements, most investors owned a .01% partnership interest in one of the Funds . . . [but] were likely unconcerned about the precise amount of their partnership interest because

arrangement in *Virginia Historic*, however, the partnership agreement contained many provisions intended to limit Pitney's risk.³⁹⁵ Pitney only made contributions to the partnership as NJSEA completed restoration activities guaranteed to generate HRTCs.³⁹⁶ NJSEA also purchased a guaranteed investment contract with a portion of Pitney's contributions that was ultimately used to secure Pitney's 3% preferred return.³⁹⁷ NJSEA made numerous additional guarantees to Pitney, including a promise to pay the cash equivalent of any HRTC benefits disallowed by the IRS.³⁹⁸

At the tax court level, the IRS argued that the transaction was a sham without any economic substance.³⁹⁹ However, the tax court pointed to Congress's legislative purpose for HRTCs—to “spur private investment in *unprofitable* historic rehabilitations”—in order to find economic substance in both the tax credits and Pitney's 3% preferred return.⁴⁰⁰ The Third Circuit focused on the IRS's argument that Pitney's arrangement with NJSEA was not a bona fide partnership.⁴⁰¹ The court cited the Supreme Court's partnership test in *Commissioner v. Culbertson*: whether the “parties in good faith and acting with a business purpose intend[] to join together in the present conduct of the enterprise.”⁴⁰² In its analysis of that question, the court relied heavily on the “entrepreneurial risk” rationale of the *Virginia Historic* court,⁴⁰³ as well as the Second Circuit's recharacterization of the *Culbertson* test as a question of debt or

the offering memo told them to expect *no* material amounts of partnership profits. Thus, *the transfer of tax credits to each investor by the partnership had no correlation to each investor's interest in partnership profits whatsoever*. To the contrary, the size of each transfer was tied exclusively to the amount of money the investor contributed to the Funds.”) (second emphasis added).

³⁹⁵ *Id.* at 462; *cf. supra* notes 378–82 and accompanying text (discussing the Fourth Circuit's finding that the *Virginia Historic* investors had also contractually isolated themselves from true entrepreneurial risk).

³⁹⁶ *Historic Boardwalk*, 694 F.3d at 462.

³⁹⁷ *Id.* at 458.

³⁹⁸ *Id.* at 456.

³⁹⁹ *Historic Boardwalk Hall, LLC v. Comm'r*, 136 T.C. 1, 20 (2011).

⁴⁰⁰ *Id.* at 26 (emphasis added).

⁴⁰¹ *Historic Boardwalk*, 694 F.3d at 448.

⁴⁰² *Id.* at 449 (alteration in original) (quoting *Comm'r v. Culbertson*, 337 U.S. 733, 742 (1949)).

⁴⁰³ *Id.* at 454–55.

equity in *Castle Harbor*.⁴⁰⁴ It focused on Pitney's potential upside and downside in the arrangement⁴⁰⁵ to determine whether it had a "meaningful stake in the success or failure of the partnership."⁴⁰⁶

The Third Circuit observed that the partnership agreement "eliminat[ed] [Pitney's] Investment Risk, Audit Risk, and Project Risk,"⁴⁰⁷ permitting Pitney to avoid "all meaningful downside."⁴⁰⁸ Moreover, the circuit court found that Pitney's upside—its 99.9% share in the partnership's residual cash flows—was unrealistic: "To put it mildly, the parties and their advisors were imaginative in creating financial projections to make it appear that [the partnership] would be a profit-making enterprise."⁴⁰⁹ Indeed, even the tax court had noted that East Hall's current deficit was expected given the legislative history of HRTCs.⁴¹⁰ The court reversed the transfer entirely, returning the credits to NJSEA,⁴¹¹ which was unable to use

⁴⁰⁴ *Id.* at 450.

⁴⁰⁵ *Id.* at 455.

⁴⁰⁶ *Id.* at 448.

⁴⁰⁷ *Id.* at 458. The partnership agreement eliminated Investment Risk by conditioning contributions on completion of qualifying rehabilitation costs. *Id.* at 455 ("First, any risk that PB would not receive HRTCs in an amount that was at least equivalent to installments it had made to-date (i.e., the 'Investment Risk') was non-existent. That is so because, under the AREA, PB was not required to make an installment contribution to HBH until NJSEA had verified that it had achieved a certain level of progress with the East Hall renovation that would generate enough cumulative HRTCs to at least equal the sum of the installment which was then to be contributed and all prior capital contributions that had been made by PB."). The partnership agreement also eliminated Audit Risk through a tax benefit guarantee. *Id.* at 456 ("[T]he Tax Benefits Guaranty eliminated any risk that, due to a successful IRS challenge in disallowing any HRTCs, PB would not receive at least the cash equivalent of the bargained-for tax credits (i.e., the 'Audit Risk')."). Additionally, there was no Project Risk, since the East Hall restoration was fully-funded prior to PB's participation. *Id.* ("Third, any risk that PB would not receive all of its bargained-for tax credits . . . due to a failure of any part of the rehabilitation to be successfully completed (i.e., the 'Project Risk') was also effectively eliminated because the project was already fully funded before PB entered into any agreement to provide contributions to HBH.").

⁴⁰⁸ *Id.* at 459.

⁴⁰⁹ *Id.* at 460 n.63.

⁴¹⁰ *Historic Boardwalk Hall, LLC v. Comm'r*, 136 T.C. 1, 26 (2011).

⁴¹¹ 1 TAXPAYER ADVOCATE SERV., NAT'L. TAXPAYER ADVOCATE: 2013 ANNUAL REPORT TO CONGRESS 328–29 (2013).

them due to its tax-exempt status.⁴¹² The holding had a “chilling effect” on the HRTC industry and effectively dried up the supply of equity capital for historical rehabilitation projects.⁴¹³

3. Revenue Procedure 2014-12

After *Historic Boardwalk*, the IRS released Revenue Procedure 2014-12, which outlines a safe harbor for bona fide partnerships investing in HRTCs.⁴¹⁴ Although the revenue procedure only applies to HRTCs,⁴¹⁵ it may offer guidance as to how the IRS would interpret other tax credit investment partnerships,⁴¹⁶ and thus, should be considered when designing an online LIHTC investment platform.

To fall under the safe harbor, the developer and investors must meet several requirements.⁴¹⁷ The developer must retain at least a 1% interest and investors must retain at least a 5% interest.⁴¹⁸ Tax credit allocations must mirror an investor’s interest in the general profits of the partnership.⁴¹⁹ The revenue procedure prohibits any

⁴¹² *Historic Boardwalk*, 694 F.3d at 433.

⁴¹³ Timothy L. Jacobs, *A Dark Future for Historic Tax Credits After Historic Boardwalk*, TAXATION OF EXEMPTS 16 (July–Aug. 2013).

⁴¹⁴ Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 415.

⁴¹⁵ *Id.* at 416.

⁴¹⁶ See Forrest David Milder, *IRS Issues Historic Tax Credit Guidance*, AFFORDABLE HOUS. FIN. (Jan 28, 2014), http://housingfinance.com/affordable-housing/irs-issues-historic-tax-credit-guidance_o.aspx (“The revenue procedure only applies to historic tax credit transactions. Nonetheless, investors or developers in any tax credit transaction should be familiar with its rules.”).

⁴¹⁷ See *infra* notes 418–25 and accompanying text (listing and interpreting the requirements of the safe harbor).

⁴¹⁸ Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 416.

⁴¹⁹ *Id.* at 417. See 26 U.S.C. § 704(b) (2012) (“A partner’s distributive share of income, gain, loss, deduction, or credit . . . shall be determined in accordance with the partner’s interest in the partnership . . . if . . . (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit . . . does not have substantial economic effect.”); 26 C.F.R. § 1.704-1(b)(4)(ii) (2013) (“Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners’ capital accounts Thus, such allocations cannot have economic effect . . . and the tax credits and tax credit recapture must be allocated in accordance with the partners’ interests in the partnership”).

guarantee that fully insures the investor's ability to obtain HRTCs,⁴²⁰ but permits certain unfunded guarantees.⁴²¹ A potentially problematic section of the Revenue Procedure states the following:

The Investor's Partnership interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the Investor's overall percentage interest in the Partnership, *separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes* to be allocated by the Partnership to the Investor.⁴²²

From one point of view, this could be read as requiring the investor's contribution be valued without including the value of the HRTCs.⁴²³ This interpretation seems unlikely, given that Congress intended, by creating HRTCs and similar tax credits, to incentivize investment in otherwise unprofitable ventures.⁴²⁴ On the other hand, this provision may merely require an investment to reflect a "meaningful stake" in the profits of the venture—not just in the tax credits—in order to be considered a "bona fide equity investment."⁴²⁵

⁴²⁰ Rev. Proc. 2014-12, 2014-3 I.R.B. 415, 417.

⁴²¹ *Id.*

⁴²² *Id.* at 416.

⁴²³ Peter J. Berrie et al., *Historic Tax Credits—IRS Issues "Safe Harbor" for Tax-Credit Investors*, FAEGRE BAKER DANIELS (Jan. 13, 2014), <http://www.faegrebd.com/21022>.

⁴²⁴ *Historic Boardwalk Hall, LLC v. Comm'r*, 136 T.C. 1, 20 (2011).

⁴²⁵ See Steven R. Schneider et al., *IRS Issues Historic Rehabilitation Credit Safe Harbor*, TAX LAW ROUNDUP (Dec. 31, 2013), <http://taxlawroundup.com/2013/12/irs-issues-historic-rehabilitation-credit-safe-harbor> ("Informal conversations with drafters of Rev. Proc. 2014-12 have confirmed that this sentence does not mean that the dollar value of the investor's contribution must be commensurate with the non-tax benefits to the investor. Instead, the 'commensurate' language means that the overall percentage interest the investor receives for its money as to the non-tax portions of the investment must be genuine and the economics must not be bled out by any 'funny business' arrangements designed to reduce the value of the investor's partnership interest.").

4. Impact on LIHTC Investment

Both the *Virginia Historic* and *Historic Boardwalk* courts emphasized that the HRTC and the policies behind it were not “under attack.”⁴²⁶ The *Historic Boardwalk* court maintained that its holding did not prohibit a bona fide partner from “capping” its exposure or “negotiat[ing] measures that minimize its risk of losing a portion of its investment in an enterprise.”⁴²⁷ Nevertheless, the decisions have had a “chilling effect” on HRTC partnerships,⁴²⁸ and have caused other tax credit industries to question the holdings’ scope.⁴²⁹ It is unclear where to draw the line between an acceptable “cap” of risk and an impermissible “shield . . . from any meaningful risk.”⁴³⁰

Some commentators have posited that *Virginia Historic* and *Historic Boardwalk* do not threaten LIHTC investments.⁴³¹ An LIHTC investor’s fifteen-year compliance period may provide sufficient exposure to a “meaningful downside.”⁴³² At five years, the compliance period for HRTCs poses a much lower risk of recapture.⁴³³ However, LIHTCs also have much in common with HRTCs. Both are tax incentives created to attract private investment to otherwise “unprofitable activities,”⁴³⁴ which the IRS may attempt to characterize as having no economic substance.⁴³⁵ LIHTC project

⁴²⁶ *Historic Boardwalk Hall, LLC v. Comm’r*, 694 F.3d 425, 462 (2012) (quoting *Virginia Historic Tax Credit Fund 2001 LP v. Comm’r*, 639 F.3d 129, 146 n.20).

⁴²⁷ *Id.* at 459.

⁴²⁸ Jacobs, *supra* note 413, at 16.

⁴²⁹ Milder, *supra* note 416.

⁴³⁰ See *Historic Boardwalk*, 694 F.3d at 459 (“Here, however, the parties agreed to shield PB’s ‘investment’ from any meaningful risk.”).

⁴³¹ Wayne Hykan, *Perspective: The LIHTC After Historic Boardwalk Hall*, AFFORDABLE HOUS. FIN. (Sept. 1, 2012), <http://housingfinance.com/economic-development/perspective--the-lihtc-after-historic-boardwalk-hall.aspx>; Milder, *supra* note 416.

⁴³² Hykan, *supra* note 431.

⁴³³ *Historic Rehabilitation Tax Credit Recapture Survey*, NAT’L TRUST FOR HISTORIC PRES. 3 (2013), http://ntcicfunds.com/wp-content/uploads/2013/01/historic-tax-credit_recapture-survey_021512.pdf.

⁴³⁴ Stearns, *supra* note 20, at 206–07.

⁴³⁵ See, e.g., *Historic Boardwalk Hall, LLC v. Comm’r*, 136 T.C. 1, 20 (2011) (“Respondent argues that Historic Boardwalk Hall is a sham because it lacked objective economic substance and that its partners lacked any

financing can also resemble that of HRTC ventures, as developers may secure non-tax credit financing prior to seeking tax credit equity.⁴³⁶ Such a timeline may be construed as reducing the risks of the enterprise.⁴³⁷

An online platform for individual LIHTC investors should take these recent cases into account. The platform should not oversimplify the transactions and should ensure that individual investors are both exposed to and aware of the project's risks.⁴³⁸ If Revenue Procedure 2014-12 offers any guidance, investor ownership interests should match their tax credit allocations,⁴³⁹ and syndicators should avoid offering guarantees or refunds.⁴⁴⁰ Not providing guarantees will help keep costs low,⁴⁴¹ though it may unnecessarily dissuade risk-averse individuals from entering the LIHTC market.⁴⁴²

business motivation other than transferring historic tax credits from NJSEA to Pitney Bowes.”).

⁴³⁶ KORB, *supra* note 94, at 50.

⁴³⁷ As long as the project is not fully-funded prior to investor participation, risk will still be a factor. *Cf.* Historic Boardwalk Hall, LLC v. Comm’r, 694 F.3d 425, 456 (2012) (“[A]ny risk that PB would not receive all of its bargained-for tax credits . . . due to a failure of any part of the rehabilitation to be successfully completed . . . was also effectively eliminated because the project was already fully funded before PB entered into any agreement to provide contributions to HBH.”).

⁴³⁸ The “lack of meaningful risk” would “weigh[] heavily in determining whether” investors are bona fide partners. *Id.* at 459.

⁴³⁹ See *supra* note 419 and accompanying text (explaining how allocations of tax credits lack economic effect, and thus must be reported “in accordance with the partners’ interests”).

⁴⁴⁰ See *supra* notes 420–21 and accompanying text (discussing the prohibition on complete guarantees and carve-out for unfunded guarantees).

⁴⁴¹ Galloway, *supra* note 12, at 27.

⁴⁴² Despite their long recapture period, LIHTCs remain a fairly low-risk investment. See *The Low-Income Housing Tax Credit Program at Year 25: A Current Look at Its Performance*, REZNICK GROUP 6 (Aug. 2011), http://www.cohnreznick.com/sites/default/files/reznickgroup_lihtc_survey_2011.pdf (“The housing tax credit program has historically demonstrated a strong track record of delivering quality housing to low-income families, meeting the expectations of institutional investors and maintaining an annual foreclosure rate that is less than 1% . . .”).

B. Securities Laws

Like tax law, securities law also distinguishes between sale and equity transactions. If investors are viewed as purchasing the tax credits, the Securities and Exchange Commission (“SEC”) will regulate such transfers only if the tax credits are securities.⁴⁴³ If, however, the transaction is construed as an investment in the underlying partnership, such a transfer could fall under recent crowdfunding legislation.⁴⁴⁴ In this scenario, the SEC’s final rules on crowdsourcing equity will determine to what extent individuals may participate in an online LIHTC investment platform, as well as how the website itself will be regulated.⁴⁴⁵

Crowdfunding is a broad term that encompasses many business models.⁴⁴⁶ Contributions to crowdfunded projects will fall under one of three categories: sales,⁴⁴⁷ gifts,⁴⁴⁸ or equity.⁴⁴⁹ Because

⁴⁴³ See Securities Exchange Act of 1934, 15 U.S.C. § 78b (2012) (describing the necessity to regulate “transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets”); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 1 SEC. L. HANDBOOK § 2:1 (2013) (“The securities laws are applicable, of course, only if a security is involved.”).

⁴⁴⁴ Jumpstart Our Business Startups (“JOBS”) Act, Pub. L. No. 112-106, § 302(a)–(b) (2012).

⁴⁴⁵ See Crowdfunding, 78 Fed. Reg. 66,428, 66,429 (Nov. 5, 2013) (“Limitations under existing regulations, including restrictions on general solicitation and general advertising and purchaser qualification requirements, have made private placement exemptions generally unavailable for crowdfunding transactions, which are intended to be made to a large number of potential investors and not limited to investors that meet specific qualifications. Moreover, a third party that operates a Web site to effect the purchase and sale of securities for the account of others generally would, under existing regulations, be required to register with the Commission as a broker-dealer and comply with the laws and regulations applicable to broker-dealers.”).

⁴⁴⁶ See *supra* note 310.

⁴⁴⁷ See Amy Feldman, *Crowdfunded Businesses May Owe Taxes, Too*, REUTERS (Aug. 13, 2012, 12:36 PM), <http://reuters.com/article/2012/08/13/us-column-feldman-crowdfunding-taxes-idUSBRE87C0F120120813> (“Say, for example, a startup uses a crowdfunding site to raise money to develop a new iPhone accessory, and offers ‘rewards’—as these campaigns typically do—of those accessories in various combinations for different pledged amounts. ‘That’s the most common situation, and it’s taxable

LIHTC investors receive credits in exchange for their contribution, the transaction cannot be a gift.⁴⁵⁰ An equity transaction occurs if the investor receives a share in the profits of the underlying partnership,⁴⁵¹ which will lead to regulation under the new crowdfunding legislation.⁴⁵² Even if the transfer is construed as a sale, the SEC may still have jurisdiction if LIHTCs are securities.⁴⁵³ This determination somewhat parallels the analysis in tax court cases that characterize tax credit investment partnerships as not bona fide or as disguised sales.⁴⁵⁴ If a tax credit investment partnership is designed properly, the investor does not purchase LIHTCs, but rather, an interest in the partnership.⁴⁵⁵ Nevertheless, where investors receive the majority of their return in LIHTCs, their investment

because you get something in return,' says [accounting firm] EisnerAmper's [Murray] Solomon.”).

⁴⁴⁸ *Id.*

⁴⁴⁹ *Id.*

⁴⁵⁰ *Id.*

⁴⁵¹ *See, e.g.*, 26 C.F.R. § 1.721-1(a) (2013) (“No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for an interest in the partnership.”).

⁴⁵² Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012) (“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any *profit-sharing agreement*, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract”); JOBS Act, Pub. L. No. 112-106, § 302(a) (2012) (creating a “crowdfunding exemption” for certain “transactions involving the offer or sale of securities” under the Securities Act of 1933).

⁴⁵³ The SEC regulates secondary market sales of securities under the Securities Exchange Act of 1934 (*see supra* note 439), which has essentially the same definition of “security” as the Securities Act of 1933. *See supra* note 452. *Cf.* Securities Exchange Act, 15 U.S.C. § 78c(a)(10) (2012) (“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract”).

⁴⁵⁴ *See supra* Part IV.A.

⁴⁵⁵ *See supra* Part I.B.1.

could be construed as a purchase, especially if an investor's exposure to partnership profits and losses is limited by extensive guarantees.⁴⁵⁶

The SEC can only regulate the sale of LIHTCs without a corresponding partnership interest if the tax credits themselves are securities.⁴⁵⁷ The term "security" is defined in the Securities Act of 1933 and the Securities Exchange Act of 1934.⁴⁵⁸ While neither definition lists tax credits expressly, several groups have commented on whether tax credits may fall under the definition. The National Association of Bond Lawyers ("NABL") has posited that tax credits stripped from Build America Bonds could "most likely" be treated as securities due to "the manner in which [the credits] are created, offered, and sold."⁴⁵⁹ LIHTCs may be considered securities, although under the NABL's rationale, the absence of a secondary market for the credits may weigh against this conclusion.⁴⁶⁰ A 2011 letter ruling by the Massachusetts Department of Revenue found that state tax credits were not securities under state law.⁴⁶¹ Although the Massachusetts state law definition of "security" differed in some substantial respects from the federal definition, it had an expansive provision that included "any other passive investment vehicles that, in the judgment of the commissioner, should be considered to constitute 'securities.'"⁴⁶²

If a LIHTC investment properly falls under the federal definition of a security as a "profit-sharing agreement" or

⁴⁵⁶ See *supra* notes 378–82 and accompanying text (describing how contractual guarantees and provisions that isolated investors from partnership income and losses led the Fourth Circuit to construe the partnership in *Virginia Historic* as a disguised sale.).

⁴⁵⁷ BLOOMENTHAL & WOLFF, *supra* note 443, at § 2:1.

⁴⁵⁸ See *supra* notes 452–53 (defining "securities" under the Securities Act of 1933 and the Securities Exchange Act of 1934).

⁴⁵⁹ *Certain Fed. Sec. Law Aspects of "Tax Credit" Bonds*, NAT'L ASS'N OF BOND LAWYERS 3 (2010), http://nabl.org/uploads/cms/documents/Certain_Federal_Securities_Law_Aspects_of_Tax_Credit_Bonds.pdf.

⁴⁶⁰ See Narasimhan, *supra* note 160, at 31 ("The Low Income Housing Tax Credit (LIHTC) market is fundamentally challenged by the lack of a viable secondary market.").

⁴⁶¹ Mass. Comm'r of Revenue, Ltr. Rul. 11-6 (May 16, 2011), available at <http://www.mass.gov/dor/businesses/help-and-resources/legal-library/letter-rulings/letter-rulings-by-years/2011-rulings/letter-ruling-11-6.html>.

⁴⁶² MASS. GEN. LAWS ch. 63, § 38B(b1/2) (2013).

“investment contract,” it will be regulated by the SEC.⁴⁶³ Both of these terms suggest a financial interest in an underlying enterprise, or equity.⁴⁶⁴ The JOBS Act addressed the possibility of crowdfunding equity from individual investors in 2012.⁴⁶⁵ Title III of the Act—“‘Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012’ or the ‘CROWDFUND Act’”—tasked the SEC with promulgating new rules as “necessary or appropriate for the protection of investors,” in establishing the crowdfunding exemption under the Securities Act of 1933.⁴⁶⁶ The SEC issued proposed rules on October 23, 2013, which set limits on the amounts investors may invest in crowdfunded equity, as well as requirements for issuers.⁴⁶⁷

Title III of the JOBS Act gave private businesses a limited ability to sell securities to non-accredited investors.⁴⁶⁸ In doing so, it allowed everyday individuals to invest in private companies, an opportunity previously only afforded to accredited or wealthy

⁴⁶³ See *supra* notes 452–53 (defining “securities” under the Securities Act of 1933 and the Securities Exchange Act of 1934); see also NAT’L ASS’N OF BOND LAWYERS, *supra* note 459, at 3 (“The definitions of “security” in the 1933 Act and the 1934 Act do not mention specifically interests in tax benefits, nor do those definitions appear to capture indirectly tax credits as a type of the specified securities, except possibly as an ‘investment contract.’”).

⁴⁶⁴ See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (“[A]n investment contract . . . means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.”).

⁴⁶⁵ JOBS Act, Pub. L. No. 112-106, § 302(a)–(b) (2012).

⁴⁶⁶ *Id.* § 302(c).

⁴⁶⁷ See *infra* notes 471–75 and accompanying text (listing the key points of the SEC’s proposed rules to protect investors participating in crowdfunding).

⁴⁶⁸ See § 302(a) (creating the “crowdfunding exemption”). In the SEC’s protection of investors, it affords accredited investors somewhat more independence in their investment decisions because of their sophistication and/or wealth. See 17 C.F.R. § 230.501(a) (defining accredited investor); cf. C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1123–24 (1988) (questioning the assumption that wealthy investors are more sophisticated because they can “bear investment risks”).

investors.⁴⁶⁹ However, the SEC must ensure that such potentially vulnerable investors are protected from fraud.⁴⁷⁰ Thus, the SEC adopted the JOBS Act investment limits in its proposed rules: individuals with incomes under \$100,000 are only permitted to invest the greater of \$2,000 or 5% of their annual income in crowdfunding, and may invest 10% of their income a year if they make \$100,000 or more.⁴⁷¹ Equity issuers may only raise \$1 million per year under the crowdfunding provision,⁴⁷² and must crowdfund through registered broker-dealers or “funding portals.”⁴⁷³ Such intermediaries provide investors with a mechanism to ask questions about a particular offer.⁴⁷⁴ Furthermore, issuers must file certain information with the SEC.⁴⁷⁵ The administrative costs of preparing such filings would almost certainly raise the costs associated with a

⁴⁶⁹ Dave Michaels, *Crowdfunding for Internet Stock Sales Approved by SEC*, BLOOMBERG (Oct. 24, 2013, 12:01 AM), <http://www.bloomberg.com/news/2013-10-23/sec-to-vote-on-crowdfunding-plan-as-white-advances-jobs-act-1-.html>. See also Crowdfunding, 78 Fed. Reg. 66,428, 66,516 (Nov. 5, 2013) (“[W]e believe that many investors affected by the proposed rules would likely be individual retail investors who currently do not have broad access to investment opportunities in early-stage ventures, either because they do not have the necessary accreditation or sophistication to invest in most private offerings or because they do not have sufficient funds to participate as angel investors.”).

⁴⁷⁰ See Crowdfunding, 78 Fed. Reg. at 66,430 (“Congress provided important investor protections for crowdfunding transactions . . . including individual investment limits, required disclosures by issuers and the use of intermediaries. The proposed rules would require that all crowdfunding transactions . . . be conducted through a registered intermediary on an Internet Web site or other similar electronic medium to help ensure that the offering is accessible to the public and that members of the crowd can share information and opinions.”).

⁴⁷¹ JOBS Act, Pub. L. No. 112-106, § 302(a)(6)(B) (2012); Crowdfunding, 78 Fed. Reg. at 66,430.

⁴⁷² § 302(a)(6)(A); Crowdfunding, 78 Fed. Reg. at 66,430.

⁴⁷³ A “funding portal” is defined in the JOBS Act as “any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others” pursuant to the Crowdfunding Exemption under the Securities Exchange Act of 1933. JOBS Act, § 304(b). The SEC proposed rules clarify that “funding portals” are brokers, and subject to the same regulation as brokers under the securities laws. Crowdfunding, 78 Fed. Reg. at 66,458.

⁴⁷⁴ Crowdfunding, 78 Fed. Reg. at 66,430.

⁴⁷⁵ *Id.* at 66,552.

LIHTC investment platform.⁴⁷⁶ However, the benefits of reaching a larger audience of individual investors may outweigh these costs.⁴⁷⁷

V. Conclusion

Bringing individual investors to the LIHTC market would provide many benefits to the low-income rental market. Individuals who are socially-motivated to help provide affordable housing can supplement the role of financially-driven investors and form a more committed presence in underserved communities.⁴⁷⁸ While the current tax treatment of passive activity credits effectively curbs a single individual's ability to participate in LIHTC partnerships,⁴⁷⁹ an online platform could pool the resources of many individuals to create sizeable investments in affordable housing projects.⁴⁸⁰ Creating such a website would require navigating evolving areas of tax law and securities regulation.⁴⁸¹ The IRS may recharacterize the investments as disguised sales, creating a tax liability for developers that subsumes the raised capital.⁴⁸² New securities legislation may also impose strict requirements on partnerships offering tax credits.⁴⁸³ Nevertheless, with some planning, a successful and cost-effective online platform is possible.⁴⁸⁴ Individual investors offer

⁴⁷⁶ *Id.* at 66,438.

⁴⁷⁷ See Dave Michaels, *SEC to Issue Crowdfunding Proposal Easing Investor Verification*, BLOOMBERG (Oct. 18, 2013), <http://www.businessweek.com/news/2013-10-17/sec-to-release-crowdfunding-rule-easing-investor-verification> (“Crowdfunding platforms raised \$2.7 billion in 2012 and funded more than 1 million projects.”).

⁴⁷⁸ Individuals could invest in areas currently ignored by CRA-regulated financial institutions. See *supra* Part II.C.2. The social motivation behind SRI suggests such individuals provide a more permanent investor-base than purely “economic” investors. See *supra* Part II.C.1.

⁴⁷⁹ See *supra* Part III.B.

⁴⁸⁰ See *supra* Part III.C.

⁴⁸¹ See *supra* Part IV.

⁴⁸² See, e.g., *Virginia Historic Tax Credit Fund 2001 LP v. Comm’r*, 639 F.3d 129, 146 (4th Cir. 2011) (“[T]he Funds should have included the money received from investors as income in their tax returns”). A complete nullification of a tax credit investment partnership is also possible. See *Historic Boardwalk Hall, LLC v. Comm’r*, 694 F.3d 425, 429 (2012) (reversing the Tax Court’s allocation of tax credits to the partners).

⁴⁸³ See *supra* Part IV.B.

⁴⁸⁴ See *supra* notes 324–31 and accompanying text (proposing modifications to the direct investment model and syndicator models). There

diversification and stability to the LIHTC market, supporting the continued availability of affordable housing in the United States.⁴⁸⁵

Appendix

The IRS calculates the applicable percentages for determining annual credit amounts on a monthly basis. The applicable percentage is the rate that yields a ten-year credit stream with a present value equal to 70% or 30% of the affordable housing project's qualified costs, depending on whether the developer uses other federal subsidies.⁴⁸⁶ While Congress has instilled a 9% floor for the applicable percentage used to determine annual credit amounts for projects without any other federal subsidies,⁴⁸⁷ the applicable percentage for projects with other federal subsidies (as well as acquisition projects) is still the rate calculated by the IRS. For these projects, Congress intended the stream of credits to cover 30% of a developer's costs.⁴⁸⁸

To calculate the applicable percentage, section 42 instructs the IRS to use a discount rate based on the average of the applicable Federal rates for mid- and long-term debt instruments.⁴⁸⁹

are numerous examples of non-traditional SRI models, whose creativity was the key to their success. Domini (*supra* notes 254–59) and more recently, Mosaic (*supra* notes 332–42) provide two such business models.

⁴⁸⁵ THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM, *supra* note 7, at 16–17.

⁴⁸⁶ 26 U.S.C. § 42(b)(1)(B) (2012).

⁴⁸⁷ Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3002(a), 122 Stat. 2879, 2879 (2008).

⁴⁸⁸ § 42(b)(1)(B).

⁴⁸⁹ § 42(b)(1)(C)(ii) (“The present value . . . shall be determined using a discount rate equal to 72 percent of the average of the annual Federal mid-term rate and the annual Federal long-term rate applicable under section 1274(d)(1) . . .”). The average of the Federal mid- and long-term rates for April 2014 is 2.57%. *See* Rev. Rul. 2014-12, 2014-15 I.R.B. 923 (listing the mid-term AFR as 1.81% and the long-term AFR as 3.32%). Seventy-two percent of that average is 1.85%.

Table 8 Calculation of Applicable Percentage	
Applicable Federal Rates (AFR) for April 2014	
Mid-term	1.81%
Long-term	3.32%
Discount rate (72 % of average)	1.85%

Using the present value formula for a finite series of payments, one can calculate the annual credit amount that yields a stream of payments whose present value covers 30% of the developer's costs.⁴⁹⁰

$$\text{Present Value} = \frac{\text{Annual Credit}}{\text{rate}} \left(1 - \frac{1}{(1 + \text{rate})^{\text{Years}}} \right) \times (1 + \text{rate})$$

One can solve for the annual credit amount as a percentage of costs. In the below equation, present value is 30% of costs, the discount rate is 1.85%, and the period is ten years.

$$\text{Annual Credit (\%)} = \frac{\text{Present Value (\%)} \times \text{rate}}{(1 + \text{rate}) \left(1 - \frac{1}{(1 + \text{rate})^{\text{Years}}} \right)}$$

$$\text{Annual Credit (\%)} = \frac{0.3 \times 0.0185}{(1.0185) \left(1 - \frac{1}{(1.0185)^{10}} \right)} = 0.0325 = 3.25\%$$

⁴⁹⁰ The present value formula for a finite stream of payments is multiplied by $(1 + \text{rate})$ because the tax credits are received at the beginning of the period. See § 42(b)(1)(C)(i), (iii) ("The present value . . . shall be determined . . . as of the last day of the 1st year of the 10-year period . . . and by assuming that the credit allowable under this section for any year is received on the last day of such year."). Thus, present value is determined at the same time as the first annual credit payment. *Id.* Since the default present value formula anticipates the first payment being made at the end of the first period (i.e., one year after the time at which present value is determined), it is appropriate here to multiply the formula by $(1 + \text{rate})$, which effectively moves the stream of annual credits one period backwards in time.

Thus, for a \$4 million affordable housing project with other federal subsidies, where 100% of the costs are incurred for qualified, low-income residences, the annual credits will total 32.5% of the developer's costs. The present value of this credit stream at the 1.85% discount rate is unsurprisingly 30% of the developer's costs. Because there is no applicable percentage floor for affordable housing projects with other federal subsidies, when investors only contribute \$0.85 for every dollar of tax credit, the developer can cover 27.6% of his costs with the investor's capital.

Table 9 Projects with Other Federal Subsidies (3.25% Credit)		
Qualified basis (100% of cost)	\$ 4,000,000.00	
Annual credits (3.25%)	\$ 130,000.00	
Total credit award (over 10 years)	\$ 1,300,000.00	(32.5% of cost)
Present value (using 1.85% discount rate)	\$ 1,198,727.61	(30% of cost)
Equity (\$0.85 per credit)	\$ 1,105,000.00	(27.6% of cost)