

Residual Value Capture in Subsidized Housing

Brandon M. Weiss*

This Article argues that our primary federal subsidized housing production program, the Low-Income Housing Tax Credit (LIHTC), will result in the unnecessary forfeit of billions of dollars of government investment and the potential displacement of tens of thousands of households beginning in 2020 when LIHTC property use restrictions start to expire. The LIHTC example is presented as a case study of an inherent dynamic of public-private partnerships—namely, the potential capture by for-profit providers of “residual value.” For purposes of this Article, this is value generated by a public-private transaction that is unnecessary to incentivize a private provider to deliver the contracted for good or service.

Drawing on corporate organizational theory, which has highlighted the role that nonprofits play in solving certain contract failures and generating positive externalities, the Article argues that, in certain contexts, partnering with nonprofit providers can be an effective approach to increasing the share of residual value that flows to public purposes. The LIHTC program is one such context, given that a nonprofit preference results in a three-sector approach whereby the federal government provides tax credits to nonprofit developers that must attract private investor equity. This framework leverages institutional strengths, including the access to capital of government, the relative fidelity to public purposes of nonprofits, and the market-based underwriting and oversight of for-profit investors.

INTRODUCTION	522
I. HISTORICAL PRECEDENT: POORLY-TAILORED INCENTIVES	526
A. <i>The Rise and Fall of Public Housing</i>	527
B. <i>Second Wave Assisted Housing</i>	528
II. CURRENT LAW: LOW-INCOME HOUSING TAX CREDITS & THE INNOVATION OF INVESTOR OVERSIGHT	531
A. <i>Legislative History</i>	531
B. <i>Program Mechanics</i>	534
1. <i>Legal Rules</i>	534
2. <i>Economics of a Deal</i>	536
3. <i>Partnership Agreement Provisions</i>	538
C. <i>LIHTC Innovations</i>	540
III. A COUNTER-NARRATIVE: RESIDUAL VALUE CAPTURE BY PROFIT-MOTIVATED DEVELOPERS	540

* Visiting Assistant Professor and Lowell Milken Institute for Business Law & Policy Fellow, UCLA School of Law. B.S. Stanford University; M.P.P. Harvard Kennedy School; J.D. Harvard Law School. I would like to thank Scott Cummings, James Grow, Jill Horwitz, and Irene Joe for their formative help in structuring this Article. Thanks also to E. Tendayi Achiume, Anthony Alfieri, Susan Bennett, David Binder, Lance Bocarsly, Raphael Bostic, Maya Brodzyak, Esme Caramello, Beth Colgan, Maureen Carroll, Luz Herrera, Matthew Kahn, Anika Lemar, Jon Michaels, Rachel Moran, Jason Oh, Sanjukta Paul, Margot Pollans, J.L. Pottenger, Alex Wang, and the participants of the UCLA Law Fellows Workshop, the NYU Clinical Law Review Writer’s Workshop, and the Southern California Junior Faculty Workshop for their valuable insights on this project. This Article benefited greatly by generous funding from the UCLA Ziman Center for Real Estate’s Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics. UCLA Institutional Review Board approval was obtained per Study No. 15-000834.

A.	<i>Public-Private Mismatch</i>	541
B.	<i>Expiring-Use Restrictions</i>	543
1.	<i>Investor Exit</i>	543
2.	<i>HUD Data</i>	545
C.	<i>Residual Value Capture</i>	547
IV.	A THREE-SECTOR APPROACH	548
A.	<i>Economic Theory of the Nonprofit: Contract Failures & Positive Externalities</i>	549
B.	<i>The Role of Nonprofit Developers</i>	550
C.	<i>Potential Critiques and Responses</i>	553
1.	<i>Efficiency Concerns</i>	554
2.	<i>Access to Capital</i>	555
3.	<i>Political Realities</i>	557
4.	<i>Vouchers</i>	558
5.	<i>Other Alternatives</i>	559
D.	<i>Implementation</i>	561
	CONCLUSION	563

INTRODUCTION

Federal rental housing policy aimed at low-income United States households has been a highly contentious subject of debate and experimentation for nearly a century. Theoretical arguments about the proper role of government,¹ the relative cost-efficiency of demand- versus supply-side interventions,² and the value of leveraging private sector capital³ have given rise to massive overhauls of federal housing policy, seemingly with each successive generation.

Despite the rigor of the debate, our current federal policy could best be described as deeply inconsistent. On the one hand, since 1949, official United States housing policy objectives have included the oft-quoted “realization as soon as feasible of the goal of a decent home and suitable living environment for every American family.”⁴ On the other hand, fewer than

¹ Compare HOWARD HUSOCK, *AMERICA’S TRILLION DOLLAR HOUSING MISTAKE: THE FAILURE OF AMERICAN HOUSING POLICY* (2003) (arguing that government involvement in housing has harmed intended beneficiaries), with Tim Iglesias, *Our Pluralist Housing Ethics and the Struggle for Affordability*, 42 WAKE FOREST L. REV. 511 (2007) (defining a plurality of “housing ethics” that combine and conflict with one another in ways that can support government intervention).

² See, e.g., William C. Apgar, Jr., *Which Housing Policy is Best?*, 1 HOUSING POL’Y DEBATE 1 (1990) (arguing that studies conducted when rental housing markets were depressed overstate the relative cost-effectiveness of demand-side approaches). For purposes of subsidized housing scholarship, “demand-side” interventions typically refer to those that provide rental assistance directly to eligible households for use on the private market. “Supply-side” interventions subsidize the construction and maintenance of new units.

³ See, e.g., Kirk McClure, *The Low-Income Housing Tax Credit Program Goes Mainstream and Moves to the Suburbs*, 17 HOUSING POL’Y DEBATE 419, 430 (2006).

⁴ Housing Act of 1949, Pub. L. No. 81-171, § 2, 63 Stat. 413, 413 (codified as amended in scattered sections of 12 U.S.C. and 42 U.S.C.) (stating in full, “The Congress declares that the

one in four *eligible* households in the United States receives housing assistance due to funding shortfalls.⁵

The reality on American streets around the country reflects this ambivalence. Homelessness abounds,⁶ and even for those with shelter, soaring rent burdens have required low-income households to make difficult tradeoffs between housing and other necessities.⁷ In the wake of Hurricane Katrina, images of families doubling or tripling up in substandard housing, or waiting in large crowds for housing assistance, shocked the nation. But these images are commonplace in modern American cities.⁸ For example, in 2010, an estimated crowd of 30,000 assembled in Atlanta to obtain an application for federal housing assistance—successful applicants merely gained admission to the local housing authority’s *waitlist*, as none of the agency’s 655 subsidized units currently was available.⁹

This disconnect between our stated policy objectives and the reality on the ground is not one of happenstance. Rather, it is the result of deep-seated philosophical divisions in American thinking about how, if at all, the federal government should respond to the basic economic fact that, left to their own devices, regional housing markets will leave many priced out of decent housing.¹⁰ On one philosophical extreme, a large and growing chorus of ad-

general welfare and security of the Nation and the health and living standards of its people require housing production and related community development sufficient to remedy the serious housing shortage, the elimination of substandard and other inadequate housing through the clearance of slums and blighted areas, and the realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family, thus contributing to the development and redevelopment of communities and to the advancement of the growth, wealth, and security of the Nation.”).

⁵ See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION’S HOUSING 30* (2014), <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs-sonhr-2014-full.pdf> [https://perma.cc/HC5P-JAL9].

⁶ See NAT’L ALL. TO END HOMELESSNESS, *THE STATE OF HOMELESSNESS IN AMERICA 6* (2015), http://www.endhomelessness.org/page/-/files/State_of_Homelessness_2015_FINAL_online.pdf [https://perma.cc/T6DL-DZLT] (stating that 578,424 people experience homelessness in America on a given night per data from the U.S. Department of Housing and Urban Development, the U.S. Census Bureau, and the U.S. Bureau of Labor Statistics). This figure includes 130,000 children under the age of eighteen. See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION’S HOUSING 34* (2015), <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs-sonhr-2015-full.pdf> [https://perma.cc/VY2E-JPU4].

⁷ See JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 6, at 31 (noting the transportation, healthcare, retirement, and food-related cutbacks required of low-income households by rising housing costs).

⁸ The New York City Housing Authority’s waitlist currently lists 270,000 applicants. Mireya Navarro, *As New York Rents Soar, Public Housing Becomes Lifelong Refuge*, N.Y. TIMES (Aug. 3, 2015), <http://www.nytimes.com/2015/08/04/nyregion/as-new-york-rents-soar-public-housing-becomes-lifelong-refuge.html> [https://perma.cc/UF5H-ARXF]; see also Jon D. Hanson & Kathleen Hanson, *The Blame Frame: Justifying (Racial) Injustice in America*, 41 HARV. C.R.-C.L. L. REV. 413, 459 (2006) (“Instead, Katrina’s aftermath gave Americans a glimpse of a far deeper, more systemic problem that many of us, in calmer climatic conditions, managed to overlook, dismiss, or deny.”).

⁹ See Noel Brinkerhoff & David Wallechinsky, *30,000 Line Up for Housing Help in Atlanta*, ALLGOV (Aug. 14, 2010), <http://www.allgov.com/news/top-stories/30000-line-up-for-housing-help-in-atlanta?news=841288> [https://perma.cc/LVN8-LG76].

¹⁰ Although the term “decent housing” requires interpretation, the standards of modern municipal building and zoning codes alone place housing out of reach for the lowest-income

vocates has drawn upon international law and norms to argue for a human right to housing.¹¹ On the other extreme, legal scholars like Robert Ellickson have noted that America provides all citizens with two forms of seed capital: a right to an education and a right to own the fruits of one's own labor.¹² These entitlements, he argues, are superior to housing assistance because they incentivize work.¹³

With few prospects for resolving these broad philosophical divisions in the near term, many scholars and policymakers have instead focused on a related, if more pragmatic, inquiry: assuming the federal government will continue to provide housing subsidies to some subset of low-income households for the foreseeable future, what is the most effective manner of doing so?

Since the Wagner-Steagall Act of 1937,¹⁴ the federal government has experimented with a wide variety of answers to this question, including four predominant and philosophically distinct methods: i) publicly-financed, publicly-owned housing starting in the 1930s (public housing); ii) publicly-financed, privately-owned housing starting in the 1950s (hereinafter "Second Wave Assisted Housing"); iii) vouchers starting in the 1970s; and finally, iv) tax credits since 1986.¹⁵

The last of these approaches has been implemented through the Low-Income Housing Tax Credit (LIHTC) program, incorporated in Section 42 of the Internal Revenue Code.¹⁶ At an annual cost of approximately eight billion dollars, the LIHTC program is by far the predominant source of government investment in rental housing development for low-income

earners. Many have argued that these standards bear some degree of responsibility for housing affordability challenges in the U.S. *See, e.g.*, EDWARD L. GLAESER & JOSEPH GYOURKO, *RETHINKING FEDERAL HOUSING POLICY: HOW TO MAKE HOUSING PLENTIFUL AND AFFORDABLE* 58–87 (Am. Enterprise Inst. ed., 2008).

¹¹ *See, e.g.*, *A RIGHT TO HOUSING: FOUNDATION FOR A NEW SOCIAL AGENDA* (Rachel G. Bratt, Michael E. Stone & Chester W. Hartman eds., 2006) [hereinafter *RIGHT TO HOUSING*]; Maria Foscarinis, *The Growth of a Movement for a Human Right to Housing in the United States*, 20 *HARV. HUM. RTS. J.* 35, 35–40 (2007).

¹² *See* Robert C. Ellickson, *The Untenable Case for an Unconditional Right to Shelter*, 15 *HARV. J.L. & PUB. POL'Y* 17, 30–32 (1992); *see also* Husock, *supra* note 1, at 14 (stating, "The truth is, devoting government resources to subsidized housing for the poor—whether in the form of public housing or even housing vouchers—is not just unnecessary but also counter-productive. It not only derails what the private market can do on its own, but, more important, it has profoundly destructive unintended consequences. For housing subsidies undermine the efforts of those poor families who work and sacrifice to advance their lot in life—and who have the right and the need to distinguish themselves, both physically and psychologically, from those who do not share their solid virtues.").

¹³ Ellickson, *supra* note 12.

¹⁴ United States Housing Act of 1937, Pub. L. No. 75-412, 50 Stat. 888 (codified as amended in scattered sections of 42 U.S.C.).

¹⁵ Note that there is an assortment of other less prominent federal programs that do not fall under these broad categories—most notably, programs that provide block grants to states, such as the HOME Investment Partnerships Program and Community Development Block Grant Program.

¹⁶ I.R.C. § 42 (2012).

households.¹⁷ The program draws on an innovative structure whereby the government allocates tax credits to private developers who in turn “transfer” them to private investors in exchange for equity used to develop rent- and income-restricted housing.¹⁸ Private capital leveraged from the tax credit has helped finance approximately 2.6 million housing units to date, more than twice the number that remains in the public housing stock.¹⁹ As a result, the program is often held up as a paragon of public-private partnerships and heralded as the most successful subsidized housing policy intervention to date.²⁰

Based on historical analysis, data analysis, examples of tax credit deals, and stakeholder interviews, this Article argues that while the *investor* feature of the LIHTC program successfully addressed certain operational failures of the public housing and Second Wave Assisted Housing programs, the LIHTC program’s heavy reliance on *for-profit developers* repeated a critical mistake of the Second Wave Assisted Housing programs. Specifically, the program creates opportunities for the private sector to capture significant “residual value.” For purposes of this Article, this is value generated by a public-private transaction that is unnecessary to incentivize a private provider to deliver the contracted for good or service.

Most central to this Article is the residual value that private owners can capture decades after a LIHTC project has been placed in service. The federal rules impose rent restrictions on LIHTC projects that last for a term of thirty years. Upon the expiration of these restrictions, private owners can legally, and in many instances dramatically, increase rents to market levels.²¹ Based on the underlying financing of these projects, which are heavily subsidized by a variety of government sources, I argue that these backend profits essentially amount to a massive windfall to private owners and are unnecessary to incentivize participation in the program.

¹⁷ Between fiscal years 2014–18, the program is estimated to cost the federal government \$40.5 billion in foregone revenue, or just over \$8 billion per year. JOINT COMM. ON TAXATION, JCX-97-14, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014–2018 26 (2014). This amount dwarfs any other federal supply-side spending programs on subsidized housing construction.

¹⁸ The tax credits provide a dollar-for-dollar reduction of the investors’ tax liability. As discussed *infra* Part II(B), since these tax credits cannot technically be sold from one taxpayer to another, the investor and developer typically enter into a partnership that allocates 99.99% of the tax credits to the investor.

¹⁹ For detailed analysis of the total number of LIHTC units financed to date, see *infra* Part III(B). There remain only 1,133,058 public housing units in operation. CTR. ON BUDGET & POLICY PRIORITIES, FACT SHEET: FEDERAL RENTAL ASSISTANCE I (2015) [hereinafter FACT SHEET].

²⁰ See, e.g., JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE DISRUPTION OF THE LOW-INCOME HOUSING TAX CREDIT PROGRAM: CAUSES, CONSEQUENCES, RESPONSES, AND PROPOSED CORRECTIVES 13 (2009), http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/disruption_of_the_lihtc_program_2009_0.pdf [<https://perma.cc/Y4D5-UVME>] (“The Low-Income Housing Tax Credit (LIHTC) program is widely regarded as the most successful affordable housing production and preservation program in the nation’s history.”); NAT’L ASS’N OF HOME BUILDERS, THE LOW INCOME HOUSING TAX CREDIT: THE MOST SUCCESSFUL AFFORDABLE RENTAL HOUSING PRODUCTION PROGRAM IN OUR NATION’S HISTORY (2011).

²¹ Note that this assumes no additional state or local restrictions.

The capture of residual value can have severe consequences. An analysis of data maintained by the U.S. Department of Housing and Urban Development (HUD) shows that, without further government intervention, the LIHTC program will result in the unnecessary forfeit of billions of dollars of government investment and the potential displacement of tens of thousands of households beginning in 2020 when LIHTC property use restrictions start to expire.

Drawing on corporate organizational theory, which has highlighted the role that the nonprofit firm plays in solving certain contract failures and producing certain positive externalities, I argue that corporate form²² is one important tool that can help channel more residual value to the stated purposes of a program rather than to private profits—for example, by engaging mission-driven nonprofits with interests as much aligned with public purposes as possible, at least in contexts where the relative tradeoffs between nonprofit and for-profit form are minimized. The LIHTC program, I argue, is one such context. Given the unique structure of the program, a nonprofit developer preference would result in a three-sector approach, whereby the federal government allocates tax credits to nonprofit developers that must attract private capital in order to make use of the credits. This approach aims to capitalize on divergent institutional features, including the access to capital of government, the “nondistribution constraint”²³ of nonprofits, and the market discipline of private investors.

The Article proceeds as follows: Part I examines certain operational failures of public housing and Second Wave Assisted Housing based on the lack of effectively calibrated stakeholder incentives. Part II describes the structure of the LIHTC program from a legal, economic, and deal-level perspective, and argues that the investor oversight mechanism improved upon the operational problems of its predecessors. Part III argues that the LIHTC program nonetheless repeats a critical failure from the Second Wave Assisted Housing program by heavily relying on profit-motivated developers that can capture significant residual value. Part IV draws on corporate organizational theory to argue for the positive role that nonprofit developers can play in addressing the residual value problem and argues for a nonprofit developer preference in LIHTC allocation.

I. HISTORICAL PRECEDENT: POORLY-TAILORED INCENTIVES

This Part first briefly reviews problems that arose in the management of the public housing stock often traced to an absence of effective stakeholder incentives. It then explores how Second Wave Assisted Housing incorporated significant economic incentives but failed to calibrate them effectively.

²² The term “corporate form” is used herein specifically to refer to whether an entity is organized as a for-profit or nonprofit.

²³ See *infra* Part IV(A) for discussion of the “nondistribution constraint,” which refers to the prohibition on nonprofits from distributing residual profits to those who control the firm.

This failure resulted in serious physical and financial problems, as well as a massive expiring-use problem in later decades.

A. *The Rise and Fall of Public Housing*

What started as the federal government's first comprehensive attempt to subsidize housing for low- and moderate-income households, a program hatched in the last significant piece of New Deal legislation, would end up becoming a frequently cited symbol of the inferiority of government as a provider of goods. Based on a model of government ownership, in which local housing authorities received federal financing to build and operate apartment buildings for eligible households,²⁴ the program became emblematic of the ineffectiveness of government-operated housing. By the late 1960s and early 1970s, public housing had come to be perceived as a failed experiment—expensive, crime-riddled, drug-infested, and, in many cases, teetering on the edge of physical and financial collapse.²⁵

The reasons offered for these problems are many: postwar demographic shifts, as former relatively higher-income households moved to the suburbs, leaving lower-income residents to inhabit inner-city public housing;²⁶ the 1969 Brooke Amendment, capping the rents that housing authorities could charge residents at 25% of household income, which led to significant operating shortfalls as costs increased;²⁷ and bureaucratic incompetence and pervasive racial segregation.²⁸ Of the many explanations put forward, at least one recurring theme emerges—the lack of effective incentives among stakeholders to ensure that a given project was soundly financed and operated.

²⁴ The government provided subsidies for public housing development pursuant to annual contributions contracts that retired the bonds originally used to finance the projects. See Charles L. Edson, *Affordable Housing—An Intimate History*, 20 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 193, 196 (2011).

²⁵ See, e.g., Alexander von Hoffman, *High-Rise Hellholes*, AM. PROSPECT (Dec. 19, 2001), <http://prospect.org/article/high-rise-hellholes> [<https://perma.cc/3ZAC-KWA3>] (arguing, by one of the foremost American subsidized housing historians, “By the 1970s, public housing was recognized as a disaster. The high-rise projects were the most notorious (although they were not the only public housing developments to be plagued by crime, vandalism, and deterioration). The Pruitt-Igoe project in St. Louis was the first to gain national notoriety, especially after government officials, with much fanfare, blew it up.”); see also Michael H. Schill, *Distressed Public Housing: Where Do We Go from Here?*, 60 U. CHI. L. REV. 497, 497–98 (1993) (“Public housing increasingly commands public attention. Scarcely a day goes by without reports in the media about the physical, managerial, and social problems that plague some publicly-owned housing developments. Accounts of appalling apartment conditions, corrupt administrators, and innocent bystanders killed by gang warfare are commonplace. Negative images of public housing have even found their way into popular culture. Bestsellers have recounted the hardships of life in public housing, while films depict life in public housing as a horror story.”).

²⁶ See Alexander von Hoffman, *A Study in Contradictions: The Origins and Legacy of the Housing Act of 1949*, 11 HOUSING POLY DEBATE 299, 316 (2000).

²⁷ See Edson, *supra* note 24. This amount was subsequently increased to 30%. *Id.*

²⁸ See von Hoffman, *supra* note 26, at 315–16; Arnold R. Hirsch, *Searching for a “Sound Negro Policy”: A Racial Agenda for the Housing Acts of 1949 and 1954*, 11 HOUSING POLY DEBATE 393, 428 (2000).

This is not to argue that public housing was a failed experiment. The stock of public housing remains sizeable today, with more than a million units still in existence.²⁹ Although popular media ingrained a myth of the failed projects in the American psyche, many would argue that in reality the problems have been exaggerated.³⁰ It is beyond dispute, however, that many projects faced serious problems, and for those that did, the absence of effective stakeholder incentives played a role.

B. Second Wave Assisted Housing

The problems with the public housing model gave rise to a new wave of federal housing programs aimed at infusing private-sector incentives into the provision of subsidized housing. As early as the Housing Act of 1949, Congress emphasized the importance of the private sector in meeting our national housing objectives. “The policy to be followed in attaining the national housing objective hereby established shall be: (1) private enterprise shall be encouraged to serve as large a part of the total need as it can; (2) governmental assistance shall be utilized where feasible to enable private enterprise to serve more of the total need”³¹

By the late 1950s, Congress began experimenting with alternatives to public housing. A variety of programs aimed at incentivizing the private development of rent-restricted housing came into being.³² This collection of Second Wave Assisted Housing programs created nearly 1.5 million units of housing.³³ The programs provided developers with an array of different financial incentives—among the various programs, direct capital grants, sub-

²⁹ FACT SHEET, *supra* note 19. This is down from a peak of 1.4 million units. ALEX F. SCHWARTZ, HOUSING POLICY IN THE UNITED STATES 168 (3d ed. 2015). The remaining stock faces a severe capital backlog that some estimates put in excess of \$20 billion. WILL FISCHER, CTR. ON BUDGET & POLICY PRIORITIES, CONVERTING FUNDING OF SOME PUBLIC HOUSING DEVELOPMENTS TO SECTION 8 SUBSIDIES WOULD HELP PRESERVE NEEDED UNITS 1 (2011), <http://www.cbpp.org/sites/default/files/atoms/files/3-25-11hous.pdf> [<https://perma.cc/6W3W-ATGY>].

³⁰ See generally Paul S. Grogan & Tony Proscio, *The Fall (and Rise) of Public Housing* (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. W007, 2000), http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/grogan_w00-7.pdf [<https://perma.cc/B85H-TL7F>].

³¹ Housing Act of 1949, Pub. L. No. 81-171, § 2, 63 Stat. 413, 413 (codified as amended in scattered sections of 12 U.S.C. and 42 U.S.C.).

³² The Section 202 program came first in 1959, followed, in 1965, by the below-market interest rate (BMIR) feature of the Section 221(d)(3) program and, in 1968, by the Section 236 program. The Section 8 program, established in 1974, ushered in a new wave of programs. Most well known is the Section 8 voucher program, but other lesser-known programs included the Section 8 New Construction, Substantial Rehabilitation, Moderate Rehabilitation, and Loan Management Set Aside (LMSA) programs. For more thorough background on these programs, see James Grow & Brandon Weiss, *Preservation of Affordable Housing*, in THE LEGAL GUIDE TO AFFORDABLE HOUSING DEVELOPMENT 411–47 (Tim Iglesias & Rochelle E. Lento eds., 2d ed. 2011).

³³ U.S. DEP’T OF HOUS. & URBAN DEV., OFFICE OF POLICY DEV. & RESEARCH, MULTIFAMILY PROPERTIES: OPTING IN, OPTING-OUT AND REMAINING AFFORDABLE 1 (2006), https://www.huduser.gov/Publications/pdf/opting_in.pdf [<https://perma.cc/M99P-WNC5>] [hereinafter OPTING IN, OPTING-OUT].

sidized loans, mortgage reduction payments, FHA insurance, and rental assistance—to stimulate housing construction.³⁴ In exchange for these incentives, developers recorded restrictions on title of the underlying property, limiting the use of the property to rental housing for households making no more than certain income limits and mandating certain upper rent limits.³⁵ These use agreements were time-limited, with the bulk of projects having restrictions effective for between twenty to forty years.³⁶

Fast forward twenty to forty years, and the ribbon cuttings were replaced by what some would characterize as a national nightmare.³⁷ As the time-limited use restrictions expired, legal aid attorneys around the country began receiving phone calls from alarmed tenants with notices that their rents would drastically increase. In markets where the difference between the restricted rents and market rents was significant, landlords did what any profit-motivated agent would do—they hiked the rents up to market levels.

The upshot was two-fold. First, the significant investment that the federal government had made in subsidizing the development of this stock of housing was forfeited. Setting aside the question of whether or not the government obtained the benefit of its bargain, there is no dispute that the converted housing no longer served the purpose of housing low-income households. Second, households across the country living in these units came under immediate threat of displacement.

Note that these issues posed problems regardless of one's view of the *temporal* aspect of subsidized housing—i.e. whether subsidized housing was intended to provide only temporary support for households that fell on hard times, or a longer-term foundation upon which to build an economic future. Even if one adopts the former view, the security of tenure issue posed a problem for households regardless of whether they had lived there for five months or five years. Similarly, given that the government has continued to provide housing subsidies to the poorest households since 1937, presumably it always should attempt to maximize the value of current resources for future public use.

The federal government responded over time with a patchwork of policy initiatives. Some of these laws attempted to mandate that owners keep

³⁴ See Grow & Weiss, *supra* note 32, at 412–13.

³⁵ *Id.*

³⁶ *Id.*

³⁷ See, e.g., RACHEL G. BRATT, REBUILDING A LOW-INCOME HOUSING POLICY 101 (1989) (“This problem of ‘expiring use restrictions’ has caused a great deal of concern in recent years . . . Congress estimated that a potential existed for over 330,000 units of Section 221(d)(3) and 236 housing to be lost as a result of the termination of low-income affordability restrictions by the year 2002. In addition, before the end of the decade, several hundred thousand units that have received Loan Management Set Asides will lose this funding because of expiring contracts, thereby making the developments less financially viable. Finally, owners of almost 500,000 units of Section 8 housing will be entitled to opt out of their obligation to rent to low-income tenants by the year 2002.”) (internal citations omitted).

rents at restricted levels,³⁸ while others provided additional economic incentives for owners not to convert.³⁹ These efforts resulted in years of contentious litigation over whether the laws constituted regulatory takings under the Fifth Amendment.⁴⁰ Interestingly, records that emerged during the course of the litigation revealed that some owners originally had underwritten these projects without any expectation of obtaining significant value when the use restrictions expired.⁴¹ In the end, hundreds of thousands of units were lost from the subsidized housing stock as a result of what has come to be known as the “expiring-use crisis.”⁴²

By the early 1980s, Congress had mostly shut down the Second Wave Assisted Housing programs. As inflation rose in the 1970s, HUD had to pour more and more rental assistance into these projects for them to maintain viability. Given that HUD had regularly provided FHA insurance as one of the initial incentives, the government often faced a choice between two

³⁸ See Emergency Low-Income Housing Preservation Act, Pub. L. No. 100-242, §§ 201–35, 101 Stat. 1877, 1877–86 (1988), amended by Pub. L. No. 100-628, §§ 1021–27, 102 Stat. 3270, 3270–71 (1988) [hereinafter ELIHPA].

³⁹ See Low-Income Housing Preservation and Resident Homeownership Act of 1990, Pub. L. No. 101-625, §§ 601–05, 104 Stat. 4079, 4249–78 [hereinafter LIHPRHA]; see also Rachel G. Bratt, *Nonprofit and For-Profit Developers of Subsidized Rental Housing: Comparative Attributes and Collaborative Opportunities*, 19 HOUSING POLY DEBATE 323, 336–37 (2010) (stating, “In 1987 and 1990, Congress passed two pieces of legislation aimed at providing first an emergency response to the expiring use issue and then what was viewed as a permanent response. Owners were guaranteed fair-market value incentives to keep the housing affordable for at least 50 years, so they could either continue to own the housing themselves or sell to nonprofit groups that made the same commitment to long-term affordability. ‘Not surprisingly,’ Achtenberg notes, ‘most owners preferred to secure the incentives for themselves rather than sell their properties to nonprofits, and reports of lucrative equity takeouts with little or no funds reinvested in the property created the appearance of yet another boondoggle for the subsidized housing industry’ By 1997, the federal government, under significant attack by the Republican Congress and with little support from the Democratic administration, abandoned this so-called ‘preservation funding.’” (citing Emily Paradise Achtenberg, *Federally Assisted Housing in Conflict: Privatization or Preservation?*, in RIGHT TO HOUSING, *supra* note 11, at 163–70)).

⁴⁰ See, e.g., *Cienega Gardens v. United States*, 331 F.3d 1319, 1323 (Fed. Cir. 2003) (holding that LIHPRHA constituted a regulatory taking), *vacated and remanded by*, 503 F.3d 1266, 1279 (Fed. Cir. 2007) (holding that ELIHPA did not constitute a regulatory taking and remanding regarding LIHPRHA), *dismissed by agreement of the parties by*, 554 U.S. 938, 938 (2008) (noting the case’s dismissal per Rule 46).

⁴¹ The *Cienega Gardens* litigation is instructive here. The Court’s analysis turned in part on the investment-backed expectations of the developers. “The actual contemporaneous offering memoranda appear to provide more reliable evidence of industry expectations Unfortunately the record contains few examples of such memoranda. But those few that are in the record are revealing. For example, when Skyline View Gardens was syndicated, the owners circulated a prospectus that touted the tax benefits of owning the property. While the prospectus assumed that the restrictions would be lifted after twenty years, it also indicated that the owners placed little value on the right to sell the property (or in the absence of a sale, the right to prepay the mortgage). The schedules demonstrating the tax benefits were based on the assumption that the partnership would sell the property after twenty-one years for only \$1. Other private placement memoranda did not even assume that the property would be sold after twenty years.” 503 F.3d at 1291.

⁴² See *Hearing on Legislation to Preserve Affordable Rental Housing Before the H. Comm. on Fin. Serv.*, 110th Cong. 3 (2008) (statement of Michael Bodaken, President, National Housing Trust).

suboptimal alternatives—provide additional rental assistance to prevent financial failure or allow foreclosure and be forced to make the banks whole for any losses. While private developers had much upside to capture where these projects operated well, the government bore the brunt of the downside. Thus, while the Second Wave Assisted Housing programs infused profit motivation into our subsidized housing policy, they failed to calibrate the incentives effectively.

By 1986, however, a new program emerged that would attempt to strike a better balance.

II. CURRENT LAW: LOW-INCOME HOUSING TAX CREDITS & THE INNOVATION OF INVESTOR OVERSIGHT

This Part first briefly reviews the legislative history of the LIHTC program and reveals a relatively narrow focus on leveraging market-based incentives without reference to any backend issues or distinctions between types of developers. It then outlines the key features of the LIHTC program from a legal, economic, and deal-level perspective. The Part concludes by arguing that the investor underwriting and oversight mechanism significantly improved upon the operational problems of prior programs.

A. *Legislative History*

Today, the LIHTC program enjoys broad support across divergent political and geographic constituencies, garnering widespread backing from politicians, real estate developers, builders, financial institutions, attorneys, accountants, consultants, certain low-income housing advocacy organizations, and an array of other stakeholders.⁴³ This broad support is all the more impressive given the fact that the program emerged as something of an afterthought grafted onto the mammoth Tax Reform Act of 1986.⁴⁴ Under the three-pronged banner of fairness, efficiency, and simplicity, the Act represented “one of the most comprehensive revisions of the federal income tax system since its inception.”⁴⁵ In its well-known effort to broaden the base and lower rates, Congress took particular aim at eliminating tax loopholes and shelters that unfairly distorted horizontal equity.⁴⁶

The U.S. Tax Code was rife with such shelters ostensibly aimed at promoting the development of low-income housing. Various provisions provided an uncoordinated array of financial incentives for investing in such

⁴³ See, e.g., JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 20, at 13 (“The LIHTC program gained broad bipartisan support because every state has successfully used the tax credits to produce and preserve affordable rental housing.”).

⁴⁴ Cf. Tax Reform Act of 1986, Pub. L. No. 99-514, § 252, 100 Stat. 2086, 2189–208.

⁴⁵ STAFF OF J. COMM ON TAX’N, 100TH CONG., GEN. EXPLANATION OF THE TAX REFORM ACT OF 1986 6 (Comm. Print 1987).

⁴⁶ Horizontal equity refers to the proposition that similarly situated taxpayers (i.e., taxpayers with the same income and assets) should be treated the same.

housing.⁴⁷ These incentives were imprecisely tailored and poorly targeted.⁴⁸ For example, while the restrictions required that residents make no more than certain specified income levels, the rules did not contain rent limits, meaning that residents could still find themselves severely rent burdened.⁴⁹ Furthermore, the subsidy levels were not calibrated to the number of low-income units provided; once a certain threshold number of units were provided, the investor could take full advantage of the financial incentives.⁵⁰ An additional disadvantage of certain pre-existing financial incentives was that the income eligibility limits were relatively lax, allowing investors to claim the benefits for projects that served households making as much as 80% of area median income.⁵¹

These sorts of inefficient tax shelters were exactly of the sort that Congress aimed to excise from the Code. The original House bill that passed in December 1985 eliminated or reduced a number of these incentives.⁵² The Reagan Administration's proposal did the same.⁵³ Neither the House nor the Administration proposed new offsetting tax benefits.

The Senate pursued a different tack when it took up the bill in March of 1986.⁵⁴ In response to concerns about the effect that eliminating these shelters would have on the low-income housing stock without any new production-related incentives, Senate Finance Committee Chairman Bob Packwood, a Republican, introduced a proposal that included proto-legisla-

⁴⁷ Preferences included preferential depreciation, five-year amortization, and special treatment of construction period interest and taxes. See STAFF OF J. COMM ON TAX'N, 99TH CONG., COMPARISON OF TAX REFORM PROVISIONS OF H.R. 3838 AS PASSED BY THE HOUSE AND THE SENATE 33 (Comm. Print 1986).

⁴⁸ See S. FIN. COMM. REP. NO. 99-313, at 8 (1986) ("The bill provides a new tax credit for low-income rental housing to consolidate the uncoordinated subsidies under present law. The credit is better targeted to low-income individuals than provisions under present law, and requires that tenants' rents are limited to affordable amounts in relation to their incomes.").

⁴⁹ "Another shortcoming of the existing tax subsidies is that none limits the rents that may be charged to low-income individuals. . . . [W]hile 96 percent of the individuals with incomes over 80 percent of area median income (the present ceiling on 'low' or 'moderate' income) paid rents of less than 30 percent of their income, only 37 percent of individuals with incomes below 80 percent of area median paid rents of less than 30 percent of their income." *Id.* at 758.

⁵⁰ "Another weakness of the existing tax subsidies is that, beyond a minimum threshold requirement of low-income units that must be served, the degree of subsidy is not directly linked to the number of units serving low-income persons. As a result, there is no incentive to provide low-income units beyond the minimum required. The amount of low-income housing credits which an owner may receive, however, is directly related to the amount of rental units made available to low-income individuals." *Id.* at 758-59.

⁵¹ "Certain of the existing Federal tax subsidies are not targeted to persons of truly low-income. . . . [A]bove-average income renters can qualify as 'low' or 'moderate' income for two reasons. First, defining such persons as those with incomes of no more than 80 percent of area median income results in an income ceiling that is relatively high, particularly when compared with the median renter income nationwide. Second, household incomes are not required to be adjusted for family size." *Id.* at 758.

⁵² STAFF OF S. COMM ON FIN., 99TH CONG., TAX REFORM PROPOSAL IN CONNECTION WITH COMM. ON FIN. MARKUP 179-81 (Comm. Print. 1986).

⁵³ *Id.*

⁵⁴ *Id.*

tive language for what eventually would become the Low-Income Housing Tax Credit program.

As with all legislative histories, it is impossible to find a completely unified voice in the materials that document the evolution of this proposal as it made its way toward President Reagan's desk for signature on October 22, 1986. There are, however, certain broadly shared themes that emerge, both in what was explicitly stated and in what was omitted.

With respect to themes clearly stated in the record: the nation faces an affordable housing crisis;⁵⁵ the private market alone will not solve the problem;⁵⁶ production-side incentives should be narrowly-tailored and targeted;⁵⁷ the rules governing these incentives should allow them to be coupled with other pre-existing federal subsidies, while ensuring that private developers are not over-subsidized or unfairly "double-dipping."⁵⁸

Equally illuminating is what is not contained in the legislative record. Although there are numerous references to efficiency-related concerns about the pre-existing tax shelters, there is almost no discussion of how the LIHTC program would be more efficient. Similarly, while there is much concern about the need to preserve the older stock of Second Wave Assisted Housing, there is not a single word mentioned in more than five thousand pages of legislative history of the bill showing any thinking about what would happen with this housing stock on the backend when affordability restrictions expire. Likewise, there is essentially no reference to any distinctions about nonprofit versus for-profit developers participating in the program, or any relative tradeoffs.

More broadly, the conversation takes place entirely within a philosophical frame that assumes the private sector should play the primary role in delivering subsidized housing. A market-based approach is simply taken as a given, a shared and unstated assumption.⁵⁹ In many ways, the passage of the

⁵⁵ See, e.g., 132 CONG. REC. 14,918 (1986) (statement of Sen. Mitchell) [hereinafter Mitchell Statement].

⁵⁶ See, e.g., 132 CONG. REC. 14,922 (1986) (statement of Sen. Cohen) [hereinafter Cohen Statement].

⁵⁷ See, e.g., S. FIN. COMM. REP. No. 99-313, at 757-68 (1986); 132 CONG. REC. 15,053-54 (1986) (statement of Sen. Cranston).

⁵⁸ See, e.g., 132 CONG. REC. 15,038 (1986) (statement of Sen. Bumpers). It should be noted that it was not only Democrats like Chris Dodd, John Kerry, and George Mitchell who strongly endorsed the proposal; many Republicans spoke in support as well. A passage in the Senate Congressional Record by Republican Senator William Cohen captures the tone of the conversation and vividly portrays some of these themes: "In practice, there is virtually no production of low-income housing without the use of one, or several . . . Federal programs. I do not believe that this is simply because investors are greedy and want to take advantage of the Government. Rather, it is because there are few market incentives to make investment in low-income housing attractive. . . . Mr. President, tax incentives for low-income housing investments do more than just give tax shelters to the rich, they provide necessary, physical shelters for our Nation's poor. If these incentives are removed, investors may find other methods of shielding their income from taxes, but the poor beneficiaries of these projects have nowhere else to go." Cohen Statement, *supra* note 56.

⁵⁹ For a critique of such market-based approaches to community economic development, see Scott L. Cummings, *Community Economic Development as Progressive Politics: Toward a Grassroots Movement for Economic Justice*, 54 STAN. L. REV. 399, 439 (2001) ("The Low-

LIHTC program marks the political moment standing polar opposite to that of the public housing program. Whereas public housing was ushered in at the height of the New Deal-era's massive expansion of the federal government, based on a model of government financing, ownership, and operation, the LIHTC program stands in stark contrast: a barnacle attached to the Reagan-era tax reform bill, a replacement of certain tax shelters for the rich with a more-tailored tax shelter, based on a model that assumes that subsidized housing resides squarely in the domain of profit-motivated entities. Nearly thirty years later, with relatively minor amendment, this remains our primary federal subsidized housing production program.

B. Program Mechanics

1. Legal Rules

How does the tax credit work? The program draws on a unique structure that leverages private sector underwriting, investment, development, and oversight. As a federally allocated tax credit administered by state housing finance agencies, all fifty states receive an annual per capita allocation of tax credits.⁶⁰ The state agencies award tax credits to real estate developers that can be organized as either for-profit or nonprofit entities. The allocation occurs pursuant to a competitive process by which developers submit applications and state housing finance agencies award credits to those developers whose application scores the highest based on criteria set forth in the agency-issued Qualified Allocation Plan (QAP).⁶¹

As nonrefundable tax credits, only taxpayers with tax liabilities can make use of the credits. Thus, developers typically transfer the credits to large financial institutions with significant federal tax bills. Technically, however, one taxpayer cannot sell tax credits to another. Per the Internal Revenue Code, only the owner of a qualified low-income building can claim the tax credit on its return.⁶² Therefore, the mechanism via which credits are transferred typically consists of the developer and the investor entering into

Income Housing Tax Credit (LIHTC) has, perhaps more than any other program, exemplified the market-based approach to CED.”).

⁶⁰ Each state receives the greater of 1) \$2.30 times the state population, or 2) \$2,680,000. This calculation is intended to set a floor for less populous states and has been indexed for inflation. See U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-330, LOW-INCOME HOUSING TAX CREDIT: JOINT IRS-HUD ADMINISTRATION COULD HELP ADDRESS WEAKNESSES IN OVERSIGHT 1 n.1 (2015), <http://www.gao.gov/assets/680/671419.pdf> [<https://perma.cc/H5KC-HA64>].

⁶¹ QAPs vary from state to state, but typically contain scoring criteria related to, for example, project location, population served, and affordability level. Also note that there are actually two different types of tax credits: 9% and 4% credits. Only 9% credits are allocated competitively. Developers who successfully apply for an allocation of tax-exempt bond financing from the state are allowed to claim 4% credits. This Article is primarily concerned with 9% credits given the competition between for-profit and nonprofit developers that results from the competitive allocation process. However, since projects developed with 4% credits similarly rely on time-limited use restrictions, many of the same expiring-use concerns apply.

⁶² I.R.C. § 42(a)-(d) (2012).

a limited partnership that will own the building after construction.⁶³ In exchange for being allocated 99.99% of the tax credits, which are taken over a period of ten years,⁶⁴ the investor makes a series of capital contributions to the partnership. These contributions serve as the initial equity necessary to develop the building.⁶⁵

In addition to the value of the tax credits, investors generally receive a number of other financial benefits—depreciation losses, fees, a share of cash flow if the project is profitable, and Community Reinvestment Act credit.⁶⁶ In exchange for the receipt of these benefits, the project must meet certain rent and income guidelines. At least 20% of the units must be affordable to households making no more than 50% of the area median income (AMI), or 40% of the units must be affordable to households making no more than 60% of AMI.⁶⁷ “Affordability” is defined, as is standard with federal housing programs, as households paying no more than 30% of gross income on housing.⁶⁸

As with the older stock of Second Wave Assisted Housing, the LIHTC program relies on time-limited use restrictions to memorialize these rent and income requirements. A regulatory agreement recorded on title provides that the use restrictions shall remain in effect for an initial 15-year compliance period⁶⁹ and, for properties starting in 1990, an additional 15-year extended-use period.⁷⁰ Thus, at a minimum, the housing must remain affordable for 30

⁶³ The developer typically serves as the general partner and the investor serves as the limited partner. Note that in some cases a limited liability company is used with the developer serving as the managing member and the investor serving as a member.

⁶⁴ I.R.C. § 42(f)(1) (2012).

⁶⁵ The process typically is more complex, because once the “lower-tier” investor closes on the tax credit partnership, it will often syndicate the credits to an “upper-tier” investor or group of investors.

⁶⁶ The last of these explains why large banks commonly outbid other would-be investors for the credits. As explained by the U.S. Government Accountability Office, “Banks invest in LIHTC projects in part to meet regulatory tests under the Community Reinvestment Act (CRA) Enacted in 1977, the purpose of CRA is to encourage insured depository institutions (banks) to help meet the credit needs of communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations. Federal financial regulators—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency—are required to assess periodically each bank’s record of helping to meet the credit needs of its entire community. . . . Under the large bank investment test and intermediate-small bank community development investment test, banks can choose to invest in various qualified community development investments, including LIHTC projects.” U.S. GOV’T ACCOUNTABILITY OFF., GAO-12-869R, COMMUNITY REINVESTMENT ACT: CHALLENGES IN QUANTIFYING ITS EFFECT ON LOW-INCOME HOUSING TAX CREDIT INVESTMENT 1–3 (2012), <http://www.gao.gov/assets/650/647549.pdf> [<https://perma.cc/LS3L-HGKX>].

⁶⁷ I.R.C. § 42(g)(1) (2012).

⁶⁸ *Id.* § 42(g)(2). Note that unlike many other subsidy programs, LIHTC households can opt to pay more than 30% of their household income on rent. The rent limits simply ensure that the rent charged for a given unit will not exceed 30% of the applicable AMI limit for the given area.

⁶⁹ *Id.* § 42(i).

⁷⁰ *Id.* § 42(h)(6)(D).

years. If for whatever reason these restrictions are violated during the initial 15-year compliance period, the IRS can recapture the tax credits.⁷¹

2. *Economics of a Deal*

The legal rules tell only part of the LIHTC story. In order to understand the incentives of the various stakeholders, an example of how the economics work in a typical tax credit deal is instructive. The example below⁷² looks at the finances of a hypothetical LIHTC project through Year-15, which, as discussed below, typically is the year the investor exits the partnership.⁷³

Suppose a developer plans to build a 50-unit affordable housing apartment complex at a total development cost of \$16M (\$320K/unit). The first step in determining how many tax credits the project would generate is calculating the “eligible basis” for the project.⁷⁴ This figure includes most hard and depreciable soft costs of the development.⁷⁵ Excluding ineligible items like the cost of land and various fees, suppose this project yields an eligible basis of \$14M. Assume further that 100% of the units in the development will be rent-restricted. To use the technical LIHTC term, the “applicable fraction” is 50/50 or 100%.⁷⁶ The applicable fraction multiplied by the eligible basis yields the “qualified basis” of \$14M.⁷⁷ Assuming the developer is successful in obtaining an allocation of competitive 9% tax credits from the state housing finance agency, the owner of the project would be authorized to claim the product of \$14M times 9%, or \$1.26M per year, on its tax returns for 10 years from the date the project is placed in service.⁷⁸ Over the course of the 10-year period, the project would generate \$12.6M in total tax credits.

Since a LIHTC developer generally will not have \$12.6M in offsetting tax losses and will need equity up front to finance the development, typically the developer will find an investor to partner with who, in exchange for making large up-front capital contributions, will claim the tax credits. The investor and the developer will negotiate a price for the tax credits. In this

⁷¹ *Id.* § 42(j).

⁷² Note that this example is purely hypothetical, but is based on reasonable market terms for LIHTC deals. Numbers would of course vary by state for reasons including differing land values and construction costs.

⁷³ See *infra* Part III(B)(1) for greater detail regarding the motivations and mechanics for the investor exit from the partnership.

⁷⁴ I.R.C. § 42(d) (2012).

⁷⁵ See Rochelle E. Lento & Danielle Graceffa, *Federal Sources of Financing, in THE LEGAL GUIDE TO AFFORDABLE HOUSING DEVELOPMENT*, *supra* note 32, at 249, 256.

⁷⁶ I.R.C. § 42(c)(1)(B) (2012).

⁷⁷ *Id.* § 42(c)(1).

⁷⁸ For non-competitive 4% deals, simply substitute 4% for 9% in the calculation. Note that the net present value of the ten-year stream of 9% credits is intended to equal 70% of the qualified basis of the project. The net present value of the ten-year stream of 4% credits is intended to equal 30% of the qualified basis. Thus, the IRS has historically made minor adjustments to the 9% and 4% rates to calibrate them such that they provide the target net present value.

example, the investor will pay some fraction of \$12.6M.⁷⁹ Suppose the pricing on this deal is \$0.95 (i.e. the investor pays \$0.95 for every \$1.00 in tax credits). The developer thus will contribute \$11.97M in equity over a series of capital contributions to the partnership in exchange for being allocated 99.99% of the total tax credits.

The value of the tax credits is not the only benefit flowing to the investor. The partnership agreement will also allocate 99.99% of the partnership losses to the investor. Key among these are depreciation losses for the assumed decrease in value over time, for example, of the improvements and personal property. Here, assume that at the end of 15 years the investor will have been allocated \$9M in depreciation losses. Assuming a corporate tax rate for the investor of 35%, this has an after tax value of \$3.15M to the investor.

In addition to tax credits and depreciation losses, the investor may also receive distributions from any positive net cash flow (assume here 5% of \$20K/year) and an annual investor management fee (assume \$7K) for a total of another \$8K per year, or \$120K by the end of 15 years.

By contrast to the investor, the economic value to the developer is more straightforward. The developer will receive a developer fee, generally capped by regulation.⁸⁰ On this deal, suppose a developer fee of \$1M. Occasionally, a portion of the developer fee is deferred and paid out of cash flow if capital sources are insufficient and to give the developer an extra incentive to ensure the project is managed well during the compliance period. In addition, the developer may receive distributions from any positive net cash flow (assume here 45% of \$20K/year) and annual partnership management fees (assume \$11K/year), for a total of \$20K/year or \$300K over 15 years.

⁷⁹ Pricing has fluctuated significantly over the years. Given the relative scarcity of LIHTC projects, potential investors often are forced to bid against each other to be selected as the limited partner. As the program has matured and investor confidence increased, pricing has increased dramatically. "At the inception of the housing credit program, equity was raised principally from small investments made by individual investors through public offerings. Beginning in the early 1990s, a corporate equity market began to develop as institutional investors began to understand the asset class, the housing tax credit program was made permanent, and syndicators quickly came to prefer institutional capital as a more efficient way to raise equity. At the national level, housing tax credits traded at net prices as low as \$0.50 in the early 1990s, steadily increased to \$0.80 per dollar of credit in the early 2000s, and skyrocketed to close to \$1.00 at the height of the equity market in 2006. However, . . . the exit of Fannie Mae and Freddie Mac and a precipitous decline in the profitability of the largest financial institutions resulted in a meltdown of the housing credit equity market. As a direct consequence, housing tax credit prices fell sharply to an average of \$0.74 in 2009, with projects in rural areas fetching as low as \$0.62. Pricing has since steadily increased in step with the national economic recovery, and as of the date of this report is averaging \$0.94, with pricing routinely exceeding \$1.00 in most urban markets." COHNREZNICK, THE LOW-INCOME HOUSING TAX CREDIT PROGRAM: A PERFORMANCE UPDATE ANALYSIS 34 (2014), https://www.cohnreznick.com/sites/default/files/pdfs/CR_LIHTC_Nov2014.pdf [<https://perma.cc/UG33-YW4F>]. Note that investors would pay more than a dollar per dollar of tax credit given the other financial and regulatory benefits that accrue to LIHTC investors.

⁸⁰ For example, in California the developer fee for 9% deals cannot exceed \$2 million. CAL. CODE REGS. tit. 4, § 10327(c)(2) (2015). The cap for 4% deals is \$2.5 million. *Id.* § 10327(c)(2)(B).

Note that since the LIHTC program does not cover all development costs, additional loans and subsidies are typically sought for acquisition and predevelopment costs. It is not uncommon, in addition to conventional lending, for a development to receive one or multiple subsidized loans from a city or state at extremely favorable rates to help cover the cost of land acquisition and other fees and expenses: perhaps a \$3M loan, with a 55-year term, 3% simple interest, and payments to be made exclusively out of net cash flow (suppose 50% of available cash) and otherwise deferred. But for the tax implications that would accrue to the partnership, such city loans could in some cases more straightforwardly be structured as grants.

So to summarize: the investor would claim \$12.6M in tax credits, \$3.15M in after-tax depreciation value, and \$120K in fees and distributions; the developer would claim a \$1M development fee and \$300K in fees and distributions; and the partnership would receive a \$3M subsidized government loan, in addition to any institutional lending provided by banks. In exchange, the public would obtain 50 units of affordable housing for 15 years through the initial compliance period. Assuming the housing is operated well and in accordance with all use restrictions once the investor exits, the public would obtain at least another 15 years of affordable housing through the end of the extended-use period.⁸¹

3. *Partnership Agreement Provisions*

While the formal legal rules and the economics of LIHTC projects help reveal the incentives at play, much of the nuance is contained in the business deal between the investor and the developer. This deal is spelled out in great detail in a limited partnership agreement that can easily run two hundred pages in length. Of particular relevance are the provisions relating to the investor's oversight and control of the developer.⁸²

Given that the investor's primary goal is to avoid IRS recapture of the tax credits due to the failure to deliver the bargained-for rent-restricted housing, the limited partnership agreement is rife with provisions allowing the investor to keep the developer on a relatively tight rein. This requires a careful balancing act, because as a limited partner, the investor has to be careful not to assume too much control at risk of being deemed a general partner and subject to general liability. At the same time, the agreement reserves a

⁸¹ Note that many state QAPs require or encourage significantly longer than 30 years of affordability. See JEREMY GUSTAFSON & J. CHRISTOPHER WALKER, THE URBAN INST., ANALYSIS OF STATE QUALIFIED ALLOCATION PLANS FOR THE LOW-INCOME HOUSING TAX CREDIT PROGRAM 18 (2002), <https://www.huduser.gov/Publications/pdf/AnalysisQAP.pdf> [<https://perma.cc/B69T-5MSH>] (noting that 41 states provided some sort of preference for projects that proposed terms longer than the federally-required minimum). However, given the absence of the threat of IRS recapture after Year-15, it is yet to be determined how effective states will be at enforcing these longer use-restricted periods.

⁸² Note that as with the hypothetical deal discussed above, the terms described here are not based on any particular LIHTC deal. Rather, they are representative of common LIHTC market terms.

number of significant rights to the investor. Below, certain common market provisions are described.

Perhaps most important are the guaranties the investor receives from the developer, including the construction completion, operating deficit, and tax credit compliance guaranties. The first requires the developer to guarantee construction completion in a good and workmanlike manner, on time and in accordance with the plans and specifications. If there are cost overruns, the developer is on the hook and required to contribute the funds necessary to finish the project. The operating deficit guaranty requires the developer to fund post-completion operating shortfalls.⁸³ A typical operating deficit guaranty would run for three to five years after completion of construction and lease up of the development, and require the developer to fund deficits that arise, perhaps as a result of higher-than-expected inflation or lower-than-expected rental revenue.⁸⁴ Finally, the tax credit compliance guaranty requires the developer to make the investor whole if for any reason the investor does not receive the amount of projected tax credits.⁸⁵ If the IRS claws back credits because a project falls out of compliance, maybe because the units are rented to income-ineligible households or at rents above the restricted levels, the developer typically must pay the investor not only the amount of the tax credit shortfall, but also the amount of any IRS fees or penalties assessed.

On top of the guaranties, the agreement requires the developer to repurchase the investor's entire interest in the partnership if any one of a number of events occurs. These events typically include: if the project is not placed in service by the required completion date; any traditional institutional construction loan financing is not repaid by its maturity date; lease-up of the building is not completed on schedule; certain important milestones are not reached that facilitate the flow of tax credits; the project is not built to satisfy basic HUD physical quality standards; or, the project will qualify for less than some floor level of tax credits.

Perhaps most drastic are provisions that grant the investor the right to remove and replace the developer. These provisions are typically triggered in the event of certain bad acts—fraud, gross negligence, intentional misconduct, or breach of fiduciary duty. They also may be triggered by uncured material breaches of the regulatory agreement, loan documents, or the limited partnership agreement. Other events may also give rise to removal rights, such as the developer declaring bankruptcy or violating securities laws.

⁸³ The operating deficit guaranty typically starts once the project has reached a basic level of financial viability based on certain metrics involving percentage lease up and debt service coverage ratios.

⁸⁴ Sometimes these guaranties are capped and structured as interest-free loans from the developer to the partnership.

⁸⁵ Certain common exceptions exist, including unexpected changes to Section 42 of the Internal Revenue Code, or tax liabilities triggered as a result of the investor's own decision to transfer its interest.

In addition to the guaranties, repurchase obligations, and removal rights, a number of other common provisions allow the investor to maintain significant control and oversight over the developer and the project. The investor typically has approval rights over the hiring and replacement of the property manager. The developer is required to provide dozens of representations and warranties attesting to financial, organizational, and other diligence-related matters, violations of which give rise to serious remedies. The investor will require the right to review and approve change orders above certain individual and aggregate levels where the developer is requesting to deviate from line-item amounts set forth in the projected budget. Finally, the developer will be required to submit lengthy monthly, quarterly, semi-annual, and annual reports to the investor, providing in-depth information on the financial and physical health of the project.

C. LIHTC Innovations

In evaluating the strengths of the LIHTC program, many regard the genius of the program as consisting of this unique relationship between investors and developers. Given the looming specter of recapture, investors are wary of investing millions of dollars in risky projects. Rigorous underwriting occurs at the front end to ensure that only the most viable projects are selected. Furthermore, the multitude of rights granted to investors allows them to keep a watchful eye during development and operations and to insist upon mid-course corrections where necessary.

Thus, along the dimension of operational proficiency, the LIHTC program successfully achieved what public housing, in many cases, did not—namely, it placed stakeholders with strong incentives in charge of underwriting, operating, and overseeing the housing. And unlike Second Wave Assisted Housing, the LIHTC program calibrates these incentives such that the stakeholders have significant skin in the game given the threat of recapture. Many point to the incredibly low default rate of LIHTC developments, by some estimates well below 1%,⁸⁶ as evidence of the success of this model.⁸⁷

III. A COUNTER-NARRATIVE: RESIDUAL VALUE CAPTURE BY PROFIT-MOTIVATED DEVELOPERS

In this Part, I argue that the structure of the LIHTC program will allow the private sector to capture significant residual value, or value generated by

⁸⁶ One estimate puts the number potentially as low as 0.63%. COHNREZNICK, *supra* note 79, at 7.

⁸⁷ A less functional, more pragmatic success of the LIHTC program is that it is a survivor. Public housing, Second Wave Assisted Housing, and the Section 8 program have all resided on the appropriations side of the government's accounting ledger, subjecting each program to attack as part of the annual federal budgeting process. As a permanent tax credit embedded in the Internal Revenue Code, the LIHTC program avoids this annual spotlight and is much less subject to the whims of the current Congress and President.

a public-private transaction that is unnecessary to incentivize a private provider to deliver the contracted for good or service.⁸⁸ The Part also explores in depth the scale of the potential expiring-use problem that will occur starting in 2020 for tens of thousands of LIHTC properties.

A. *Public-Private Mismatch*

As discussed above, our federal housing policy goals include realizing as soon as feasible a decent home and suitable living environment for every American family. Likewise, the legislative history of the LIHTC program spoke to the need for an effective program to house our nation's poor. These goals are not of the type one would find memorialized in the organizing documents of a tax credit investor or a for-profit developer. Rather, often per the dictates of fiduciary duties to shareholders, large banks and real estate developers are primarily concerned with maximizing profits.

The transition from public housing to a private sector delivery model starting in the 1950s therefore introduced a tension into our federal housing policy: namely, that between the public goals of our housing programs and the profit-motivated interests of the entities charged with implementing them. The investor-related innovations ushered in by the LIHTC program thus have not come without cost.

The problem of how to effectuate public goals in arrangements with private actors is not a new one. With the explosion of privatization in modern American governance, however, it is a problem that has gained enhanced salience in recent years.⁸⁹ Among the many potential difficulties inherent in contracting with private providers: language can be ambiguous, often pro-

⁸⁸ As a preliminary matter, I set aside a number of potential problems with the program that do not necessarily relate to the misalignment of public and private incentives. One critique of the program has been that since it is a capital delivery program aimed at making housing affordable to those at 50% or 60% of AMI, it is not designed to provide housing to the lowest-income families without layering additional operating subsidies. *See, e.g.,* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 5, at 32. Additionally, unlike the Section 8 program, which ensures that tenants pay no more than 30% of their income on rent, residents in LIHTC units will pay no more than 30% of *the relevant AMI levels*, but it is very possible this exceeds 30% of their actual household income. *See* Katherine M. O'Regan & Keren M. Horn, *What Can We Learn About the Low-Income Housing Tax Credit Program by Looking at the Tenants?*, 23 HOUSING POL'Y DEBATE 597, 599 (2013). As a result, tenants in LIHTC buildings can end up rent-burdened—as discussed above, one of the same problems that existed with the pre-1986 reform housing tax shelters. Lack of tenant rights as compared to the public housing program is another common critique, such as the lack of a right to organize or make use of certain grievance procedures. *See* NAT'L HOUS. LAW PROJECT, OVERVIEW: LOW INCOME HOUSING TAX CREDIT (LIHTC) PROGRAM 3 (2012) (noting no tenant grievance procedures are required by statute or regulation). Many if not all of these problems could be addressed via relatively straightforward changes to I.R.C. Section 42 or to state QAPs.

⁸⁹ *See generally* Symposium, *Public Values in an Era of Privatization*, 116 Harv. L. Rev. 1212 (2003); MARTHA MINOW, PARTNERS, NOT RIVALS: PRIVATIZATION AND THE PUBLIC GOOD (2002); GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY (Jody Freeman & Martha Minow eds., 2009); Jon D. Michaels, *Privatization's Pretensions*, 77 U. CHI. L. REV. 717 (2010); JOEL F. HANDLER, DOWN FROM BUREAUCRACY: THE AMBIGUITY OF PRIVATIZATION AND EMPOWERMENT (1996).

viding significant room for interpretation; contracts and governing rules commonly contain gaps and may be silent on key issues; unforeseen events may occur that were not contemplated at the time of contracting; or, it is very possible that, for a variety of reasons, the government simply struck a deal that did a poor job of maximizing the stated policy goals.⁹⁰

These difficulties arise squarely within the LIHTC program. Section 42 of the Internal Revenue Code sets forth the skeletal parameters of the program;⁹¹ states enact Qualified Allocation Plans that provide further regulations and criteria for project selection; a regulatory agreement between the state housing finance agency and the project owner contains the contractual obligations of the developer. Essentially anything outside of these documents is left to the project owner to determine.⁹²

Thus, when proponents of the LIHTC program herald the private-sector oversight leveraged by the program, the question arises: *what kind of oversight?* And the answer is that the program provides exactly the oversight necessary to ensure that, per the terms of statute, regulation, or contract, investors will not lose their tax credits, no more and no less.

This oversight is significant. Every year the developer must submit reports to the state housing finance agency, certifying that the promised number of units is being rented to the promised income-eligible households, at the promised rent levels.⁹³ If the property manager has allowed the project to go into physical or financial disrepair, such that the bargained for housing is no longer being provided, the housing finance agency will notify the IRS and not only will investor-claimed tax credits be recaptured,⁹⁴ but also hefty fees and penalties may be assessed. As discussed above, the investor therefore will bring all of its rights to bear on the developer, including, at most extreme, removal and replacement, to ensure that recapture does not occur.

Nevertheless, much of public value falls outside of the scope of this investor-leveraged accountability. For example, aside from the sheer number of rent-restricted units, what *kind* of housing is produced? Is it merely the brick and mortar hard units bargained for, or are there onsite supportive services?⁹⁵ Are the unit sizes varied to accommodate large and small families? Where is the housing situated—in areas identified pursuant to the logic of some public purpose (for example, expanding the geography of opportunity, or reinvesting in disinvested inner-city neighborhoods) or to the logic

⁹⁰ See, e.g., Nestor M. Davidson, *Relational Contracts in the Privatization of Social Welfare: The Case of Housing*, 24 YALE L. & POL'Y REV. 263, 279 (2006) (arguing that relational contracting has arisen as an alternative to discrete contracting given certain "practical challenges to achieving contractual clarity").

⁹¹ By reference to Section 42 here, I mean to include the associated interpretative IRS regulations, revenue rulings, private letter rulings, and other forms of IRS guidance.

⁹² This is of course barring other requirements imposed by, for example, project lenders.

⁹³ State housing finance agencies also are required to conduct physical inspections of the properties during the initial compliance period at least every three years.

⁹⁴ Note that not necessarily all credits will be recaptured. For partial violations, the IRS has a mechanism for prorating the recapture amount.

⁹⁵ Supportive services typically refer to on-site services provided to individuals with physical or mental disabilities or special health needs.

of maximizing private returns? And, perhaps most critically, what happens to the units, to the billions of dollars invested by the government, and to the current residents when affordability restrictions expire?

Part IV(B) presents evidence that compares nonprofit and for-profit developers across a variety of these metrics. Here, however, I use the last of these questions as an example to flesh out the residual value problem.

B. *Expiring-Use Restrictions*

1. *Investor Exit*

Roughly 10 years after a tax credit project has been placed in service, the investor has exhausted all available tax credits.⁹⁶ The initial compliance period runs for 15 years, so the investor typically remains in the limited partnership through Year-15 to ensure that the project continues to operate well. After Year-15, the threat of tax credit recapture goes away.⁹⁷ While the investor potentially continues to derive some value from the project in the form of depreciation losses and share of cash flow, the primary economic incentives have been tapped and certain liabilities may begin to accrue.⁹⁸ At this point, investors typically want to exit the partnership.

Market terms for LIHTC deals often include a purchase option or right of first refusal for the developer to purchase the investor's interest in the partnership or in the underlying project at Year-15. A common purchase price formula used is the greater of i) fair market value, or ii) assumption of all debt on the property, plus payment of any taxes incurred by the investor as a result of the transfer. Given that these properties are often saddled with significant long-term "soft" debt,⁹⁹ and since the rent-restricted projects often are not generating large amounts of cash flow, it is frequently the case that the latter of these two formulas is greater. As a result, investors commonly exit limited partnerships at Year-15, with the developer picking up their tax bill and assuming all debt on the property.

All investor-leveraged accountability is now gone.¹⁰⁰ Starting in 1990, federal law required that properties receiving tax credits must remain afford-

⁹⁶ As a technical matter, it is common for only a partial year's worth of credits to be claimed in Year-1, given that the building is typically placed in service mid-year. Therefore, another final partial installment of credits is often claimed in Year-11.

⁹⁷ See I.R.C. § 42(j)(1)(A) (2012).

⁹⁸ Even though depreciation losses continue to provide economic value, public companies may not want to have an asset that appears to be performing poorly listed on their balance sheet. Furthermore, other potential liabilities continue to accrue, including the threat of large exit taxes.

⁹⁹ This refers to the subsidized government loans described *supra* Part II(B)(2).

¹⁰⁰ Telephone Interview with Bill Pavão, Former Exec. Dir., Cal. Tax Credit Allocation Comm. (July 13, 2015) (on file with author) [hereinafter Pavão Interview] (stating, "During my tenure, we had some instances where we had noncompliance in Year-17. And the cases I'm thinking of, we had a heck of a time to get the attention of the head of the property owner because that big stick was gone. You didn't have the threat of recapture or dealing with the IRS. We had a couple property owners who didn't envision doing business with us in the

able for an additional extended-use period of 15 years, and some states have required even longer terms.¹⁰¹ The IRS, however, leaves it to states to conduct all compliance and enforcement after Year-15.¹⁰² During this second 15-year period, it is unclear the extent to which state agencies have the capacity to adequately monitor the behavior of developers statewide.¹⁰³

In the best-case scenario, however, the property makes it to the end of its use-restricted term providing decent and affordable housing to all of its residents. At this point, the developer is free to do whatever it likes with the property in question.¹⁰⁴

So what happens? This is where we arrive in uncharted waters. Given that Congress enacted the extended-use period requirement in 1990, the first LIHTC projects will reach Year-30 in 2020. Every year after that, LIHTC projects around the country will hit their expiration dates in successive waves.

Although there is no evidence yet with respect to owner behavior at Year-30, there is no reason to believe that profit-motivated owners, free from the bonds of regulatory agreements, will not seek to maximize profits. In soft markets, where rents in the surrounding neighborhood are not significantly higher than tax credit rents, there may not be much change. For properties that need funds for rehabilitation, certain owners may choose to apply for a new round of tax credits, which in turn would provide new rent restrictions on the property.¹⁰⁵ For a significant number of owners, particularly in hot real estate markets where the difference between market rents and tax credit rents is steep,¹⁰⁶ we are likely to see for-profit owners raising

future, and they would just say, ‘Hey, sue us under the terms of the regulatory agreement and it’ll be a big drawn out expensive mess.’ So the dynamic really does change after Year-15.”)

¹⁰¹ See *supra* note 81.

¹⁰² See Pavão Interview, *supra* note 100.

¹⁰³ See *id.* (stating, “There are remedies under the regulatory agreement. Now we just have a regulatory agreement that clouds title. . . . We can petition a court to appoint a receiver. In some cases we can try to get another owner in there. . . . [D]uring my tenure, [the California Tax Credit Allocation Committee] hadn’t set itself up to be in the business of taking over properties. It is a huge bureaucratic mess, it is a big deal. Gonna spend a lot of brainpower and energy to enforce this stuff in court. That’s also an administrative danger. People will start blowing [us] off. . . . To some degree, it felt like the state was bluffing to some degree. I’ve got legal authority to pursue remedies and we’re prepared to do that. Frequently that was enough to bring people back in line—if they want to continue to do business with us, then you better do better on the backend. . . . Most people don’t blow us off after Year-15. And people do sign these 55-year regulatory agreements entering into a binding relationship with us for 55 years. But when push comes to shove, is that really enforceable? Yes it is, but . . .”). Note that California’s QAP requires the execution of a 55-year use-restriction.

¹⁰⁴ This assumes no additional state or local restrictions.

¹⁰⁵ Note, however, that as the stock of expiring LIHTC properties increases, this option may diminish as resources available for resyndication cannot meet the growing need.

¹⁰⁶ For example, the average market rent in Los Angeles County is \$1,520 per month. See Tim Logan, *Rents Rise Again in Southern California, But Not So Fast This Time*, L.A. TIMES (Apr. 2, 2015), <http://www.latimes.com/business/realestate/la-fi-rents-rise-again-in-20150402-story.html> [https://perma.cc/A8HK-8UCX]. By contrast, the maximum monthly rent that can be charged for pre-2008 LIHTC two-bedroom apartments at the 50% AMI restricted level is \$961. CAL. TAX CREDIT ALLOCATION COMM., MAXIMUM RENTS FOR PROJECTS PLACED IN SERVICE ON OR BEFORE 12/31/2008 (2015). At the 60% AMI restricted level, the maximum is

rents to market levels. At this point, the billions of dollars invested in this stock of housing will provide no further public value in the form of affordability. For the low- and moderate-income residents of these properties, this likely will mean dramatic rent increases. For those without the ability to absorb such higher rents, the result may be eviction and displacement. In short, the national nightmare that many experienced with the expiring-use crisis of Second Wave Assisted Housing may be about to replay itself.

2. HUD Data

What is the scope of this brewing problem? Despite the fact that the LIHTC program technically falls under the purview of the U.S. Department of Treasury, HUD maintains a large database of properties developed using LIHTC financing.¹⁰⁷ Data are currently available for all projects placed in service through 2013, subject to a few caveats.¹⁰⁸ The database contains not only information about the number of projects, but also information across a wide variety of demographic, financial, and organizational variables, including: location, units per project, annual credit allocation, bedroom size distribution, rent limits, nonprofit vs. for-profit sponsor, whether the project received other federal sources of subsidized financing, and whether the project targets a specific population (families, the elderly, individuals with disability, or the homeless).

The database contains information on a total of 40,502 LIHTC projects containing 2,591,239 total units. 2,253,788 of these are rent-restricted units.¹⁰⁹ For properties for which there is sponsor information, nonprofits developed 21.99% of the projects and 19.57% of the units, and for-profits developed 78.01% of the projects and 80.43% of units.¹¹⁰

Table 1 contains data relevant to the potential expiring-use problem for *projects* developed between 1990, when the 30-year use restriction requirement started, and 2013, the last year for which the database has complete data. The use restrictions for projects placed in service in 1990 will expire in 2020. In that year, a total of 1,286 projects will lose their rent limits, at least 874 of them developed by for-profit sponsors. By 2024, a total of 6,891

\$1,153, and at the 30% AMI level (for projects that promised deeper affordability to gain more favorable QAP scoring), the maximum level is \$576. *Id.* Thus, low-income residents could stand to face a rent increase anywhere from several hundred to nearly one thousand dollars per month.

¹⁰⁷ U.S. DEP'T OF HOUS. & URBAN DEV., LOW-INCOME HOUSING TAX CREDIT DATABASE, <http://lihtc.huduser.org> [<https://perma.cc/9UMS-3Z8G>].

¹⁰⁸ The database is missing data for these states for the years noted: AK(2013); CT(2012, 2013); KY(2013); MO(2008, 2010); NM(2010, 2011); NV(2010). The database contains a few projects placed in service in 2014, and one project in 2015. There is also a small set of properties that does not contain placed in service information. These omissions suggest that the numbers provided in this Article *understate* the scope of potential LIHTC expiring-use issues.

¹⁰⁹ The average building size is 65 units, the median is 41 units, with on average 59 rent-restricted units per building, and a median of 40 rent-restricted units per building.

¹¹⁰ Note that for some of the projects listed in the database as having a nonprofit sponsor, it is possible that these are actually joint ventures with for-profit partners. Thus, the number of projects developed solely by nonprofit sponsors likely is even lower.

projects will have lost their restrictions, at least 4,618 of them developed by for-profits. Roughly 5,000 to 8,000 more projects expire every successive five years, with the majority of projects developed by for-profit sponsors. By 2043, all 34,447 projects developed between 1990 and 2013 will have expired.

TABLE 1: CUMULATIVE NUMBER OF LIHTC *PROJECTS* EXPIRING BY NONPROFIT VS. FOR-PROFIT SPONSOR—2020 TO 2043¹¹¹

Expiration Year	Nonprofit Projects	For-Profit Projects	Unknown Sponsor Projects	Total Projects
2020	90	874	322	1,286
2024	665	4,618	1,608	6,891
2029	2,201	9,691	2,525	14,417
2034	3,936	14,916	3,216	22,068
2039	5,765	19,641	4,234	29,640
2043	7,002	22,274	5,171	34,447

Table 2, which looks at total number of expiring LIHTC *units*, provides perhaps an even more vivid image. In 2020, 41,512 rent-restricted apartment units will lose their federal tax credit restrictions, at least 26,407 of them developed by for-profit sponsors. Within the first five years, 252,140 units will expire, at least 167,603 of them developed by for-profits. By 2043, all 2,080,343 LIHTC units for which there is sponsor type data developed between 1990 and 2013 will have expired, nearly 1.4 million of them developed by for-profit entities.

TABLE 2: CUMULATIVE NUMBER OF LIHTC *UNITS* EXPIRING BY NONPROFIT VS. FOR-PROFIT SPONSOR—2013 TO 2043¹¹²

Expiration Year	Nonprofit Units	For-Profit Units	Unknown Sponsor Units	Total Units
2020	4,091	26,407	11,014	41,512
2024	31,665	167,603	52,872	252,140
2029	120,459	479,355	109,486	709,300
2034	204,576	886,129	163,971	1,254,676
2039	309,379	1,227,034	236,381	1,772,794
2043	388,437	1,399,179	292,727	2,080,343

¹¹¹ This table evaluates properties subject to the 30-year use restriction. Thus, it starts with 2020, since that is the first year in which properties subject to the 30-year use restriction will be expiring. The table excludes the year 2044, since HUD's database has minimal information regarding the number of properties placed in service in 2014.

¹¹² See note 111, *supra* regarding the scope of units covered by this table.

As with the Second Wave Assisted Housing stock, these numbers mean two things. First, billions of dollars invested in the converting stock will no longer serve the purpose of housing low-income households. Second, the households living in these more than two million apartments potentially will face the threat of displacement. Other federal, state, and local restrictions may provide some protection.¹¹³ But for a large subset, without further government intervention, we will see residents evicted from their homes, families uprooted from their communities, and similar pains of displacement that we saw with respect to the Second Wave Assisted Housing stock.¹¹⁴

C. *Residual Value Capture*

The economic value that LIHTC owners can capture by raising rents after use restrictions expire is not governed by any law or regulation contained in the LIHTC program. Nothing in the design of the program prevents the owner from claiming this value, and they are entirely within their legal rights to do so.¹¹⁵ Perhaps, one might argue, this is just the cost of doing business with the private sector. A deal was struck, the developer upheld its end of the bargain, and the public got that for which it bargained.

Further, given the paucity of mention in the legislative history regarding what Congress expected to happen on the backend, we are left to speculate about what policymakers contemplated when they drafted the law. Was this the intended outcome for the program? Perhaps in order to incentivize owners to take part in the program, Congress assumed developers would require the ability to raise rents after thirty years and convert to market rate housing? Maybe this problem is instead an example of the flaws in discrete contracting; the issue of backend displacement was simply unforeseen, a gap in the contract. This is not an unrealistic possibility given the demands of politics and the fact that politicians are less incentivized to focus on problems that may occur many decades in the future. This may particularly be the case in the LIHTC context given that, as revealed in the review of the legislative history, the program resulted from a relatively late-in-the-game response to the elimination of certain tax shelters, not a process aimed at designing the most thorough housing program possible.

Whatever the reason, I argue that the issue of expiring-use restrictions on LIHTC properties serves as a case study of an inherent feature of public-private partnerships—namely, the capture of residual value. Again, for pur-

¹¹³ These restrictions may be in the form of local rent control or rent stabilization laws; other regulations that apply to the property as a result of additional state or local financing; or longer extended-use periods as a result of more stringent state QAP rules. In the case of the latter two possibilities, this would simply extend, but not eliminate, the expiration date.

¹¹⁴ This is a problem not unlike what currently occurs in gentrifying neighborhoods around the country. Here, rather than increased economic activity leading to upward pressure on neighborhood property values, that pressure already exists and is unleashed overnight with the expiration of long-term legal restrictions.

¹¹⁵ Assuming there are no additional restrictions as discussed above, *supra* note 113.

poses of this Article, this is value generated by a public-private transaction that is unnecessary to incentivize a private provider to deliver the contracted for good or service.

Regardless of what Congress assumed would happen upon the expiration of use restrictions (or whether Congress even considered this question), there are many reasons to believe the prospect of capturing this value was unnecessary to motivate participation in the LIHTC program at the outset. Recall the economics of a LIHTC deal.¹¹⁶ The competitive 9% tax credit is intended to provide roughly 70% of the equity necessary to develop a LIHTC project. The remaining 30% comes from other sources such as institutional lending, or highly-subsidized loans from, for example, state or local agencies, which often reimburse developers for funds they may have had to front to acquire the land or pay for certain predevelopment costs. Rarely does the developer contribute any significant equity during construction to cover development costs. In some cases, it is possible for a developer to finance a LIHTC project using little to none of its own capital, hence yielding close to infinite returns.

Given such favorable terms, the economics of these tax-driven deals yields the conclusion that potential income streams thirty or more years in the future are not but-for causes of developer participation in the program. One for-profit developer representative confirmed that such future income was not even considered in the financial underwriting of its projects.¹¹⁷ As with the Second Wave Assisted Housing stock, the discounted net present value of these future income streams appears to be superfluous to motivate program participation. Developers potentially stand to earn millions of dollars upfront in the form of a developer fee. The backend value—unnecessary to motivate the delivery of the subsidized housing—is nothing more than residual value captured by the private sector.¹¹⁸

How might we think about addressing the residual value problem to ensure that more of this value flows to the stated purposes of the program rather than to private profits? In Part IV, I argue that provider selection may offer part of the solution.

IV. A THREE-SECTOR APPROACH

Drawing upon corporate organizational theory, which has highlighted the role that the nonprofit firm plays in solving certain contract failures and producing certain positive externalities, this Part argues that corporate form is one important tool that can help address the residual value problem. Ap-

¹¹⁶ See *supra* Part II(B)(2).

¹¹⁷ Telephone Interview with senior executive at California-based for-profit affordable housing development company (Oct. 6, 2015) (on file with author).

¹¹⁸ Note that the residual value problem likely would not exist if the credits were allocated pursuant to a simple market mechanism. The fact that a state agency allocates credits to developers via a methodology not simply based on cheapest cost is what enables the existence of profits in excess of those necessary to competitively motivate program participation.

plying this theory in the context of subsidized housing, I argue that a three-sector approach, whereby the federal government allocates tax credits to nonprofit developers that partner with profit-motivated investors, would not only help solve the residual value problem, but also would yield additional public value. This Part concludes by considering various counterarguments and suggesting how this framework might be implemented.

A. *Economic Theory of the Nonprofit: Contract Failures & Positive Externalities*

Economic theory has grappled with the problem of explaining the proliferation of nonprofit firms over the last fifty years. Legal scholars have provided both negative and positive explanations for the role of the nonprofit firm; the former theorizing that nonprofits solve certain market failures, and the latter arguing that nonprofits provide certain positive externalities.

In his foundational article outlining the “contract failure theory” of the nonprofit, Henry Hansmann argued that the defining feature of nonprofits is the “nondistribution constraint”—or the prohibition on distributing residual profits to those who control the firm.¹¹⁹ This constraint, he argues, solves a variety of contract failures, including prominently failures that arise in the principal-agent context. Specifically, he highlights situations in which the purchaser of the good or service is not the end consumer, and thus is at a disadvantage in evaluating the quality of the good or service provided. Hansmann argues that the nondistribution constraint, and the attendant lack of personal profit motivation on the part of the agent, increases the attractiveness of nonprofits as agents in such transactions, because they are less likely to engage in shirking or providing less high quality outputs for their own personal profit.¹²⁰

Others have theorized that nonprofits have proliferated not only in response to contract failures, but also given the positive role they play in pro-

¹¹⁹ See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

¹²⁰ As Professor Hansmann later described, “[I]t is argued that nonprofits of all types typically arise in situations in which, owing either to the circumstances under which a service is purchased or consumed or to the nature of the service itself, consumers feel unable to evaluate accurately the quantity or quality of the service a firm produces for them. In such circumstances, a for-profit firm has both the incentive and the opportunity to take advantage of customers by providing less service to them than was promised and paid for. A nonprofit firm, in contrast, offers consumers the advantage that, owing to the nondistribution constraint, those who control the organization are constrained in their ability to benefit personally from providing low-quality services and thus have less incentive to take advantage of their customers than do the managers of a for-profit firm. Nonprofits arise (or, rather have a comparative survival advantage over for-profit firms) where the value of such protection outweighs the inefficiencies that evidently accompany the nonprofit form, such as limited access to capital and poor incentives for cost minimization [T]his theory suggests, in essence, that nonprofits arise where ordinary contractual mechanisms do not provide consumers with adequate means to police producers” Henry Hansmann, *Economic Theories of Nonprofit Organization*, in THE NONPROFIT SECTOR 27, 29 (Walter W. Powell ed., 1987).

viding certain goods and services.¹²¹ Jill Horwitz, for example, has found empirical evidence that corporate form plays a role in the types of services provided by hospitals. In one study, nonprofit hospitals were more likely than for-profit hospitals to offer consistently unprofitable services like psychiatric emergency care and less likely than for-profits to offer consistently high profitable services like open-heart surgery.¹²² Assuming less profitable services like psychiatric emergency care are desirable, subsidies received by nonprofits, such as the nonprofit tax exemption, may be warranted.¹²³

While the contract failure and positive externality theories provide descriptive explanations for the proliferation and persistence of nonprofits, they also provide normative insights helpful to solving the residual value problem. In many ways, the residual value problem is a variation on the contract failures discussed by Hansmann. Where Hansmann is primarily concerned with the risk of private agents capturing value explicitly contracted for while shirking their obligations, here the problem is how to minimize the share of residual value that a private agent captures for its own profit versus channeling that value toward the stated programmatic purposes.

The nondistribution constraint helps solve both problems. In the same way that we are less concerned that nonprofits will skim value explicitly contained in hard-to-police contracts, we might similarly be less concerned that nonprofits will divert from public purposes value generated by a transaction that was unnecessary to incentivize their participation in the program. Likewise, the positive externality theory might provide additional justification for favoring nonprofits as providers of our subsidized housing. If in a given transaction, nonprofits provide desirable goods or services that otherwise would not be provided by for-profits, or provide them to a greater degree, then, all else equal, enlisting nonprofits as the provider in a given transaction would inherently increase the public value.¹²⁴

B. *The Role of Nonprofit Developers*

Could the theoretical insights of the contract failure and externality theories of nonprofits help address the residual value issue in the context of subsidized housing? The answer, I argue, is yes. Conversely, the subsidized housing context provides evidence useful to corporate organization theory. Some have argued that Hansmann's theory is idealized and lacks empirical evidence to prove his claims about the functional efficacy of the nondistribu-

¹²¹ Such theories are referred to herein as "positive externality" theories.

¹²² See Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 YALE J. ON REG. 139, 171-73 (2007).

¹²³ *Id.* at 196 ("Nonprofits are different than for-profits. They offer different services, meet different needs, and very likely operate out of motivations of which we (and our liberal tax code) would approve.") (emphasis in original).

¹²⁴ See discussion *infra* in Part IV(C) regarding how all else is, of course, not equal between nonprofits and for-profits.

tion constraint.¹²⁵ Once again, subsidized housing, and its more than eighty years of experimentation, is instructive.

Part I(B) above examined the expiring-use issues that arose with respect to Second Wave Assisted Housing as landlords raised their rents to market levels and evicted residents upon the expiration of long-term use restrictions. Of particular interest, however, is the fact that not all landlords behaved the same way under these circumstances. Predictably, HUD data show that nonprofit owners were significantly less likely to raise rents and displace tenants. For example, certain Second Wave Assisted Housing programs gave owners the option to exit certain subsidized housing programs early. A regression analysis conducted by HUD found that 86.1% of for-profits opted out whereas only 9.2% of nonprofits owners did so.¹²⁶

Similarly, the California Housing Partnership Corporation (CHPC), a state-chartered entity that tracks expiring-use data in California, devised an “at-risk” metric used to gauge how likely a building is to be lost from the subsidized housing stock.¹²⁷ Based on reviewing data for thousands of Second Wave Assisted Housing properties statewide, one of the primary variables used in its at-risk calculation is corporate form of ownership entity.¹²⁸ A given property is likely to rank significantly more at-risk of being converted to market rate housing where the owner is a for-profit rather than a nonprofit.¹²⁹

These findings are not surprising. Rather, they affirm what any basic economic model would predict: that when given the opportunity, for-profit entities are more likely to prioritize profits over other goals, whereas non-

¹²⁵ See Michael H. Schill, *The Role of the Nonprofit Sector in Low-Income Housing Production: A Comparative Perspective*, 30 URB. AFF. Q. 74, 93–94 (1994) (“Hansmann’s (1980) theory of nonprofit organization is admittedly an idealized theory; there is no guarantee that those in charge of nonprofit organizations will not violate the nondistribution constraint.”).

¹²⁶ See OPTING IN, OPTING-OUT, *supra* note 33, at 19, 24 (noting differences between nonprofit and for-profit owners in rates of opting-out of the project-based Section 8 program and terminating certain use restrictions, and concluding, “Properties operated by nonprofit organizations were much less likely to opt out than were properties operated by for-profit owners.”).

¹²⁷ See CAL. HOUS. P’SHIP CORP., THE TAX CREDIT TURNS FIFTEEN: CONVERSION RISK IN CALIFORNIA’S EARLY TAX CREDIT PORTFOLIO 14 (2001) [hereinafter CHPC REPORT] (“In the absence of other restrictions, projects with for-profit general partners will likely convert to market as the partners seek to capture the appreciated value of their properties. On the other hand, nonprofit general partners will generally seek to preserve affordability even in the absence of any ongoing deed restrictions. (CHPC’s experience with the HUD-assisted portfolio has demonstrated that this is usually—although not always—the case.”); see also SHIMBERG CTR. FOR AFFORDABLE HOUS., A RISK ASSESSMENT METHOD FOR PRESERVATION OF ASSISTED RENTAL HOUSING 39 (2008), http://flhousingdata.shimberg.ufl.edu/docs/Risk_Assessment_Final_052608.pdf [<https://perma.cc/T4V9-KLVV>] (noting that “presumed differences in mission between for-profit and non-profit owners can drive decisions about terminating affordability restrictions. For-profit owners have a strong focus on the financial bottom line and aim for maximization of returns A for-profit is more likely to exit the funding program and sell the property or convert to market-rate housing if it makes financial sense to do so. The mandate of a non-profit owner is generally to serve lower income families in the community. Therefore, the risk of conversion is marginal.”).

¹²⁸ CHPC REPORT, *supra* note 127.

¹²⁹ See *id.*

profits, with their double- or triple-bottom lines,¹³⁰ are less likely to do so. Thus, with respect to the residual value problem posed by expiring-use issues, there is evidence that enlisting nonprofit agents as providers of subsidized housing would be one way of structuring these transactions such that, all else equal, more residual value would flow to public, rather than private, purposes.

The positive externality theory might also warrant greater nonprofit participation in subsidized housing. For example, analysis of HUD's LIHTC database shows that nonprofits are more likely than for-profits to provide housing targeted at the deepest affordability levels to the formerly homeless. For properties for which the database contains information, 25.80% of nonprofit sponsored properties targeted the homeless, whereas only 9.56% of for-profit sponsored properties did.¹³¹ In addition, Rachel Bratt has found that nonprofits are more likely to provide housing with services available to populations with special needs—services that generally are not particularly lucrative.¹³² Thus, in the same way that nonprofit healthcare providers are willing to provide less consistently profitable services to patients, there is evidence that nonprofit housing providers similarly are willing to sacrifice profits to provide certain desirable services.¹³³

On a variety of other measures, there is evidence that the kind of housing nonprofit developers produce is different than that produced by for-profit developers in ways that yield additional public value. For example, there is evidence that nonprofit sponsors are more likely to locate their housing in difficult to develop areas,¹³⁴ and “in keeping with the mission of many nonprofits to house large families, these groups were more likely than for-profit developers to build units larger than 1,000 square feet.”¹³⁵ Others have argued even more broadly that nonprofits take a more holistic approach to housing that results in a number of positive neighborhood spillover effects including community empowerment and in particular that community development corporations are more closely connected, and therefore responsive, to the needs of the community.¹³⁶

¹³⁰ This refers to the concept that nonprofits have multiple ultimate goals, including, frequently, the pursuit of profits, social welfare, and sustainability.

¹³¹ The database also reveals that nonprofits (79%) are more likely than for-profits (68%) to have *any* target—these targets include such categories as housing targeted at families, the elderly, the disabled, and the homeless.

¹³² See Bratt, *supra* note 39, at 330.

¹³³ As one interviewee summarized, “You can never calibrate the program to what’s going to be happening in the market in 20–40 years, you are always chasing the game. The way you get out of that is by working with people who aren’t in the game: nonprofits and public agencies.” Telephone Interview with James Grow, Deputy Dir., Nat’l Hous. Law Project (June 26, 2015) (on file with author).

¹³⁴ See Bratt, *supra* note 39, at 330 (“Between 1995 and 2003, nonprofit sponsors located their properties in more difficult neighborhoods than the total universe of LIHTC properties . . .”).

¹³⁵ *Id.*

¹³⁶ See, e.g., Schill, *supra* note 125, at 93 (“At least in theory, nonprofit housing development by local groups can be used as a method to empower residents and improve depressed communities. In addition to gaining control over economic resources, the organizations’ mem-

This is not to argue that the goals of nonprofit housing developers are perfectly aligned with our federal housing goals or with each other. It is only a heuristic to talk about “public purposes” and “nonprofit missions.” The purposes of government, as well as the incentives and behaviors of nonprofits, are diverse and non-monolithic. Nevertheless, “despite being private entities like for-profits, nonprofits are *more likely* than for-profits to adopt goals in the public interest.”¹³⁷ If, with respect to relationships between the government and private providers, our aim is to structure these arrangements such that the maximum amount of residual value flows to stated program purposes rather than private interests, there appears to be significant evidence in the subsidized housing context that provider selection, and specifically engaging nonprofit housing providers, is one way to do so. Given the nondistribution constraint and the expected positive externalities, *all else being equal*, more value will flow to public rather than private interests when the government contracts with nonprofit providers.¹³⁸

C. *Potential Critiques and Responses*

Much is packed into that notion of “all else being equal.” Nonprofit enterprises are, after all, much different than for-profits. This subsection explores some of the critical differences and argues that many of the typical critiques of nonprofits are less potent in the LIHTC context given the three-sector structure that would emerge between the government, private investors, and nonprofit developers. This subsection also addresses other critiques not solely related to the difference between nonprofits and for-profits.

bers gain experience in operating and managing a local enterprise. Groups that successfully complete a housing development gain credibility and respect both inside and outside the community. Frequently, the group will expand its activities to include community advocacy, economic development, and the delivery of social services. Particularly effective organizations can achieve political influence outside the neighborhood and secure additional resources In terms of choice or organizational structure, the nonprofit corporation is likely to be best suited to accomplishing community empowerment objectives.”); *see also* Bratt, *supra* note 39, at 340–41.

¹³⁷ Horwitz, *supra* note 122, at 158 (emphasis added). Nonprofits “may differentially respond to private or public market failures by devoting more resources to serving the needy, or they may maximize the quality and quantity of medical services at the expense of profits.” *Id.* “Regulated organizations often have too much leeway to act in their self-interest, which may undermine their furtherance of public goals. . . . Yet even the most carefully designed systems cannot always sufficiently channel the self-interest of profit-seeking institutions toward public ends. Regulators cannot always accurately predict the responses of regulated institutions to carefully designed incentive systems. And sometimes they do not even know exactly how they wish regulated institutions to behave This study suggests that ownership offers another mechanism through which regulators can alter the strength of response to a given financial incentive. That is, rather than alter the incentive itself to dampen an organizational response, one could simply target different types of organizations to vary the intensity of response to a given incentive. Or regulators could vary financial incentives by form, setting rates by firm type *or selectively contracting with different firm types.*” *Id.* at 189–90 (emphasis added).

¹³⁸ Part IV(D) fleshes out more specific ideas for implementation at the federal and state policy levels.

1. *Efficiency Concerns*

The big concern is, of course, that nonprofit developers are less efficient than for-profit developers. Framed another way, nonprofits are a solution that defeats the original purpose of privatizing our subsidized housing—the nondistribution constraint is, perhaps, the antithesis to the notion of having economic skin in the game. This constraint, remember, is a prohibition on distributing residual profits to those who control the firm. The introduction of economic incentives, the argument goes, brought a discipline to the process of underwriting, developing, and operating housing in the long run that the public housing model lacked.

In the LIHTC context, however, even if we increased or exclusively relied on nonprofits as developers, there would remain a critical profit-motivated entity in the equation: namely, the investors. The only nonprofit LIHTC projects developed are those that can attract investor equity. At present, there is an incredible amount of variation in the sophistication and technical expertise of nonprofit housing developers.¹³⁹ They range in size and capacity from local neighborhood-based nonprofits doing their first thirty-unit project to large, multi-state nonprofits that develop and operate thousands upon thousands of units. As evidenced by the sizeable chunk of LIHTC projects already being developed by nonprofits, investors are finding that at least some subset of nonprofits possess the capacity and expertise worth underwriting.¹⁴⁰ Given the risk of recapture if the property ends up in physical or financial disrepair, investors will only put their money into projects that are designed and operated effectively.

The notion that nonprofits can operate housing effectively over the long run is not of course proof that a nonprofit will provide the same bang for the government's buck as a for-profit. In both cases, maybe the investor is satisfied because it has negotiated the same return on investment. But if the nonprofit only provides forty units and the for-profit provides fifty units, then the investor mechanism has nonetheless failed to eliminate the potential efficiency gap. There is some evidence, however, that shows this is not what happens in reality—i.e., that LIHTC units developed by nonprofits are not in fact more costly on a per unit basis than comparable units developed by for-profits.¹⁴¹

¹³⁹ See Bratt, *supra* note 39, at 325–27; Schill, *supra* note 125, at 81–84.

¹⁴⁰ See Telephone Interview with Shola Giwa, Asset Mgmt. Consultant, Esperanza Cmty. Hous. Corp. (Sept. 1, 2015) (on file with author) (discussing a number of nonprofit-developed affordable housing projects in Los Angeles).

¹⁴¹ See Bratt, *supra* note 39, at 344 (noting one study finding no statistically significant difference in cost-effectiveness between for-profit and nonprofit developers); CAL. DEP'T OF HOUS. AND CMTY. DEV., CAL. TAX CREDIT ALLOCATION COMM., CAL. HOUS. FIN. AGENCY & CAL. DEBT LIMIT ALLOCATION COMM., AFFORDABLE HOUSING COST STUDY: ANALYSIS OF THE FACTORS THAT INFLUENCE THE COST OF BUILDING MULTI-FAMILY AFFORDABLE HOUSING IN CALIFORNIA 34 (2014) (“As a result, we believe that the finding with respect to different developer types [referring to nonprofit vs. for-profit developers] is inconclusive. Additional information is needed to be able to determine which factors related to organizational structure are impacting cost versus other factors such as the type of projects different organizations

This may be in part due to the fact that the nondistribution constraint does not mean that no economic incentives are in play with respect to nonprofits. This rule is easily misunderstood to mean that employees at nonprofits are not allowed to receive any incentive-based compensation, which is not the case.¹⁴² Furthermore, even though managers are not taking home profits, there is still some economic incentive to ensure the general viability and economic health of the organization—hence, incentives like the deferred developer fee and incentive management fees still play a motivational role for nonprofit agents. That motivation is simply balanced against the other goals of the nonprofit. Finally, economic incentives are not the only driving forces—scholars have speculated on the functional role that, for example, intrinsic motivation of nonprofit employees plays in ensuring quality outputs.¹⁴³

None of this is to argue that nonprofit developers and for-profit developers provide the exact same level of efficiency as subsidized housing providers—more research is necessary to evaluate this claim. However, there is strong reason to believe that the special structure of the LIHTC program, which layers developer and investor incentives, has the unique ability to capitalize on the best of what the nonprofit and for-profit sectors have to offer: the nonprofit developer providing a degree of fidelity to public purposes and the for-profit investor ensuring a baseline level of efficiency.

2. Access to Capital

Another common critique of nonprofit providers is that they are at a structural disadvantage for raising capital. The nondistribution constraint is a double-edged sword with the downside being that investors generally are not interested in enterprises that cannot distribute residual profits to owners.¹⁴⁴ As a result, nonprofit developers typically have smaller balance sheets than for-profits do.¹⁴⁵

choose to work on based on an organization's mission.”). Note that in addition to considering operational costs and viability, ideally comparisons of relative efficiency between nonprofit and for-profit developers also should consider issues of deferred capital maintenance.

¹⁴² See, e.g., James R. Hines Jr., Jill R. Horwitz & Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1194 (“This [nondistribution constraint] requirement does not, however, mean that salaries must be fixed. The IRS recognizes that, ‘when there are adequate safeguards, benefits derived from incentive compensation plans accrue not only to the affected employee, but also to the charitable employer through increased productivity or cost stability, thus adding to, rather than detracting from, the accomplishment of their exempt purpose.’ Nonprofits, therefore, may structure executive compensation so that it varies with quantity and quality of output”) (citing *Health Care Update*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR THE FISCAL YEAR 1987 (1987)).

¹⁴³ *Id.* at 1197.

¹⁴⁴ Note that in LIHTC projects, investors are not investing in nonprofit developer sponsors directly, but rather in separate single-purpose entities that own the project.

¹⁴⁵ This critique can relate back to the efficiency critique. For-profit developers often claim that their larger balance sheets enable them to provide more valuable guaranties to banks, which in turn allows them to obtain more financing at better rates. They also argue that they are able to negotiate more effectively with investors to obtain better pricing for tax cred-

Here, again, the structure of the LIHTC program helps to ameliorate this concern. As discussed above, the competitive 9% tax credit is intended to provide roughly 70% of the equity necessary to develop a LIHTC project. Therefore, regardless of whether the developer is a nonprofit or for-profit, the government provides the bulk of the financing. The remaining 30% comes from other sources such as institutional lending, or soft loans from, for example, state or local agencies. Rarely are development costs covered by developer equity. This is not true, however, with respect to certain pre-development costs, which often must be borne by the developer, at least until the tax credit closing. Further, the cost of the land is not included in the tax credit eligible basis, and thus other acquisition sources must be assembled where the developer does not already own the land. Here, for-profit developers argue, they are often at an advantage in being able to carry significant pre-development costs and act swiftly to scoop up desirable properties when they become available.¹⁴⁶

The idea that the government should provide subsidized financing to for-profit developers because they already have more capital seems somewhat counterintuitive and at least worth pausing on. An alternative solution would be to redirect resources currently channeled to for-profit developers, for example in the form of long-term subsidized city loans, and instead provide more readily accessible sources of pre-development and acquisition financing to nonprofit developers. Some jurisdictions have already begun creatively developing pre-development and acquisition funds.¹⁴⁷ Other mechanisms that build the capacity of the nation's nonprofits seem worth exploring, rather than designing housing policies around the predetermined assumption that we must continue to subsidize for-profit developers.

Nonetheless, in the near term, for idiosyncratic reasons,¹⁴⁸ there may be potential projects that would be desirable to develop using LIHTC financing and where the project only works with the financial backing of a particular for-profit developer.¹⁴⁹ It is not uncommon for nonprofit and for-profit developers to form a joint venture on LIHTC projects as co-developers; often the for-profit provides the necessary up-front capital and the nonprofit acts

its. Whether any associated gains flow to public purposes versus private profits is an open empirical question.

¹⁴⁶ Nonprofits often cannot move as swiftly given the need to assemble acquisition financing from a variety of sources.

¹⁴⁷ For example, the New Generation Fund in Los Angeles provides "flexible acquisition and predevelopment financing for developers committed to the creation and preservation of affordable housing in the City of Los Angeles. Made possible through a partnership between the Los Angeles Housing + Community Investment Department, local foundations, and public lending institutions, the Fund is capitalized with \$65.5 million of lendable proceeds . . ." See NEW GENERATION FUND LLC, <http://newgenerationfund.com/> [<http://perma.cc/DYW4-FTCX>].

¹⁴⁸ For example, particularly high land costs; lack of nonprofit interest in a particular area; or absence of available state or local soft subsidy sources.

¹⁴⁹ For-profits more than nonprofits develop so-called "80/20 deals," where 80% of the units are market-rate and the minimum 20% of units are rent-restricted in order to obtain tax credits. Although not the only type of mixed-income development, for-profit developers argue that their ability to leverage funds makes these projects more feasible.

as the service provider and community conduit. In some cases, where the nonprofit is a legitimate, bona fide nonprofit, this arrangement works well, and some of the benefits explored above of combining for-profit and nonprofit incentives materialize.

Thus, as described more fully in Part IV(D), the best policy proposal would allow for some participation by for-profit developers where a particularly compelling project could not be built but for the access to private developer capital or, perhaps, given some other specific expertise or capacity.¹⁵⁰ The argument would be even stronger in the context of a partnership with a bona fide nonprofit co-developer. However, this would not argue against a more general and default preference for nonprofit developers.

3. *Political Realities*

If nonprofit developers would deliver more public value than for-profit developers, one might wonder why state allocating agencies are not already channeling tax credits disproportionately to nonprofits. Nothing in the U.S. Tax Code prevents states from allocating tax credits to nonprofits; to the contrary, it requires a ten percent minimum set-aside for nonprofit developers.¹⁵¹ One might argue the fact that states have chosen to skew tax credit allocation toward for-profits is evidence itself that for-profit developers provide greater public value.

This is an argument that can be addressed in part by reference to political realities. One former senior state tax credit official summarized in depth the strong influence of state lobbying groups in allocation decisions.¹⁵² The impact of such groups at the state level is at least one factor that should make us skeptical that current allocation procedures maximize federal housing goals.

Aside from direct lobbying, other political considerations likely play a role as well. The expiring-use issues that nonprofits would help ameliorate will not arise for at least thirty years from the date of credit allocation. As noted above, addressing this seemingly distant problem may not be a priority

¹⁵⁰ See Rachel G. Bratt, *Should We Foster the Nonprofit Housing Sector as Developers and Owners of Subsidized Rental Housing?*, (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper RR07-12, 2007), http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/rr07-12_bratt.pdf [<https://perma.cc/L4MT-HHHL>] (arguing for the value of partnerships between nonprofit and for-profit developers given unique institutional capacities).

¹⁵¹ I.R.C. § 42(h)(5) (2012).

¹⁵² Pavão Interview, *supra* note 100 (“There is a statewide organization that focuses more on for-profit developers of affordable housing. That organization and that community . . . are very generous donors to public officials. When a state treasurer takes over office it is often that organization that was aggressive fundraisers for that official. If a treasurer decided, ‘I want to start erring on the side of nonprofit developers,’ they would really be choosing between two very powerful communities. And they would be favoring the one that is not the big fundraising machine. A treasurer would have to be willing to overcome that: ‘I know I am going to be trying to gore the ox of a community that provides campaign funding.’ As a practical matter, the treasurers I have worked with have decided we’re not going to take that on. To the extent they are both good at what they do, why would we want to favor one over the other?”).

of politicians given their incentives.¹⁵³ This is especially the case when we are yet to reach 2020 and there has not yet been any immediate political crisis drawing attention to the issue.

An alternative critique is that, even if it would be optimal from a policy perspective to favor nonprofit developers, one of the virtues of the LIHTC program is its broad political popularity. It might be argued that the coalition of stakeholders that has supported the program at the federal level will fall apart if for-profit developers are largely replaced by nonprofit developers.

Such a result is unlikely. The LIHTC program would still be beneficial to the same financial institutions, attorneys, accountants, consultants, contractors, certain low-income housing advocacy organizations, and array of other stakeholders if nonprofits continued to partner with investors to develop the housing. The for-profit developer community is the primary constituency that would be disadvantaged. It is possible that for-profit developer participation in the program was critical in the early years—simply the price we had to pay to get as many stakeholders on board as possible. But it is worth drawing an analogy to the pricing for tax credits. Investors used to pay less than \$0.50 per dollar of tax credits. As the program matured, and investors gained confidence in the returns yielded by LIHTC projects, the pricing increased dramatically. More of every dollar invested in the program went to housing production rather than investor profit. Similarly, in order to get the program passed and, eventually, made a permanent tax credit, perhaps the optimal strategy used to be to ensure profits to as many private stakeholder groups as possible. Now that the program has existed for thirty years and enjoys a broad spectrum of stakeholders committed to its ongoing viability, we no longer need to deliver those excessive profits to the for-profit developer community.

4. *Vouchers*

Some might argue that this entire conversation is for naught. Perhaps a three-sector approach to subsidized housing development would be an improvement over previous “supply-side” programs.¹⁵⁴ But per this critique, the federal government should not be in the business of subsidizing housing *development* at all. Rather, if we want to subsidize housing for low-income households, many have argued the most effective way to do so is through “demand-side” programs that provide direct rental support to households, such as Section 8 vouchers.

Part of this critique rests on an efficiency concern—not related to the relative efficiency of nonprofits versus for-profits as discussed above, but rather the inefficiency of the LIHTC program as a whole given the number

¹⁵³ Perhaps from an *ex ante* economic perspective the cost of this problem should be discounted given that it will not arise for many years in the future of any particular tax credit allocation. From an *ex post* perspective, however, the cost is significant in present terms, when considering public value loss and the cost to replace the expiring stock of subsidized housing.

¹⁵⁴ See *supra* note 2 for discussion of “supply-side” and “demand-side” programs.

of parties involved in financing the transaction and the compensation required by each of them.¹⁵⁵ Vouchers, by contrast, rely on a relatively streamlined mechanism by which the federal government simply allocates funding to local housing authorities that help pay a portion of the rents for eligible households living in private rental housing.

A full discussion of this long-standing debate is beyond the scope of this Article.¹⁵⁶ Whether vouchers are more efficient in all cases is not clear and appears to be somewhat sensitive to local market characteristics.¹⁵⁷ Further, regardless of efficiency concerns, scholars have argued convincingly that supply-side interventions can provide worthwhile benefits that vouchers do not.¹⁵⁸ Specific benefits that have been noted include improving distressed communities, providing supportive services, increasing access where vouchers are difficult to use, and community empowerment.¹⁵⁹ Thus, even if vouchers are generally more efficient, there are other reasons we might continue to support supply-side interventions as one tool in the federal subsidized housing policy toolkit.¹⁶⁰

5. *Other Alternatives*

The corporate form of the developer is not the only mechanism via which to address the residual value problem. Nonprofit developers are by no means a panacea—some nonprofit developers that participated in the Second

¹⁵⁵ Critics argue that the large number of stakeholders who support the program do so at considerable cost. The banks, syndicators, investors, and so on, all require fees or profits in order to entice their participation.

¹⁵⁶ For a foundational discussion of this debate, see Apgar, *supra* note 2.

¹⁵⁷ *Id.*

¹⁵⁸ See Schill, *supra* note 125, at 92 (“Nevertheless, because demand-oriented housing subsidies may not be optimal in all housing markets and may not achieve all housing-related objectives, supply-oriented subsidies targeted to nonprofit organizations may be justified under certain conditions on grounds of economic efficiency. For housing allowances and vouchers to be effective, at least in the short run, sufficient vacancies must exist to give tenants a choice among alternative accommodations. In a small number of tight U.S. housing markets, tenants, particularly racial minorities, have experienced some difficulty using housing allowances and vouchers Even in markets that do not exhibit entry barriers or a high degree of racial discrimination, demand-oriented subsidies may not be effective in achieving objectives that go beyond bricks and mortar. In the United States and parts of the United Kingdom such as Scotland, housing policy has been used to further the objective of neighborhood regeneration. Demand-oriented subsidies are generally ineffective in improving particular communities because they are not geographically focused; in fact, one of their main advantages is that they provide housing consumers with freedom of mobility. Supply-oriented subsidies, however, can be targeted to particular neighborhoods or sites within neighborhoods. Supply-oriented subsidies targeted to nonprofit organizations may also generate nonhousing benefits for lower income communities.”)

¹⁵⁹ *Id.* at 93.

¹⁶⁰ In this Article, I argue that a nonprofit developer preference would improve over the current LIHTC program. However, this is not to argue that it is not also worth exploring alternative supply-side approaches. For example, future research should examine the dynamics at play with respect to public housing properties that did not fall into financial or physical disrepair. Perhaps a direct capital grant program that addresses those failures is worth piloting. Unlike the LIHTC program, however, such an effort would face the difficulty of requiring Congressional appropriations.

Wave Assisted Housing programs behaved no differently than for-profit developers. Furthermore, not all housing nonprofits have missions closely aligned with federal housing policy goals. If given the chance to play a greater role in the LIHTC program, certain nonprofits would no doubt behave opportunistically.

Other legal scholars have proposed approaches for dealing with the difficulty of embodying public law priorities in private contracts. Nestor Davidson, for example, has argued that given the difficulties of public-private agreements based on discrete contracting, we should instead rely more heavily on relational contracting—or longer-term, often repeat-player arrangements, that foster a sense of mutual responsibility over program goals and attempt to engender shared norms of reciprocity between the government and the private agent.¹⁶¹

Furthermore, Davidson assumes this approach will go hand-in-hand with other mechanisms, stating:

Another response can be found in the selection and screening mechanisms that governments employ to decide with whom to enter into the kinds of long-term collaborations at issue. Mission-driven nonprofit entities, for example, may have distinct advantages in this regard over for-profit entities, although even within the for-profit sector there are entities that are likely to be more appropriate long-term partners. Laura Dickinson has argued in this vein that third-party accreditation can provide an effective tool to enhance norms of accountability internal to a given industry.¹⁶²

Another potential approach to dealing with the residual value problem as it arises in the LIHTC context would be to extend the term of the use restriction—perhaps in perpetuity, or to the longest term permitted under state law. However, simply lengthening the required period of affordability indefinitely is no panacea. As a consumable good, housing needs periodic infusions of capital to maintain building quality. An approach that focuses on an extended-use restriction without also providing adequate sources of recapitalization will not be effective in the long run. Without a dedicated source of rehabilitation financing from the government, owners are often

¹⁶¹ Davidson, *supra* note 90, at 264 (“Recognizing the relational, yet at times imbalanced, nature of these agreements yields prescriptions that seek to foster reciprocity and solidarity on the part of private providers. Tempering some measure of governmental discretion, or creating mechanisms to balance the parties’ adjustments over time, may enhance the benefits of engaging the private sector in service provision, and may also provide alternative means to address threats to accountability. By rewarding fidelity on the part of private actors to the public values involved in services traditionally provided by the government, a relational approach can harness private incentives in the long run in a way that reinforces, rather than undermines, important public law norms. In various contexts other than privatization, relational contracts scholars have recognized the value that strategies of mutual commitment can bring to the long-term governance of contractual relations.”).

¹⁶² *Id.* at 314 (citing Laura Dickinson, *Government for Hire: Privatizing Foreign Affairs and the Problem of Accountability Under International Law*, 47 WM. & MARY L. REV. 135 (2005)).

forced to confront difficult decisions that balance the desire to maintain maximum affordability against the need to ensure project habitability. Given the current resource-constrained reality, the best we can hope for is that when these difficult decisions arise, the stewards of this stock of housing make them with an eye toward maximizing public goals rather than private profits. Thus, while longer use restrictions may be helpful in certain circumstances, and particularly where preservation resources are accessible, they do not obviate the arguments for a nonprofit developer preference.

These are not either-or solutions. Rather, corporate form, relational contracting, third-party accreditation, longer affordability terms, and yet other mechanisms may all work together to help address problems like residual value capture that arise from a mismatch in public and private goals.

D. Implementation

The insights of this Part could be effectuated by a variety of policy proposals. The strongest proposal would be to mandate that only nonprofit developers are eligible to participate in the LIHTC program. This would not be unprecedented for our federal subsidized housing programs—the Section 202 program referenced in Part I(B) permitted only nonprofit developers to participate.¹⁶³ In this context, however, there may be access to capital reasons, described in Part IV(C)(2), not to exclude for-profit developers entirely.¹⁶⁴ The more moderate version of the proposal would be a preference for nonprofit-developed projects in QAP scoring.¹⁶⁵ When the scoring for competitive tax credit projects is tallied, nonprofits would presumptively be awarded credits unless competing for-profit projects presented a particularly compelling case.

This policy could be implemented via one of two straightforward routes. The first would be through an amendment to Section 42 of the Internal Revenue Code. This would have the advantage of making the rule binding on all fifty states. It would, of course, also require a politically divided federal government to agree on statutory amendments. Though such an agreement is unlikely, tax reform has been a subject of serious discussion in recent years, much as it was in 1986 when the LIHTC program came into being.¹⁶⁶ Presidential advisors and congressional committees have recently focused on the LIHTC program and considered ways to amend the pro-

¹⁶³ See Grow & Weiss, *supra* note 32, at 412.

¹⁶⁴ Similarly, in contexts where nonprofit and for-profit developers are not in competition for scarce credits, subsidized housing produced by for-profits is presumably better than none at all. This may frequently be the case with respect to 4% credits where states do not exhaust their annual cap on tax-exempt date. For relevant distinctions between 9% and 4% credits, see *supra* note 61.

¹⁶⁵ See *supra* note 61 and accompanying text for a description of QAP scoring.

¹⁶⁶ See, e.g., Michael Rubinger, *Two Tax Credits That Work*, N.Y. TIMES (July 12, 2013), <http://www.nytimes.com/2013/07/13/opinion/two-tax-credits-that-work.html?> [<http://perma.cc/5JYL-LT2S>].

gram.¹⁶⁷ A window of opportunity could open in which it would be possible to insert a nonprofit preference into Section 42.

The other route would be for states to adopt amendments to their Qualified Allocation Plans.¹⁶⁸ This has the advantage of bypassing Congress. The downside of the QAP approach is that it would require a fifty-state effort—an effort certain to be challenged by the same for-profit developer interest groups described in Part IV(C)(3). The intensity of this resistance is likely to vary by state. This method at least would lead to a partial victory, whereby certain states successfully implemented changes to their QAPs. For those states, the changes would yield significant dividends now and in the decades to come.¹⁶⁹

These are admittedly prospective approaches. In other words, they do not retroactively affect projects that have already been placed in service, but rather aim to prevent the problem from ballooning even further and to set federal housing policy on a better course for the long-term future. For projects that already have been constructed using LIHTC financing, the policy options are more limited and familiar. When 2020 rolls around, a patchwork of carrot and stick approaches will be available to federal, state, and local governments that want to preserve the affordability of this stock of housing. Such jurisdictions would be wise to refer to the well-documented set of policy options considered in the context of the Second Wave Assisted Housing stock.¹⁷⁰

¹⁶⁷ See, e.g., STAFF OF S. FIN. COMM., 113TH CONG., TAX REFORM OPTIONS FOR DISCUSSION (May 15, 2013) (reviewing a variety of proposals to alter the LIHTC program); Common Sense Housing Investment Act of 2015, H.R. 1662, 114th Cong. § 5(b) (2015) (proposing certain increases to the per capita allocation of credits); DEP'T OF TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 31–41 (2014), <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY-2015.pdf> [<https://perma.cc/T5PQ-LAB5>] (suggesting a number of revisions to the LIHTC program, including adding certain preservation-related criteria to the state allocation process).

¹⁶⁸ California's housing finance agency recently circulated one proposed change to its QAP that would have given nonprofit developers certain special rights with respect to future LIHTC developments. CAL. TAX. CREDIT ALLOCATION COMM., PROPOSED REGULATION CHANGES WITH INITIAL STATEMENT OF REASONS 71 (2015), http://www.treasurer.ca.gov/ctcac/programreg/2015/20150715/proposed_regs.pdf [<https://perma.cc/2RX8-2KDX>] (proposing a regulation that, for 9% deals in which all general partners are nonprofits, would require that the partnership agreement with the investor grant the nonprofit a right of first refusal to purchase the project at Year-15 pursuant to a calculation set by statute). While a step in the right direction, without further policies, the execution of rights of first refusal can be difficult for some of the access to capital reasons set forth in Part IV(C)(2).

¹⁶⁹ Perhaps early adopter states would serve as models to other states regarding the positive externalities associated with nonprofit development as discussed in Part IV(B).

¹⁷⁰ These policy options are not the focus of this article and have been discussed at length elsewhere. See, e.g., NAT'L HOUS. LAW PROJECT, *Congress Considers Overdue Preservation Agenda*, 38 HOUS. L. BULL. 72 (2008) (discussing policy options including, for example, offering additional resources to owners in exchange for extended affordability terms, enacting a federal first right of purchase, and providing vouchers to displaced tenants).

CONCLUSION

By 2043, two million apartments in America will have lost the current federal restrictions that keep them affordable to low-income households. Nearly 1.4 million of them are owned by profit-motivated entities. Barring additional federal, state, and local restrictions, a sizeable portion of the investment America has made in this stock of housing since 1987 will no longer be serving the purpose of helping every American family attain a decent home. Rather it will be captured by private industry.

At the same time, every year we invest roughly eight billion additional dollars in this program, sending roughly 100,000 units in 1,400 new apartment projects off to a similar fate. The families occupying these apartments at the time of transition will face the threat of displacement and homelessness—a negative piece of our nation’s housing history repeating itself on a massive scale.

Given the critical importance of decent housing to economic mobility and the fact that so many millions of American families go without, regardless of disagreements about whether and to what degree the government should intervene, it would seem hard to argue with one proposition: that to whatever extent the government does provide subsidies, it should do so in a manner that captures the most value for public, rather than private, purposes.

Both theory and evidence support the argument that corporate form of provider is one way to increase the public share of value created in government-provider transactions. Given the nondistribution constraint of nonprofits, the incentives are less strong to steer value away from public goals. Evidence regarding positive externalities further supports the argument for a nonprofit preference.

Nonprofits suffer from their own endemic weaknesses and are by no means a perfect solution. But the structure of the LIHTC program significantly ameliorates critiques that arise in other settings. The unique relationship between investor and developer holds the promise of effectively calibrating incentives in a way unseen in our prior housing programs—creating a hydraulic tension between fidelity to public purposes and operational competence rigorously patrolled by investors with millions of dollars at stake.

Federal subsidized housing provides a robust eighty-year case study from which to draw insights as different sectors of the government are increasingly relying on public-private partnerships. The LIHTC program supports the proposition that privatization is not a binary question of government versus private provision. Rather, it is a question of how best to balance the interplay of institutional strengths and weaknesses of government, private enterprise, and the social sector. The tripartite structure that emerges in nonprofit-sponsored LIHTC deals is one model that, while not perfect, advances toward the best we can hope to achieve in a human-run enterprise.

