Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit

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I. INTRODUCTION

The phrase "tax expenditures" was not used until 1967 in a speech by Stanley Surrey. Special tax incentives for particular types of economic activity, however, have been part of the United States income tax system since its inception in 1913. Tax expenditures are revenue losses arising from provisions of the federal tax laws that allow a special exclusion, exemption or deduction from gross income or that provide a special credit, a preferential rate of tax or a deferral of tax liability. These special provisions are not necessary to implement the income tax structure itself but are instead government expenditures made through the tax system, hence the name "tax expenditures." The prevailing opinion among academic tax lawyers, Treasury officials and tax economists is that the tax system is a poor vehicle for the efficient allocation of resources.

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1. In 1967, Stanley Surrey was Assistant Secretary for Tax Policy in the Treasury Department. Assistant Secretary Surrey conducted the research that provided a "Tax Expenditure Budget," published in the Annual Report of the Secretary of the Treasury in 1968. Stanley S. Surrey, Pathways to Tax Reform: The Concept of Tax Expenditures vii (1973).

2. Richard Goode, Lessons from Seven Decades of Income Taxation, in Options for Tax Reforms 13, 20 (Joseph A. Pechman ed., 1984). The deduction for home mortgage interest has been in the law since 1913. Id. at 20. In addition, the deduction for non-business taxes and the exclusion for interest on state and local securities dates back to the original tax act. Id. In 1917, Congress enacted the deduction for charitable contributions to encourage taxpayers to make charitable donations. Id. at 21. Congress was concerned that the recent tax increases necessary to finance World War I would cause a decrease in the level of charitable contributions. Id. Therefore, the charitable contribution deduction was one of the first important examples of a deliberate incentive program legislated by Congress. Id. at 20.


4. Surrey, supra note 1, at vii. In essence, such special provisions are viewed as a means of providing governmental financial assistance and have a purpose similar to direct expenditures. Id. Tax expenditures in the income tax system have a wide ranging and significant impact on individual and corporate taxpayers. Id. at 50. Individual taxpayers are affected as consumers, wage earners, investors or recipients of benefits under income transfer programs. Id. Examples of tax expenditure provisions available to individual taxpayers include: (1) the exclusion of employer pension contributions from employee wages; (2) the interest deduction for home mortgages; and (3) the retirement income tax credit. Id. at 13, 93-97.

Corporations have also benefitted greatly from tax expenditures. Id. at 77. Although some tax expenditures are geared toward specialized industries, many other special provisions affect corporations in general such as accelerated depreciation deductions for fixed assets. Id. at 78.
for social policy. Nonetheless, virtually all industrialized countries make use of tax expenditures as a substitute for government spending programs otherwise known as direct expenditures.

The reasons for the widespread use of tax expenditures are varied. According to Professor Aaron, the popularity of tax expenditures "derives from a peculiar alliance among conservatives, who find attractive the alleged reduction in the role of government that would follow from extensive use of tax credits, and liberals anxious to solve social and economic problems—by whatever means—before it is too late." Proponents of tax expenditures maintain that such incentives encourage the private sector to participate in social programs because the "most convenient form for subsidizing a businessman is through his income tax." And for some, the thought of only using the tax system for raising revenue is "just antediluvian." Finally, at least with re-

5. See id. at 146 (arguing that many tax incentive provisions relate to programs that are essentially experimental in nature and as result are inappropriate for establishing social policy); see also Richard L. Doernberg, A Workable Flat Rate Consumption Tax, 70 Iowa L. Rev. 425, 425 (1985) (describing current tax law as having weighted down nation's economy "with a hodgepodge of inefficient, distorting provisions"); Donald C. Lubick, The Treasury Department and Tax Legislation, in TAX LEGISLATIVE PROCEDURES 11, 14 (Colvin ed., 1980) (discussing proliferation of tax expenditures as leading to complexities in administering tax law); Bernard Wolfman, Federal Tax Policy and the Support of Science, 114 U. Pa. L. Rev. 171, 184 (1965) (observing that support for science through tax subsidies is often wasteful and inefficient method of funding). But see Edward A. Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973, 975-76 (1986) (arguing that tax expenditures can be more efficient than direct expenditures because of lower transactional costs).

6. See INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY 9 (Paul R. McDaniels & Stanley S. Surrey eds., 1985) (citing Australia, Austria, Belgium, Canada, France, Ireland, Japan, New Zealand, Spain, the Netherlands, the United Kingdom and West Germany—prior to its unification with East Germany—as examples of industrialized countries that employ tax expenditure provisions).

7. See Surrey, supra note 1, at 147 (citing Henry J. Aaron, Tax Exemptions - The Artful Dodge, TRANSACTION, March 1969, at 5). Certainly a tax expenditure program can be designed to have little government bureaucracy, as can a direct spending program. But this is not true of the low-income housing credit where, with respect to particular provisions, the state housing credit agencies, the Internal Revenue Service and the Department of Housing and Urban Development must supervise various aspects of the program.

8. 115 Cong. Rec. 12,875-77 (1969) (statement of Senator Charles Percy in support of S. 2192, 91st Cong., 1st Sess. (1969), a bill that provided tax incentive for manpower-training and employment); see also Zelinsky, supra note 5, at 1011 (arguing that "[c]ommunication through the tax system is frequently the government's cheapest method of conveying its policies, particularly in the case of small businesses and middle-income taxpayers").

spect to the United States, the budget process and the committee system within Congress promote use of the tax system. Unlike other congressional committees, the tax-writing committees (the Senate Finance Committee and the House Ways and Means Committee) are able both to authorize a particular program and appropriate the necessary funds through a reduction in revenue receipts. Thus, a tax expenditure program bypasses the normal two committee process. The Budget Enforcement Act of 1990 (BEA) exacerbates this procedural advantage because the tax-writing committees can pay for any new social programs, designed as tax expenditures, with either tax increases or spending cuts. The appropriations committees, on the other hand, have only one option—to cut spending.

The low-income housing credit is a contemporary example of a government program implemented through the tax code. To increase the stock of affordable housing without appropriating public funds directly for that purpose, Congress decided to give the private sector a tax incentive to build and renovate low-income rental housing. This Article focuses on the debate over the low-income housing credit to illustrate the problems inherent in using the tax code to implement social policy. Proposed low-in-

10. Usually, Congress must take two steps before the federal government can spend money on an activity. Stanley E. Collender, The Guide to the Federal Budget Fiscal 1993 1 (1992) [hereinafter Federal Budget Fiscal 1993]. First, an authorization, substantive legislation establishing guidelines for a given activity, must be passed. Id. Second, an appropriation must be passed to enable an agency to spend money. Id. Both an authorization and an appropriation are necessary for an activity to be included in the budget because a program must be allowed to exist and money must be provided for its implementation. Id.

The reasons for this dual requirement are mostly political. The two-step authorizations/appropriations procedure separates program decision-making from financial decision-making within Congress. Thus, the rules purport to limit the Appropriations Committees to financial issues while barring them from substantive policy in order to prevent an excessive concentration of legislative power. Allen Schick, Congress and Money: Budgeting, Spending, and Taxing 170 (1980).

11. Surrey, supra note 1, at 145. In addition, members of Congress can most effectively accomplish their legislative goals through the committees on which they serve. Thus, the members of the tax-writing committees have strong incentives to use the tax code for their social policy initiatives. See Schick, supra note 10, at 504 (observing that tax legislation provides Congress with opportunity to provide benefits to political interest groups).


13. Id.

14. Id. For a discussion of sequestration procedures and spending limits, see infra notes 298-303 and accompanying text.
come housing credit legislation attempted to address housing policy issues in the tax code and found itself in apparent conflict with tax policy considerations. Part II of this Article examines two housing policy goals that appear to conflict with tax policy goals, determines that these conflicts are real and discusses how to resolve the conflicts between tax policy and social policy goals.

First, the use of below-market purchase options to facilitate the transfer of credit properties to organizations dedicated to the provision of low-income housing appears to conflict with the tax policy goal of limiting tax benefits to the "true owner" of the property. The Low-Income Housing Tax Credit Act of 1989\(^\text{15}\) proposed to allow nonprofit organizations and tenant cooperatives to negotiate below-market purchase options with the investors during a project's initial development without disqualifying the investors from claiming the credit while they own the property.\(^{16}\) Because an owner who grants a below-market purchase option has no right to appreciation, Congress maintained that this owner has relinquished one of the benefits of ownership. With ownership at issue, the grant of a below-market purchase option would justify depriving the investors of tax benefits such as depreciation deductions and the tax credit. This tax policy concern—that the below-market purchase option removed any reasonable expectation of deriving a profit independent of tax benefits—made this proposed modification unacceptable to Congress. This Article discusses the inappropriateness of this tax policy principle in the context of the low-income housing credit.

Second, the goal of encouraging investment in low-income housing appears to conflict with the tax policy goal of ensuring that the wealthy pay an equitable amount of taxes; a maxim known as vertical equity.\(^^{17}\) The Community Revitalization Tax Act of 1989\(^^{18}\) proposed to increase the pool of investors eligible to use the low-income housing credit by modifying the passive

\(^{15}\) S. 980, 101st Cong., 1st Sess. (1989) [hereinafter S. 980].

\(^{16}\) Id. § 2.

\(^{17}\) Vertical equity refers to the relative amount of taxes paid by taxpayers with different incomes and requires that those with greater ability to pay actually pay more tax. This maxim—that as one's income rises the proportion of income that one pays as a tax rises—is one of the justifications for the progressive rate structure of the United States income tax system. Michael J. Graetz, Federal Income Taxation Principles and Policies 17 (1988); William A. Klein et al., Federal Income Taxation 19 (1993). See generally Walter J. Blum & Harry Kalven, Jr., The Uneasy Case for Progressive Taxation 3 (1953) (analyzing progressive taxation).

activity rules in order to limit their scope to include only losses, not credits. Congress maintained that this proposed modification to the passive activity rules would undermine the equity of the tax code. Using tax expenditure analysis, this Article asserts that allowing wealthy taxpayers to receive the benefit of the low-income housing credit does not conflict with the goal of vertical equity if the tax credit is fully capitalized or, in the alternative, is treated properly for income measurement purposes.

Although the larger debate focuses on the propriety of federal intervention in the domestic economy and the use of the tax system to accomplish such intervention, this Article necessarily assumes that Congress has affirmatively chosen to intervene in the economy through the tax system. An evaluation of the economic efficiency and the political and moral implications of this choice is beyond the scope of this Article. Rather, this Article seeks a reevaluation of tax policy principles when the tax code is being used solely to accomplish social policy goals. The low-income housing credit example illustrates why tax policy concerns should not frustrate congressional intent in accomplishing social policy objectives.

19. Id. § 2.
20. For a discussion of why a capitalized tax credit does not violate vertical equity, see infra notes 237-46 and accompanying text.
21. For a discussion of remediating inequities in both direct expenditures and tax expenditures, see infra notes 217-36 and accompanying text.
22. See U.S. DEP’T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND GROWTH (1984) [hereinafter TAX REPORT], reprinted in FEDERAL TAXES BULLETIN 51 (1984) (containing “Volume 1 - Overview”) (asserting that income tax system interferes with economic choices and retards saving, investment and growth). The Tax Report advocates a tax policy of non-intervention in the domestic economy. Id. It asserts that because the tax system has expanded beyond its primary purpose of raising revenue to subsidizing a long list of economic activities through exclusions, deductions, tax credits and preferential tax rates, the tax system has become too complicated, unfair and intrusive. Id.
23. For articles examining the debate over the use of tax expenditures in lieu of direct expenditure programs, see Doernberg, supra note 5, at 425; Lubick, supra note 5, at 11, 14; Wolfman, supra note 5, at 184; Zelinsky, supra note 5, at 975-76; CONGRESSIONAL BUDGET OFFICE, THE COST-EFFECTIVENESS OF THE LOW-INCOME HOUSING TAX CREDIT COMPARED WITH HOUSING VOUCHERS: A CBO STAFF MEMORANDUM, reprinted in 56 TAX NOTES 493 (1992) [hereinafter CBO] (discussing use of low-income housing credit as compared to housing vouchers as method to provide low-income housing for poor).
24. For a thorough discussion of the efficiency of tax incentives in terms of “universal market efficiency,” “sectoral efficiency” and “technical efficiency,” see Zelinsky, supra note 5.
A. Purpose of the Low-Income Housing Credit

The low-income housing credit provides an incentive for the private sector to build and renovate low-income rental housing. The goal is to increase the affordable housing stock available to low-income tenants. In exchange for reducing the rent that they charge qualified low-income tenants, the owners receive a tax credit designed in part as compensation for rent reduction.\(^{25}\) Using the tax credit for this purpose creates a partnership between the federal government and the private sector concerning the provision of affordable housing. Absent the tax credit or other government subsidy, the private sector has little economic incentive to provide low-income housing. The investment itself provides an inadequate return because low-income housing does not usually appreciate in value and rental income is limited.\(^{26}\)

Until 1974, most federal housing activities were structured as new construction programs. Public housing projects were initially built, owned and operated by state-chartered, local public housing authorities using federal monies to finance development costs.\(^{27}\) In the 1960s, however, Congress decided that it was more efficient for the private sector to use government subsidies to build, own and operate this housing than it was for the government to undertake such activities itself.\(^{28}\) With the decline in fed-


\(^{26}\) For a discussion of certain economic realities in low-income housing, see infra notes 153-55 and accompanying text. Senator William S. Cohen stated that "[i]t is precisely because the economics of low-income housing are so unattractive that the Congress has, since 1949, encouraged the goal of low-income housing for poor people through direct spending programs and tax incentives." 132 Cong. Rec. S8152 (daily ed. June 23, 1986) (statement of Sen. Cohen); see also Sharon Hom, Does Real Estate Syndication Provide a Viable Financing Strategy for Low Income Housing?, 50 Brook. L. Rev. 913, 915 (1984) (noting that marketplace, without government involvement, has not been viable mechanism for development of low-income housing).


\(^{28}\) Section 901 of the Housing and Urban Development Act of 1968 "declares that it is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families." Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 901, 82 Stat. 476, 547. Consequently, the Act of 1968 added § 236 to the National Housing Act and contemplated the formation of partnerships as the vehicle for the participation of private investors in the provision of affordable housing. Id. at 498, 549.
eral spending on housing during the Reagan era, the low-income housing credit became and remains the largest federally funded program encouraging new construction and rehabilitation of low-income housing.\textsuperscript{29} Even among all existing housing programs, the low-income housing credit is substantial. For example, the tax expenditure on low-income housing credits was $0.6 billion in 1991, compared with $1 billion spent on housing vouchers.\textsuperscript{30}

B. \textit{Structure of the Low-Income Housing Credit}

The low-income housing credit may be claimed annually, generally over a ten-year period, by an owner of a qualified residential rental project beginning with the taxable year in which the building is placed in service.\textsuperscript{31} Most of the tax credit units produced to date have been assembled by for-profit developers who typically sell shares in the project to one or more outside investors, either through large public offerings or private placements and other partnership arrangements.\textsuperscript{32} Newly constructed buildings, certain rehabilitation expenditures that are treated as a separate new building and newly acquired existing structures if substantially rehabilitated are eligible for the credit.\textsuperscript{33} The low-income housing credit is available only on rent-restricted units that are leased to qualifying low-income tenants.\textsuperscript{34} A qualified


\textsuperscript{30} CBO, supra note 23, at 494. With the permanent extension of the low-income housing credit in 1993, the tax expenditure related to the credit will be $4.864 billion for the years 1994-1998. Joint Committee on Taxation, \textit{Estimated Budget Effects of the Revenue Provisions of H.R. 2264 3} (JCX-11-93).

\textsuperscript{31} I.R.C. § 42(f)(1) (CCH 1993).

\textsuperscript{32} ICF Incorporated, \textit{Evaluation of the Low-Income Housing Tax Credit} 4-14 (1991) [hereinafter ICF Study]. Non-syndicated projects or sole proprietors account for only about 14 percent of all tax credit units. \textit{Id.}

\textsuperscript{33} I.R.C. § 42(d)-(e) (CCH 1993).

\textsuperscript{34} I.R.C. § 42(g)(1)-(2) (CCH 1993). Gross rent is restricted to 30% of the imputed income limitation, which is determined by assuming a family size
residential rental project must remain as rental property with a minimum number of rent-restricted units throughout a fifteen-year period. The credit is recaptured with interest from all owners if the project fails to comply with the rent limits and set-aside requirements during this compliance period or from any owner who sells his interest in the project.

For any project allocated the tax credit after 1989, the owner must agree to provide low-income units for at least thirty years. Under some conditions, however, an owner may terminate this commitment after fifteen years. First, the owner may sell the project at any price if the buyer agrees to abide by the tenant income-and-rent limitations for an additional fifteen years. If no such buyer is found, the owner must notify the housing agency of its intention to sell the building or convert it to higher-income units. The housing credit agency then has one year to find a

equivalent to 1.5 times the number of bedrooms in the housing unit. I.R.C. § 42(g)(2). For further discussion concerning the gross rent restriction and the requirements that must be satisfied for rental projects to qualify for the low-income housing tax credit, see infra notes 43-44 and accompanying text.

35. I.R.C. § 42(i)(1) (CCH 1993). For a discussion of the minimum number of rent-restricted units required in each building, see infra note 43 and accompanying text.

36. I.R.C. § 42(j) (CCH 1993). The percentage of the credit recaptured phases out in the 11th through the 15th year. CBO, supra note 23, at 494. Generally, recapture can occur when there is a change in the ownership of a building or a partnership interest. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., II-96 (1986). However, if there are more than 35 partners in the partnership, the partnership is treated as the owner of the project for purposes of recapture, and no recapture of the credit will occur unless transfers within a 12-month period are in excess of 50% in value of the total partnership interests. I.R.C. § 42(j)(5); H.R. Conf. Rep. No. 841, supra, at II-96.

Otherwise, to avoid recapture, the owner selling the building or the partnership interest may post a bond in an amount that satisfies the IRS, if it is reasonably expected that the building will be operated as a qualified low-income building for the rest of the compliance period. I.R.C. § 42(j)(6)(A)-(B). Revenue Ruling 90-60 provides guidance on how to post the bond that must be maintained throughout the compliance period plus 58 months after the end of the compliance period. Rev. Rul. 90-60, 1990-2 C.B. 4, modified Rev. Rul. 90-67, 1990-2 C.B. 4. The Revenue Ruling provides percentage factor amounts to be applied to calculate the amount of the bond that must be posted. Id.

37. I.R.C. § 42(h)(6) (CCH 1993). This extended low-income housing commitment is an agreement with respect to the property, recorded pursuant to state law as a restrictive covenant, that requires the appropriate percentage of the building to remain available as rent-restricted units for low-income occupancy. Individuals who meet the income limitation applicable to the building (whether prospective, present or former occupants) have the right to enforced this agreement in state court.


willing buyer at a formula price that is generally equal to the outstanding balance on secured indebtedness, plus the investors’ equity contributions, increased annually by the consumer price index (CPI)—not to exceed five percent per year.\(^41\) Finally, if the agency is unable to find a suitable buyer, the owner is free to sell or convert the project subject to the limitation that existing tenants cannot be evicted without cause for three years.\(^42\)

Residential rental projects qualify for the tax credit only if 1) twenty percent or more of the units are occupied by individuals with incomes that are no more than fifty percent of area median income, as adjusted for family size, or 2) forty percent or more of the units are occupied by individuals with incomes that are no more than sixty percent of area median income, as adjusted for family size.\(^43\) Regardless of which condition is satisfied, the gross rent paid by a family in a low-income unit may not exceed thirty percent of the imputed income limitation that is determined by assuming a family size equal to 1.5 times the number of bedrooms in the unit.\(^44\)

The Treasury sets the credit rate so that the annual credit amounts generate a stream of benefits with a net present value of either seventy percent or thirty percent of the basis attributable to qualifying low-income units.\(^45\) The applicable percentage de-

\(^{41}\) I.R.C. § 42(h)(6)(F).

\(^{42}\) I.R.C. § 42(h)(6)(E)(ii); see also CBO, supra note 23, at 494 (noting that low-income units can be converted to another use if state housing agency cannot find buyer, but low-income tenants must be permitted to remain with restricted rents for three years).

\(^{43}\) I.R.C. § 42(g)(1) (CCH 1993).

\(^{44}\) I.R.C. § 42(g)(2). For this purpose, efficiency units are treated as being occupied by one person and all other units are treated as being occupied by 1.5 persons for each separate bedroom. I.R.C. § 42(g)(2)(C). So for the purpose of determining rent levels, a two bedroom unit is treated as if occupied by three persons. Because the income qualification for a three person household is 54 percent of area median income in a “40/60” project, rent for a two bedroom unit would equal 50% of 54% of the area median income. The area median income figures to be used are those published by HUD each year, under § 8 of the United States Housing Act of 1937 § 2 et seq., as amended, 42 U.S.C. § 1437 et seq. (Supp. II 1990). I.R.S. Notice 88-80, 1988-2 C.B. 396; see also STEVENS & TRACY, supra note 29, at 25 (noting that area median income figures to be used are published by HUD each year and are listed on state-by-state basis). For low-income buildings placed in service prior to 1990, the maximum allowable rent was determined on the basis of the actual family size of the occupants. The 1993 Act allows owners of such buildings to make an irrevocable election to use apartment size in determining maximum allowable rent. OBRA 1993 § 13142(c), 107 Stat. at 439.

\(^{45}\) The Treasury’s monthly adjustments of the credit percentage are to be determined on a discounted after-tax basis, based on the average of the annual applicable federal rates (AFR) for mid-term and long-term obligations for the
depends on the type of low-income housing expenditure. For September 1992, the credit rate was set at 8.55% for seventy percent present value property and 3.66% for thirty percent present value property. A taxpayer’s credit amount in any taxable year is computed by applying the appropriate credit percentage to the proportion of the eligible basis in a qualified low-income building that is attributable to the low-income rental units. The eligible basis of a new building is its adjusted basis, which includes construction costs and other costs for depreciable property attributable to the building. The cost of land, market rate units, syndication and financing are not eligible for the credit.

Generally, any building eligible for the credit must receive an allocation of credit authority from the state or local housing credit agency where the qualifying low-income housing project is located. Each state has a limited amount of credits that can be

46. The reduced credit is available for certain subsidized housing and the purchase cost of existing housing that is rehabilitated. I.R.C. § 42(b)(2)(B) (CCH 1993).


49. I.R.C. § 42(d); Bluebook, supra note 45, at 154.

50. Bluebook, supra note 45, at 157. Eligible basis of existing buildings consists of: (1) building rehabilitation costs; and (2) purchase cost of existing buildings acquired. Id. The cost of land, however, is not included in the calculation of eligible or adjusted basis. Id. In general, eligible basis is established at the time the building is placed into service. Id. Similarly, with regard to rehabilitation expenditures made on an existing building that was recently purchased, capital expenditures incurred during the first year of the credit period can be included in eligible basis. Id.

51. Projects financed with the proceeds of tax-exempt bonds subject to the state volume cap under § 146 are not required to receive an allocation of credit authority from the appropriate state or local housing credit agency. I.R.C. § 42(h)(4) (CCH 1993); see also Bluebook, supra note 45, at 167 (noting that exemption from mandatory allocation requirement is provided for buildings financed with proceeds of tax-exempt bonds). However, the project must still satisfy the requirements for allocation of a housing credit under the qualified allocation plan applicable to the area in which the project is located. I.R.C. § 42(m)(1)(D).

52. I.R.C. § 42(h)(1) (CCH 1993); see Bluebook, supra note 45, at 167 (observing that developers of building eligible for low-income housing credits must
allocated in any one given year. The annual credit limitation for a
state is equal to $1.25 multiplied by the number of residents in
the state.\textsuperscript{53} Thus, a state with a population of ten million people
has an annual credit limitation of $12.5 million. The state's total
actual credit limitation also includes any unallocated credits from
the prior year and any credits previously allocated but returned
by a project.\textsuperscript{54} Nationally, the new credit allocation authority for
1992 was $315.2 million.\textsuperscript{55}

The credit is subject to the rules of the general business
credit and is not allowed against the alternative minimum tax.\textsuperscript{56}
With respect to the passive activity rules, the credit (but not a
loss) is treated as arising from rental real estate activities in which
the taxpayer actively participates. This means that the credit is
eligible for special treatment when applying the passive activity
rules and may be used to offset tax on up to $25,000 of nonpas-
active income.\textsuperscript{57} Currently, for depreciation purposes, the basis of
low-income housing property is not reduced by the amount of

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reserve allocation of credit authority from state or local agency in jurisdiction

where project is located).

53. I.R.C. § 42(h)(3)(C)(i) (CCH 1993). Ten percent of this figure ($0.125
per resident), however, is set aside for exclusive use by qualified nonprofit

The Omnibus Reconciliation Act of 1989 had extended the low-income
housing credit for one year but with only an equivalent of nine months worth of
credit ($0.9375 per resident). Omnibus Reconciliation Act of 1989 (OBRA
extended the credit through 1991 and restored the credit to $1.25 per resident
of 1991 extended the credit through June 30, 1992, again at $1.25 per resident.
105 Stat. 1686, 1687. The 1993 Tax Act makes the low-income housing credit
permanent, effective retroactively to June 30, 1992—the date the tax credit pro-
vision expired. OBRA 1993 § 13142(a), 107 Stat. at 438.

54. I.R.C. § 42(h)(3)(D) (CCH 1993) (allowing unused housing credit for
given year to be carried over to succeeding year).

55. I.R.S. Notice 92-5, 1992-6 I.R.B. 11 (reporting recent estimate of resi-
dent population of 50 states by Bureau of the Census as 252 million people).
The total resident population is multiplied by $1.25. I.R.C. § 42(h)(3)(C)(i)
(CCH 1993). The total credit authority for 1992 was $476.8 million. This
equalled the new 1992 authority plus any carryovers of unused authority from
prior years plus any returned credits plus national pool credit authority. Na-
[hereinafter 1992 Snapshot].

56. I.R.C. §§ 38(c), 55(c)(2) (CCH 1993). For a discussion of provisions
enacted to ensure that the wealthy pay an equitable share of taxes, see infra
notes 168-95 and accompanying text.

57. I.R.C. § 469(i) (CCH 1993). For a discussion of the $25,000 allowance,
see infra notes 187-91 and accompanying text. For a discussion of the 1993 Tax
Act changes to the passive activity rules with respect to taxable years beginning
after December 31, 1993, see infra note 186.

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The low-income housing credit claimed.\textsuperscript{58}

The low-income housing credit had expired on June 30, 1992.\textsuperscript{59} However, in the 1993 Tax Act, Congress permanently extended the low-income housing credit retroactively effective to June 30, 1992.\textsuperscript{60}

C. History of the Low-Income Housing Credit

The low-income housing credit was enacted as part of the Tax Reform Act of 1986.\textsuperscript{61} It replaced tax incentives such as special accelerated depreciation,\textsuperscript{62} five-year amortization of certain rehabilitation expenditures\textsuperscript{63} and special deductions for interest and taxes paid during the construction period.\textsuperscript{64} Congress believed that these existing tax expenditures for low-income rental housing had not been effective in providing affordable housing for low-income individuals. These provisions were not sufficiently targeted, did not limit the rent that could be charged to tenants and were not directly linked to the number of units serving low-income persons.\textsuperscript{65}

The initial response to the credit program was not strong; approximately twenty percent of the authorized credits were allocated in 1987, the first year of the program.\textsuperscript{66} In response to crit-

\textsuperscript{58} I.R.C. § 42(d)(4)(C) (CCH 1993). For a discussion of the recommended treatment for the low-income housing tax credit, see infra notes 238-39 and accompanying text.

\textsuperscript{59} I.R.C. § 42(o) (CCH 1992), repealed by OBRA 1993 § 13142(a), 107 Stat. at 438.

\textsuperscript{60} OBRA 1993 § 13142(a), 107 Stat. at 438.


\textsuperscript{62} I.R.C. § 168(b)(4) (CCH 1985), amended by Tax Reform Act of 1986 § 201, 100 Stat. at 2121-37. Section 168(b)(4), prior to being amended, allowed accelerated depreciation at 200% declining balance over 15 years. \textit{Id.} Currently, however, the statute requires that all residential real property be depreciated over 27.5 years. I.R.C. § 168(c)(1) (CCH 1993).

\textsuperscript{63} I.R.C. § 167(k)(1), repealed by OBRA 1990 § 11812(a)(1)-(2), 104 Stat. at 1388-534.

\textsuperscript{64} I.R.C. § 189(d)(1), repealed by Tax Reform Act of 1986 § 803(b)(1), 100 Stat. at 2355. The Internal Revenue Code currently requires that interest and taxes incurred with respect to real property and attributable to the construction period be capitalized. I.R.C. § 263A(f) (CCH 1993); \textit{Bluebook}, supra note 45, at 511 n.63.

\textsuperscript{65} S. Rep. No. 318, supra note 25, at 758.

\textsuperscript{66} \textit{National Council of State Housing Agencies} & \textit{Ford Foundation, Low-Income Housing Tax Credit In The 1990's} 7 (1989); see also \textit{National Council of State Housing Agencies, Low-Income Housing Tax Credit Production, Calendar Year 1987} (1993) (presenting schedule of total credit authority and credits allocated for all 50 states and indicating that 20% of total credit authority was allocated for 1987).
licisms of the credit, Senators George Mitchell and John C. Danforth formed a task force in May, 1988, to 1) review the achievements of the credit program, 2) define the appropriate role of the credit in the overall housing policy framework and 3) propose improvements needed to create an optimum program. The task force comprised representatives of academia, the housing development community, tenants, nonprofit organizations, real estate syndicators and state housing credit agencies. The Mitchell-Danforth Task Force undertook a detailed assessment of the program, meeting on six occasions to hear testimony from a total of fourteen witnesses.

The Report of the Mitchell-Danforth Task Force on the Low-Income Housing Tax Credit, released in January 1989, became the basis for two pieces of legislation introduced by Senators Danforth and Mitchell, the Community Revitalization Tax Act of 1989 (S. 342) and the Low-Income Housing Tax Credit Act of 1989 (S. 980). Many of the recommended changes in these bills were adopted in the Omnibus Budget Reconciliation Act of 1989 (OBRA 1989) and the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990). In order to demonstrate the problems of adhering too strictly to tax policy principles when implementing social policy through the tax code, this Article outlines the various housing policy objectives in these bills and the tax policy considerations that postponed, jeopardized or thwarted their successful implementation.

II. Housing Policies in Conflict with Tax Policy Considerations

A. Transferring Ownership to Housing Nonprofits

The Low-Income Housing Tax Credit Act of 1989 included

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68. See id. at 19, app. 1 (noting six specific dates on which Task Force met and panelists that appeared before Task Force on each day).
69. S. 342, supra note 18.
70. S. 980, supra note 15.
71. OBRA 1989 § 7108, 103 Stat. at 2306-22. In addition to restructuring the low-income housing tax credit, OBRA 1989 extended the credit through 1990 although only on a nine months equivalent basis ($0.9375 instead of $1.25 per resident). Id.
72. OBRA 1990 § 11407, 104 Stat. at 1388-475. OBRA 1990 also restored the credit to $1.25 per resident and extended it through 1991. Id.
73. S. 980, supra note 15.
many of the Mitchell-Danforth Task Force recommendations related to the restructuring of the low-income housing credit. For example, the Task Force recommended that nonprofit organizations and tenant cooperatives should be allowed to negotiate below-market purchase options with investors during a project’s initial development without disqualifying the investors from claiming the credit while they own the property. The Mitchell-Danforth Task Force had recommended this change as a means of extending the low-income use of the property well beyond the fifteen-year compliance period. There was great concern that as private owners became legally able, they would convert their low-income properties to more profitable uses. Consequently, the Task Force encouraged increased participation by nonprofit groups in the ownership and management of the low-income housing credit properties. Because use of the refundability mechanism was not considered politically feasible, below-market purchase options were the second best alternative for increasing nonprofit ownership of these properties.

74. Id.

75. MITCHELL-DANFORTH TASK FORCE REPORT, supra note 67, at 19. The task force made other recommendations that were designed to ensure: (1) that states fully use their allocations; (2) that tax-exempt bonds and other federal, state and local subsidies are used efficiently; (3) that the low-income housing credit is responsive to the development process, whether sponsored by for-profit or not-for-profit developers; (4) that the housing credit program is viable in center city, urban and rural markets; and (5) that the housing tax credits are compatible with other housing subsidy programs. Id.

76. See id. at 3-4 (offering several recommendations designed to extend “duration of low-income use”). On March 2 and 3, 1988, several representatives of nonprofits testified as to the desirability of below-market purchase options as a means to ensuring that the property would be permanently devoted to nonprofit low-income housing. See Low-Income Housing Tax Credits and the Role of Tax Policy in Preserving the Stock of Low-Income Housing: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 100th Cong., 2d Sess. 182, 275-76 [hereinafter 1988 HEARINGS] (testimony of Andrew Ditton, Vice-President of the Local Initiatives Support Corporation, and statement of Barry Zigas, President of the National Low Income Housing Coalition). Mr. Ditton and Mr. Zigas asserted that an absolute preference should be adopted for housing transfers from for-profit to not-for-profit organizations. Id.

77. 1988 HEARINGS, supra note 76, at 182. The representatives for the nonprofit organizations predicted serious low-income housing shortages if nonprofit organizations could not take advantage of the tax credit other than by entering into syndications with for-profit groups. Id. As housing markets become increasingly tight, for-profit groups are likely to convert the low-income housing projects after the 15-year period into market rate housing units. Id.

78. MITCHELL-DANFORTH TASK FORCE REPORT, supra note 67, at 19.

79. Refundability provides that a taxpayer with no tax liability is entitled to a check from the Treasury for any tax benefits. For a discussion of refundability and other options, see infra notes 125, 139-44 and accompanying text.
With the enactment of the low-income housing credit in 1986, Congress clearly intended for nonprofit organizations to continue playing a major role in providing low-income housing. Congress demonstrated this intent in the initial legislation by creating a special set-aside for qualified nonprofit organizations.\textsuperscript{80} Ten percent of each state's credit authority is set aside for the exclusive use of qualified nonprofit organizations, an amount currently equal to $0.125 per resident of the state.\textsuperscript{81} Although the state may not reduce the amount of the set-aside, it may allocate additional amounts of the remaining credit authority to qualified nonprofit organizations.

Despite this clear preference toward nonprofit involvement in the credit program, the low-income housing credit is not refundable. Taxpayers receive the benefit of the credit only to the extent that they have tax liabilities to offset the credit. Because nonprofit organizations are tax-exempt entities, it is necessary for them to form partnerships with taxpaying investors to take advantage of the provision.\textsuperscript{82} Typically, a nonprofit will function as a one percent general partner in a low-income housing credit transaction\textsuperscript{83} and the limited partners who invest will receive ninety-nine percent of the tax benefits.\textsuperscript{84} In some cases, a nonprofit group will be a co-general partner with a for-profit developer. These arrangements, however, do not give the nonprofit organization control over the low-income housing project. After the low-income use restriction expires, the limited partners may le-

\textsuperscript{80} I.R.C. § 42(h)(5)(C) (CCH 1993). The organization must be a § 501(c)(3) or § 501(c)(4) organization that has as one of its exempt purposes, the fostering of low-income housing. \textit{Id}. The organization also must materially participate in the development and continuing operation of the qualifying project. I.R.C. § 42(h)(6) (CCH 1993); see also BLUEBOOK, supra note 45, at 167-68 (expressing intent to foster development of low-income housing by providing for set-aside allocations of credit authority to qualified nonprofit organizations).

\textsuperscript{81} I.R.C. § 42(h)(5)(A) (CCH 1993); see also I.R.C. § 42(h)(3)(C)(i) (setting housing credit ceiling for calendar year equal to $1.25 multiplied by the state population).

\textsuperscript{82} 1988 \textit{Hearings}, supra note 76, at 409 (statement of John V. Helmick on behalf of Yale Law School’s Workshop on Shelter for Homeless and H.O.M.E., Inc.). The Yale Shelter Project complained that too much of the credit was spent on the transaction costs of the lawyers, accountants and middlemen necessary to set up the complex structures needed for using the credit. \textit{Id}.

\textsuperscript{83} \textit{Id}. (discussing methods commonly used by nonprofit organizations to transfer tax benefits derived from housing credits to for-profit investors).

\textsuperscript{84} A nonprofit organization that is a general partner must receive allocations of the income, gain, loss, deduction and credit proportionate to its interest in the partnership. Treas. Reg. § 1.704-1(b)(4)(ii) (as amended in 1991). Except in unusual circumstances, this one percent allocation of the credit to the nonprofit partner is wasted.
gally require the project to be sold or converted to market use. They require the project to be sold or converted to market use.

Thus, the nonprofit organized to develop and operate the low-income housing is not legally entitled to control the long-term use of the tax credit property.

One goal of housing policy is to ensure that housing produced using government subsidies remains in low-income use for the longest period possible. Nonprofit organizations involved in the provision of low-income housing share this goal and would provide longer-term low-income occupancy than would for-profit investors. With respect to a project allocated the tax credit after 1989, nonprofits may be able to purchase the low-income housing units at the end of fifteen years for a statutorily defined formula price in exchange for continued low-income occupancy. This formula, however, may translate into a purchase price that could easily equal seventy percent of the original development cost plus the amount of outstanding debt and any subsequent capital improvements. This price will be too high for the majority of nonprofit organizations unless additional government monies are made available.

Alternatively, many corporate investors in low-income housing would be willing to grant a nonprofit organization a below-market purchase option on the property. These for-profit corporations often have no interest or desire to continue ownership of low-income housing beyond the fifteen-year compliance period. They invest in low-income housing in order to respond to their

85. See 1988 Hearings, supra note 76, at 182 (observing that investment partnerships are legally free to convert property to high-income use at end of use restrictions). For projects that were allocated credits in 1987, 1988 and 1989, all use restrictions end after 15 years. For projects receiving credit allocations after 1989, the owners will be able to dispose of the project after 15 years only under certain conditions. For a description of these conditions, see supra notes 38-42 and accompanying text.

86. MITCHELL-DANFORTH TASK FORCE REPORT, supra note 67, at 9.

87. Id. at 19; see also 1988 Hearings, supra note 76, at 176-84 (statement of Andrew Ditton, Vice-President of Local Initiatives Support Corporation, describing nonprofit organizations as driving force behind low-income housing effort and as not susceptible to pressures of abandoning low-income housing projects after initial 15 year period).

88. I.R.C. § 42(h)(6)(F) (CCH 1993). The formula price is generally equal to the outstanding balance on secured indebtedness, plus the investors’ equity contributions, as increased annually by the CPI, not to exceed five percent per year. For further discussion of the formula price, see supra note 41 and accompanying text.

89. Assuming an investor’s initial equity was 35% of the original development costs and annual CPI increases of 5% for 15 years, the investor’s selling price could total as much as 70% of the original development costs.

community's housing crisis while receiving unique economic, social and corporate image benefits.\textsuperscript{91} The benefit of possible appreciation of the low-income housing units (residual value after the fifteen years) is not an important consideration for many corporate investors.\textsuperscript{92} Most corporations (excluding personal service or subchapter S corporations)\textsuperscript{93} receive a greater return than individual investors on a given low-income housing investment. Because they are not subject to the passive activity rules, these corporations can take advantage of depreciation deductions as well as the tax credit.\textsuperscript{94} Thus, because corporations already receive an adequate return, they are willing to forego future appreciation to advance other social goals.\textsuperscript{95} Unfortunately, current law limits the ability of nonprofit organizations, at the outset of the development process, to structure agreements with corporate owners that would allow the property to be inexpensively transferred to nonprofit ownership at the end of the fifteen years through the use of a below-market purchase option.\textsuperscript{96}


\textsuperscript{92} Id. For example, the Enterprise Foundation, a nonprofit charitable organization, has been able to successfully market tax credit investments to certain socially-minded corporations for an after-tax internal rate of return of 15% during the projected 15-year holding period (disregarding cash flow or capital appreciation and achieving this return solely from the tax credits and tax benefits). 1988 Hearings, supra note 76, at 170-71 (statement of F. Barton Harvey, III, Deputy Chairman of Enterprise Foundation).

\textsuperscript{93} I.R.C. § 469(a) (CCH 1993). Individuals and personal service corporations are subject to the disallowance rules for passive activity credits and losses. Id. This means that personal service corporations and the individual shareholders of subchapter S corporations may only offset the low-income housing credit against the regular tax liability of the taxpayer allocable to all passive activities as defined in § 469(c). Thus, unlike a regular C corporation, neither the individual shareholders of a subchapter S corporation nor a personal service corporation are able under most circumstances to receive the full benefit of the low-income housing credit or losses from these projects. Id. For a discussion of the 1993 Tax Act changes to the passive activity rules, see infra note 186.

\textsuperscript{94} I.R.C. § 469(a) (CCH 1993). Closely held corporations can offset business income, but not portfolio income, with tax credits and passive losses. I.R.C. § 469(e)(2).

\textsuperscript{95} 1989 Hearings, supra note 91, at 145-46 (statement of Paul S. Grogan, President of Local Initiatives Support Corp.)

\textsuperscript{96} MITCHELL-DANFORTH TASK FORCE REPORT, supra note 67, at 19. But see infra notes 138-42 and accompanying text for an explanation of the right of first refusal provision.
1. Tax Benefits Available Only to the True Owner

Tax law limits the availability of tax benefits—such as deductions and credits—to the true owner. Legal doctrines concerning ownership of property for tax purposes have evolved over the years through a series of court decisions holding that a true owner must possess sufficient ownership attributes. Revenue rulings and procedures issued by the Internal Revenue Service (IRS) also provide guidance in this area. The determination of tax ownership signifies who is entitled to the low-income housing credit and depreciation deductions with respect to the property.

The law regarding the ownership of real estate for tax purposes is in a state of confusion. Essentially, the economic substance of a transaction, not its form, determines who is an owner for tax purposes. Yet the leading United States Supreme Court decision, Frank Lyon Co. v. United States, stands for the proposition that a sale-leaseback will be respected regardless of tax motivation if the transaction has a bona fide business purpose and the lessor retains sufficient benefits and burdens of ownership. Unfortunately, Lyon did not specify the determinative

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97. Alvin C. Warren, Jr., The Requirement of Economic Profit in Tax Motivated Transactions, 59 Taxes 985, 988 (1981). One test that has been used to determine whether ownership attributes are sufficient is “whether the buyer-lessee would acquire an equity that it could not prudently abandon.” Id.

98. Rev. Rul. 72-543, 1972-2 C.B. 87 (providing comprehensive list of tax consequences associated with property ownership and demonstrating when lessee will be treated as true owner in sale-leaseback situation).


The problem is that the cases are generally concerned with determining which of two (or more) parties is the ‘owner’ of a specific depreciable asset. But to the extent that the concept of ownership has any real meaning (outside of tax law), it relates not to an asset as a whole, but to certain rights to act with respect to that asset.

Id. In addition to this conceptual problem, there are difficulties with the tangible definition of ownership, evidenced by the suggestion that some consider it a “realistic hope of profit” while others view it as “a realistic possibility of loss.” Id.


102. Id. at 583-84. For a criticism of this decision, see Bernard Wolfman, The Supreme Court in the Lyon’s Den: A Failure of Judicial Process, 66 Cornell L. Rev. 1075, 1094 (1981). In evaluating the Court’s opinion, Professor Wolfman states that “the poor substantive result in Frank Lyon presents a strong argument for hesitation on the part of the Court to grant certiorari in a civil tax case unless it is certain that a square conflict divides the circuits.” Id. Professor Wolfman is critical of the Court’s reasoning; government counsel and the operation of the whole adversary process in this case. Id. at 1076-77. He takes particular issue
content of the ownership attributes\textsuperscript{103} and at least six different tests for the determination of tax ownership exist in lower court decisions.\textsuperscript{104} Two of the most frequently cited tests are: 1) whether sufficient benefits and burdens of ownership have passed from the seller to the purchaser (the "benefits and burdens" test);\textsuperscript{105} and 2) whether the purchaser has acquired sufficient characteristics of tax ownership (the "various-factors" test).\textsuperscript{106}

The "benefits and burdens" test typically involves consideration of several factors such as: the right to appreciation in the value of the property; the right to use the property; the right to the profits generated by use of the property; liability for real estate taxes; and the risk of loss.\textsuperscript{107} Although courts often implicitly weigh these factors, most cases take an aggregate approach to analyzing the benefits and burdens of ownership.\textsuperscript{108} In contrast, courts using the "various-factors" test discuss factors such as passage of title, the parties' treatment of the transaction, equity in

with many of the 26 enumerated factors that the Court emphasized in reaching its conclusion. \textit{Id.} at 1086-88.

\textsuperscript{103} For a discussion of the \textit{Frank Lyon Co.} case and the attributes of true ownership, see Warren, supra note 97.

\textsuperscript{104} Richard E. Marsh, Jr., \textit{Tax Ownership of Real Estate}, 39 \textit{TAX LAW}, 563, 566-67 (1986). Mr. Marsh argues that the six tests, with the possible exception of the benefits and burdens test, misstate current law. \textit{Id.} The six tests in reverse order of their frequency of application are:

\begin{itemize}
\item[(1)] whether, under state law, title or 'equitable title' has passed to the purchaser (the 'title' test);
\item[(2)] whether the parties intended the transaction to be treated as a sale (the 'intent' test);
\item[(3)] particularly as to sellers on an accrual method of accounting, whether the transaction unconditionally obligates the purchasers to pay the purchase price (the 'accrual' test);
\item[(4)] whether sufficient benefits and burdens of ownership have passed from the seller to the purchaser (the 'B & B's' test);
\item[(5)] whether, under an ever growing laundry list of "relevant factors," the purchaser has acquired sufficient characteristics of tax ownership (the "various-factors" test);
\item[(6)] whether either title or the benefits and burdens of ownership has passed (... the 'Dettmers' test).
\end{itemize}


\textsuperscript{105} See Boykin v. Commissioner, 344 F. 2d 889, 894 (1965) (citing Merrill v. Commissioner, 40 T.C. 66 (1963), aff'd, 336 F.2d 771 (9th Cir. 1964)); see also Marsh, supra note 104, at 567-68.

\textsuperscript{106} See Commissioner v. Segall, 114 F.2d 706, 709-10 (6th Cir. 1940), rev'd 38 B.T.A. 43 (1938), \textit{cert. denied}, 313 U.S. 562 (1941) (emphasizing factors such as passage of title, transfer of possession, purchaser's unconditional duty to pay and intention of parties).

\textsuperscript{107} Marsh, supra note 104, at 575-76.

\textsuperscript{108} \textit{Id.}
the property, the existence of a binding legal obligation, the right of possession, liability for property taxes and the right to appreciation and operating profits. Under the "various-factors" test, a tax owner of property is the one with a preponderance of these incidents of ownership. In any event, an analysis of the more recent cases indicates that most courts appear to be applying the "benefits and burdens" test to determine tax ownership.

In the leasing area, where the IRS sometimes attempts to treat the lease of property as a sale, the IRS undertakes a case-by-case analysis based on the specific facts and circumstances of each case. In Revenue Ruling 55-540, the IRS listed the criteria that distinguish a sale from a true lease of property. A lease may be recast as a sale if any one of the criteria is present. The focus of the cited criteria is generally on those transactions in which the lessee pays rent in excess of fair rental value in exchange for a bargain purchase option. The IRS has promulgated guidelines in Revenue Procedure 75-21 for the issuance of an advance


111. Id. at 582-83. For a recent case focusing on the benefits and burdens test, see Major Realty Corp. v. Commissioner, 42 T.C.M. (CCH) 373 (1981), aff'd in part and rev'd in part, 749 F.2d 1483 (11th Cir. 1985).


113. Id. The criteria that distinguish a sale from a true lease of property are:
(a) Portions of the periodic payments are made specifically applicable to an equity [interest] to be acquired by the lessee.
(b) The lessee will acquire title upon the payment of a stated amount of 'rentals' which under the contract he is required to make.
(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.
(d) The agreed 'rental' payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.
(e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.
(f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

Id. at 41-42 (citations omitted).


ruling on whether certain equipment leasing transactions will be respected for federal income tax purposes. Although the guidelines do not apply to real property leases, they are still generally considered when structuring lease transactions. The guidelines include such criteria as: 1) the lessor must retain sufficient benefits and burdens of ownership; 2) there must be a reasonable expectation of deriving a profit independent of tax benefits; and 3) the lessee may not have a below-market purchase option. The IRS will respect a lease only if the lessor retains a significant residual in the property and obtains some net cash flow from the transaction.

The right to appreciation has been an important incident of ownership for the purposes of determining the tax owner of property under both the case law and the administrative guidance provided by the IRS. The prohibition against the lessee obtaining a below-market purchase option demonstrates the IRS's position that such an option sufficiently curtails the right to appreciation so as to justify treating the transaction as a sale. Thus, in the IRS's view, ownership of the property has shifted to the lessee and tax law principles require that the tax benefits afforded

116. Id. The criteria of Revenue Procedure 75-21 are as follows:
   (1) the lessor must have made a minimum unconditional at-risk investment in the property equal to 20% of the cost of the leased property at the beginning of and during the entire lease term;
   (2) the lessor must demonstrate that the fair market value at the end of the lease will be equal to at least 20% of the original cost of the property and the remaining useful life will be the longer of one year or 20% of the originally estimated useful life of the property;
   (3) the lessee, any shareholder of the lessee, and any party related to the lessee cannot furnish or lend any part of the funds to purchase the leased property or guarantee any indebtedness of the lessor with respect to such property;
   (4) the lessor must represent that the lease will produce a profit and have a cash flow in addition to the value of any tax benefits, such as the depreciation allowance;
   (5) no member of the lessee group may have a contractual right to purchase the property from the lessor at a price below the fair market value at the time of exercising the right; and
   (6) the lessor may have neither a contractual right to cause the lessee to purchase the property when the property is first placed in service nor any present intention to acquire such a contractual right. The effect of any such right acquired at a subsequent time will be determined at that time, based on all the facts and circumstances.

117. See id. (discussing criteria considered necessary for transaction to be treated as valid lease).

118. See Dunlap v. Commissioner, 74 T.C. 1377, 1436 (1980) (stating that taxpayer's right to appreciation in value of property is very important in determining tax ownership).
by deductions and credits follow tax ownership. Similarly, there was congressional concern that the grant of a below-market option (as proposed by the Low-Income Housing Tax Credit Act of 1989) was a substantial enough relinquishment of one of the benefits of ownership such that true ownership was at issue. Therefore, Congress was unwilling to enact the Mitchell-Danforth Task Force's recommendation that would permit the grant of a below-market option to nonprofit organizations during a credit project's initial development.

2. Tax Benefits Independent of Tax Ownership

Even if one concedes that the grant of a below-market purchase option is enough to jeopardize tax ownership, statutory precedents exist for providing tax benefits independent of tax ownership. For example, prior to 1986, a taxpayer was eligible for accelerated write-offs of up to $40,000 of rehabilitation expenditures, if the taxpayer participated in a program that provided for the below-market sale of low-income housing units to tenants.

Another example was a provision in the 1981 Economic Recovery Tax Act known as "safe harbor leasing." Under the safe harbor leasing provision—including certain requirements were met—a leveraged equipment lease was recognized for tax purposes even if the lessor had no prospect of a pre-tax profit and retained no residual. In other words, the leveraged lease was

119. See Rev. Rul. 55-540, 1955-2 C.B. 42. This Revenue Ruling holds that the transaction will be treated as a sale if, "the property may be acquired under a purchase option which is nominal in relation to the value of the property . . . or which is a relatively small amount when compared with the total payments which are required to be made." Id.; see also Rev. Proc. 75-21, 1975-1 C.B. 716 ("No member of the Lessee Group may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised.").

120. I.R.C. § 167(k)(2)(B), repealed by OBRA 1990 § 11812(a)(1)-(2), 104 Stat. at 1388-534. Section 167(k)(2)(B) was applicable to expenditures for the rehabilitation of low-income rental housing that were incurred prior to January 1, 1987, provided that the rehabilitation was conducted pursuant to a program certified by the Secretary of Housing and Urban Development, his appointee, a state or the United States. Id.


122. Id.

123. Id. The requirements under the "safe harbor leasing" provision were: (1) that the lessor be a corporation, a partnership where all partners are corporations, or a grantor trust in which the grantor and all beneficiaries are corporations or partnerships consisting of corporations; (2) that the minimum
respected for tax purposes even though the lessor lacked substantial ownership attributes. Safe harbor leasing was essentially a compromise offered in lieu of actual refundability. The goal was to make the benefits of the accelerated cost recovery system and the investment tax credit more widely available and to protect companies holding unusable tax benefits from becoming targets of takeover bids. Nonprofit organizations would prefer to receive the benefits

investment of the lessor was not less than 10% of the adjusted basis of the property at the time the property first became the subject of the lease and at all times during the lease; and (3) that the term of the lease was not greater than 90% of the useful life of the property for purposes of § 167 or 150% of the present class life of the property. Id.

124. See id. For a general discussion of tax ownership, see supra notes 97-119 and accompanying text.

125. The mechanism of refundability provides that a taxpayer with no tax liability is entitled to a check from the Treasury for any tax benefits. Refundability was rejected with respect to the safe harbor leasing provision for reasons summarized in the following passage. See Emil Sunley, Safe Harbor Leasing, TAX FOUND. TAX REV., Apr. 1982, at 17. According to Emil Sunley:

Refundability would tend to increase further the enormous power of the tax-writing committees. Refundability also might further erode the perception that the tax system is fair, since some companies will be paying what will be viewed as a negative income tax. Nonrefundability may also help keep the investment credit from entities not subject to the income tax, such as state and local governments, charities, and schools. Finally, the business community may fear that if the investment credit is made refundable, Congress will view it not as a reduction in tax, but as a subsidy program for business, thereby endangering the basic credit itself.

Id. at 19.

126. See id. at 17. Sunley notes that "without some form of transferability or refundability of the tax benefits, profitable companies that cannot currently use all their tax deductions and credits will become targets for tax-motivated mergers or takeovers." Id.

Safe harbor leasing was repealed in 1982 for a variety of reasons. See Stephen B. Cohen, Federal Income Taxation: A Conceptual Approach 605-43 (1989). Corporations are not sympathetic beneficiaries of tax incentives. Safe harbor leasing was characterized by the Washington Post on December 3, 1981 as "[t]he [g]reat [b]usiness [g]iveaway" and the "rent a deduction" provision by former Internal Revenue Commissioner Sheldon S. Cohen. Id. at 618-19. Conversely, John Chapotan—Assistant Secretary of the Treasury for Tax Policy—defended safe harbor leasing before the Senate Finance Committee on December 10, 1981, as a way to "make good investments equally profitable for companies in different tax situations." Id. at 619.

The safe harbor leasing technique was not considered effective from a cost-benefit perspective. Id. at 623-25 (noting testimony of Professor Paul McDaniel before Senate Budget Committee (November 24, 1981)). Moreover, there was serious concern over the revenue loss from these leasing transactions. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 53 (Comm. Print 1982).

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of the tax credit through the refundability mechanism. Unfortunately, refundability was not seriously considered when the low-income housing credit was created. None of the incentives that the low-income housing credit replaced, such as five-year amortization of rehabilitation expenditures, were refundable. Before 1978, refundable tax credits were considered revenue reductions for budget purposes. However, under budget procedures adopted in 1978, the refundable portion of any new refundable tax credit is treated as an "outlay" and brought within the scope of Appropriations Committee review. Although the Appropriations Committee cannot recommend any substantive changes in the legislation, it can recommend an amendment to limit the total amount of funding available for the legislation. This limited role is enough of a disincentive to using the refundability mechanism because the tax-writing committees are disinclined to surrender their exclusive jurisdiction over a tax program.

Pursuant to the recommendation of the Mitchell-Danforth

127. For a discussion of refundability, see supra note 125. For a discussion of nonprofit organizations' preferences regarding the tax credit, see 1988 Hearings, supra note 76, at 182, 278-79, 294, 410 (testimony of Andrew Ditton, Vice President of the Local Initiatives Support Corp., statement of Barry Zigas, President of the National Low Income Housing Coalition, letter of Sheldon L. Baskin, and statement of John V. Helmick on behalf of the Yale Law School's Workshop on Shelter for the Homeless and H.O.M.E. Inc.). Mr. Ditton observed that a refundable credit would allow nonprofits to avoid syndication as is now necessary in order to utilize the credit. Id. at 182. Mr. Zigas agreed with Mr. Ditton stating that, "[m]any nonprofit organizations are reluctant to take advantage of the tax credit because they cannot use it without giving up ownership of the property." Id. at 278. Mr. Helmick also preferred refundability for nonprofits, but stated that if that were not possible he would prefer allowing nonprofits to transfer low-income housing credits directly to individual investors because that would be more efficient than the current practice. Id. at 410. The primary advantage of refundability for nonprofits is that "[i]t would offer the possibility of financing housing which would start out and end up in the nonprofit or social housing sector, free of the expiring use concerns which are now preoccupying us." Id. at 278.


129. Id. "Outlays" are defined as the amount of dollars spent for a particular activity. Federal Budget Fiscal 1993, supra note 10, at 200. The total results from both new budget authority provided this year and from unexpended balances of budget authority provided in previous years. Id.

130. Data and Materials, supra note 128. In addition, an annual appropriation is required for any new refundable credit whereas prior to 1978, the authority of the permanent appropriation for tax refunds had been used. Id.

131. Essentially, the tax expenditure system allows the tax committees to function as both an authorizing or legislative committee as well as an appropriations committee. These committees authorize the substantive program and ap-
Task Force, the Low-Income Housing Tax Credit Act of 1989\textsuperscript{132} proposed the use of below-market purchase options to encourage increased participation by nonprofit groups in the ownership of low-income housing.\textsuperscript{133} Unfortunately, Congress would not accept this modification because of the tax policy concern that use of such options removed any reasonable expectation that investors would derive a profit independent of tax benefits. As a compromise, however, the legislative process that culminated in the enactment of OBRA 1989 yielded a special rule that permits owners to receive the credit and other tax benefits even though the tenants hold a right of first refusal for the purchase of their units (at the end of the fifteen-year compliance period) for a specified minimum purchase price.\textsuperscript{134} The price is generally equal to the outstanding indebtedness secured by the property plus all federal, state and local taxes attributable to the sale.\textsuperscript{135} The next year, in OBRA 1990, this provision was expanded to permit other organizations such as tenant cooperatives, resident management corporations, qualified nonprofits\textsuperscript{136} and governmental agencies to incorporate a right of first refusal at this special formula price into the deal at the outset.\textsuperscript{137}

The formula right of first refusal is a rather unusual legislative creation.\textsuperscript{138} Normally a right of first refusal is "a right to buy before or ahead of [another]; thus, . . . [the contract gives] to the prospective purchaser the right to buy upon specified terms, but,

propriate the necessary funds through a reduction in revenue receipts. Surrey, \textit{supra} note 1, at 145.

\textsuperscript{132} S. 980, \textit{supra} note 15.

\textsuperscript{133} For a discussion of the proposed use of below-market purchase options to encourage nonprofits to participate in ownership of low-income housing, see \textit{Mitchell-Danforth Task Force Report}, \textit{supra} note 67, at 19.

\textsuperscript{134} I.R.C. § 42(i)(7)(A) (CCH 1993), \textit{enacted by OBRA 1989} § 7108(q), 103 Stat. at 2321 ("No federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low income building merely by reason of a right of [first] refusal held by the tenants . . . .").

\textsuperscript{135} I.R.C. § 42(i)(7)(B) (CCH 1993). Federal, state and local taxes attributable to the sale are known as the investors' exit taxes. The outstanding indebtedness excludes any indebtedness incurred within the five-year period ending on the date of the sale to the tenants. \textit{See id.}

\textsuperscript{136} I.R.C. § 42(h)(5)(C). For a discussion of "qualified nonprofits," see \textit{supra} notes 80-87, 96 and accompanying text.

\textsuperscript{137} I.R.C. § 42(i)(7)(A); \textit{see also OBRA 1990} § 11407(b)(1), 104 Stat. at 1388-474.

\textsuperscript{138} The legislative history is silent on the mechanics of the right of first refusal and, as of yet, there is no administrative guidance. Nonetheless, one can surmise that if a potential buyer makes an offer to an investor, then the holder of the right of first refusal (tenant, nonprofit, etc.) has the right to offer the statutorily defined formula price for the building.
and this is the important point, only if the seller decides to sell. Therefore, unlike an option, the right of first refusal does not give the holder the power to compel an unwilling owner to sell. The compromise was most likely structured in this manner because the right of first refusal leaves more power in the hands of the owner whereas a purchase option would have given more discretion to the prospective buyer. Clearly, the statute does not allow the holder of the right of first refusal much discretion as to price because the minimum purchase price formula will not necessarily yield a below-market value price. Thus, non-profit groups have neither received the ability to negotiate the purchase price of their choice nor the power to compel an unwilling owner to sell. The right of first refusal does not protect against the fact that the transaction corporate investors might be willing to negotiate during the initial development of the low-income housing property is not necessarily the transaction they would choose fifteen years in the future.

The concerns over tinkering with one of the benefits of ownership, the right to appreciation with respect to the low-income housing credit properties, are misplaced. Arguably, given the nature of investment in low-income housing, the structure of low-income housing credit transactions almost never meets the case-law requirement of a potential pre-tax economic return or criteria provided by the IRS in Revenue Procedure 75-21. For

139. J.A. Bryant, Jr., Annotation, Pre-emptive Rights To Realty As Violation Of Rule Against Perpetuities Or Rule Concerning Restraints On Alienation, 40 A.L.R. 3d 920, 924 (1991). The right of first refusal is distinguishable from an option, in that an option allows a holder to compel the sale of property. Id. The right of first refusal is a right that is contingent or conditioned on the owner’s willingness to sell. Id.

140. Id.; see also R. David Wheat, Comment, Clarifying the Nature of Louisiana’s Right of First Refusal in the Transfer of Immovables, 47 LA. L. REV. 899 (1987) (contrasting option and right of first refusal).


142. The National Housing Law Project testified that the minimum purchase price is likely to be prohibitive for many community groups. For example, exit taxes for a single 98-unit project entering construction in New York City in 1992 are estimated at $568,000. Daniel D. Pearlman & Roberta L. Youmans, Statement of the National Housing Law Project Submitted to the House Committee on Ways and Means 7 (March 23, 1993).

143. Knetisch v. United States, 364 U.S. 361 (1960) (holding transaction invalid for tax purposes because only appreciable effect of transaction was to reduce Knetisch’s tax liability). For a discussion of the economic profit requirement, see also Warren, supra note 97, at 986-87.

144. For a discussion of Revenue Procedure 75-21, see supra notes 115-16 and accompanying text.
example, while investors in rental real estate typically obtain a return on investment through a return of cash flow, appreciation at the time of disposition and any tax benefits realized, the profit for investors in low-income housing is almost solely derived from tax benefits. The fact that tax benefits provide these investors with the return that makes the transaction worthwhile was acknowledged in 1986 when the low-income housing credit was created.  

At that time, Senate Finance Committee Chairman Packwood justified the low-income housing credit on the basis that tax incentives, not economic cash flow or appreciation, were the true motivation behind investments in low-income housing.

In the instance of low-income housing, it indeed does not appreciate in value and indeed the rents are fixed. And if we are going to have low-income housing in this Nation for the very poor or those close to very poor, we might as well realize the marketplace itself cannot afford to provide it.

Therefore, if we do not have some incentive, whether it is a Government appropriation program or a Government tax incentive, there will be no low-income housing...

The IRS itself has acknowledged that congressional intent should be considered as one of the facts and circumstances in determining whether a taxpayer entered into an activity with the objective of making a profit. In Revenue Ruling 79-300, the IRS decided not to use the “not-for-profit” argument of section 183 to deny the tax losses from the construction and operation of an apartment project for low- and moderate-income housing.

148. Rev. Rul. 79-300, 1979-2 C.B. 112. The IRS acknowledged that tax policy concerns should not frustrate congressional intent in accomplishing housing policy objectives. Id.
149. I.R.C. § 183(a) (CCH 1993). This section provides that an individual who engages in a nonprofit activity will not be allowed any deductions attributable to such activity other than (1) deductions allowed regardless of whether or not such activity is engaged in for profit and (2) a deduction equal to the amount of the deduction that would be allowable only if the activity was engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable in (1). I.R.C. § 183(b)(1)-(2).
under section 236 of the National Housing Act. The legislative history indicated that in limiting rental charges, Congress assumed that the deductibility of tax losses would provide investors with an adequate return from their investment in low- or moderate-income housing. Consequently, application of section 183 to disallow losses in this situation would frustrate Congress' intent in enacting the housing legislation.

Thus, any attempt to inject a pre-tax profit requirement into the determination of the tax ownership of low-income housing credit projects ignores the economic realities of this kind of investment. The benefits normally inherent in owning real estate are not present in low-income housing credit projects. Investors in qualified low-income housing projects are forced to comply with rent restrictions that circumscribe their right to collect fair market rents. Thus, the rents collected will rarely exceed the sum of the operating costs and mortgage payments, making it extremely unusual for investors to receive any positive cash flow.

Moreover, the rules for projects allocated tax credits after 1989 already limit the investors' right to appreciation. Investors must first offer the housing to a buyer who will continue its low-income use or allow the housing credit agency one year to find such a buyer at a statutorily defined formula price. The owners are free to sell or convert the project only if the agency cannot find a suitable buyer. Even then, however, the owners' actions are heavily restricted in that they may not evict existing tenants without cause for a period of three years. Thus, investors are usually unable to receive the highest price for their property unless they postpone disposition or conversion until after the thirty-year

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151. S. Rep. No. 1123, 90th Cong., 2d Sess. 85 (1968). Referring to investors in low-income housing, the Senate report stated that "assuming the member of the partnership is in a relatively high income tax bracket, his share of the depreciation losses, plus income from project operations would provide an after tax return on his investment . . . ." Id.


153. Professor Warren argues that where Congress has enacted an incentive for the very purpose of inducing changes in taxpayer behavior, requiring a pre-tax profit would directly interfere with this congressional goal. Warren, supra note 97, at 990.

154. I.R.C. § 42(h)(6)(l) (CCH 1993) (describing procedure if there is no buyer willing to maintain low-income status of credit project).

extended use period. By law, their right to appreciation has been limited.

Furthermore, at least with respect to offerings targeting corporate investors, any residual value of the low-income units is ignored for purposes of valuing the owners’ return on the investment except for the expectation that corporate investors will not have a tax liability at the end of fifteen years.\textsuperscript{156} The assumption of no residual is also made in the prospectuses of many public offerings. Therefore, the right to appreciation should not be given such significance for the purpose of determining who is the real owner.\textsuperscript{157} It is also unclear who, if not the investor, would be the real owner in this situation. Only the investor bears the risk of loss on his investment if the low-income housing property does not continue to meet the tenant income-and-rent restrictions over the fifteen-year compliance period.\textsuperscript{158} Should a nonprofit organization (usually a one percent general partner) or a tenant be considered the owner of the low-income housing property solely because of an option to purchase the property in fifteen years at a below-market price? Unlike the lease/sale situation, neither the nonprofit organization nor the tenant is paying excessive rents that should be recharacterized as installments on the purchase price.\textsuperscript{159}

Requiring the retention of a residual would make the low-income housing credit a less efficient method of conferring tax benefits on low-income renters. Depending on market adjustments, such a requirement could result in the investor reaping more benefits should there be appreciation in the value of the property. Tax expenditures to stimulate certain investments are most efficient when investors receive no more than is necessary to induce the investment. A below-market purchase option transfers more of the benefits to low-income tenants and facilitates transfer of ownership to those organizations dedicated to preserving the affordable housing stock. Congress’ unwillingness to provide ex-

\textsuperscript{156} See 1989 Hearings, supra note 91, at 162 (statement of F. Barton Harvey, III, Deputy Chairman, The Enterprise Foundation).

\textsuperscript{157} For a discussion of the right to appreciation as an incident of ownership, see supra note 118 and accompanying text.

\textsuperscript{158} See I.R.C. § 42(g) (CCH 1993). If the low-income housing property fails to comply with the applicable requirements during the fifteen-year compliance period, the taxpayer will usually have to recapture the tax credit. I.R.C. § 42(j). For a discussion of the rules regarding the recapture of the tax credit, see supra note 36.

\textsuperscript{159} For a discussion of the criteria that distinguish a sale from a true lease, see Revenue Ruling 55-540, 1955-2 C.B. 39.
plicitly for the ability to use a below-market purchase option has jeopardized an important housing policy objective—the transfer of low-income housing to owners who will continue to keep it available to low-income tenants—for no apparent tax policy gain.

B. Encouraging Investment in Low-Income Housing

The housing policy goal of encouraging investment in low-income housing has been jeopardized by the tax policy goal of ensuring that the wealthy pay an equitable amount of taxes. However, no conflict between these two goals actually exists if the low-income housing credit is fully capitalized. Full capitalization occurs when investors pay a sufficient premium for the after-tax income such that the yield equals that of a comparable taxable investment taking into consideration liquidity, risk and other factors. This phenomenon is known as the payment of implicit taxes.160 Absent adequate payment of implicit taxes, the conflict between these two goals can be reconciled by treating the tax credit properly for income measurement purposes. This Article concludes that the proper tax treatment of the low-income housing credit is to reduce the basis of the low-income housing credit property.161

The low-income housing credit is an explicit example of a tax expenditure provision that is functionally equivalent to a direct expenditure program. It is a housing program (administered by the IRS and the appropriate state or local housing credit agency) that seeks to increase the stock of affordable rental housing by encouraging new construction or rehabilitation of housing for low-income tenants. The low-income housing credit attempts to provide a market rate of return to the investors who provide the equity for a project.162 In exchange, the owner must set aside a minimum number of units that have rent ceiling restrictions for low-income tenants.163 The Joint Committee on Taxation estimated that this program would cost the government $700 million

160. For further discussion of implicit taxes and capitalization of the tax credit, see infra notes 242-55 and accompanying text.

161. For a discussion of the proper treatment of tax credits for income measurement purposes, see infra notes 238-39 and accompanying text.

162. For a discussion of the purpose and economic effect of the low-income housing credit, see supra notes 25-26 and accompanying text.

163. I.R.C. § 42(g)(1)-(2) (CCH 1993). For a more detailed discussion of the rent restrictions placed on qualified low-income housing units, see supra notes 43-44 and accompanying text.
in foregone tax revenues in 1992.\textsuperscript{164}

The goal of the program is to stimulate the production or rehabilitation of low-income housing so that low-income individuals can have a decent and affordable place to live.\textsuperscript{165} For 1989, full utilization of the low-income housing credit would have produced approximately 127,350 units of low-income housing.\textsuperscript{166} In order for the tax credits to translate into quality low-income housing projects, the bidding for the tax credits must be competitive. Moreover, to guarantee that the maximum number of projects are realized, the credit must be in sufficient demand so as to fully utilize each state’s allocation of credit authority. Thus, the low-income housing credit must be designed to ensure a steady flow of equity capital to compete for the available credits. Restrictions that decrease the pool of investors merely diminish the amount of equity raised per credit dollar.\textsuperscript{167}

1. \textit{Ensuring That the Wealthy Pay an Equitable Amount of Taxes}

As originally enacted, the low-income housing credit was subject to three separate limitations on how much tax credit any individual investor could utilize. First, the passive activity rules allowed the credit to offset taxes on up to $25,000 of nonpassive income, but only if the investor’s adjusted gross income was be-


\footnote{165. Rental units qualify a building for the tax credit only if the tenants have an income below a specific predetermined level. I.R.C. § 42(g)(1)(A)-(B) (CCH 1993). For a more detailed discussion of rent and income restrictions, see \textit{supra} notes 43-44 and accompanying text.}

\footnote{166. \textit{National Council of State Housing Agencies, Low-Income Housing Tax Credit Production, Calendar Year 1989} (May 7, 1990). The 97.8\% actual allocation in 1989 was expected to produce 124,518 low-income units once the projects were placed in service. If by the end of the year the taxpayer has spent ten percent of the project’s expected cost, the low-income housing credit project may be placed in service up to two years after the end of the year in which the project was allocated the tax credit. I.R.C. § 42(h)(1)(E) (CCH 1993).}

\footnote{167. \textit{See Mitchell-Danforth Task Force Report, supra note 67, at 4. Assuming that enough investors in low-income housing credit properties are affected by the passive activity, general business credit and alternative minimum tax limitations as to reduce demand below the level of supply at the break-even point (the price at which the return equals the after-tax return from similar but taxable investments), syndicators can no longer sell all of their tax credits at the break-even yield. They must therefore compete for the available investors by offering increased yields. This establishes a new equilibrium price at which the yield is higher for the investors but the quantity of dollars invested in low-income housing is lower than it would be without these restrictions. \textit{See Daniel Shaviro, Selective Limitations on Tax Benefits}, 56 U. CHI. L. REV. 1189, 1243 (1989) (providing further discussion of this analysis).}
low a threshold that began at $200,000 and phased-out at $250,000.\textsuperscript{168} Second, the general business credit provision established a maximum amount of income tax liability that could be reduced by general business tax credits in any year.\textsuperscript{169} Third, the alternative minimum tax rules did not allow the low-income housing credit as an offset against the alternative minimum tax.\textsuperscript{170} These provisions were intended to address the concern that wealthy investors would avoid paying their fair share of taxes by investing in low-income housing.

In 1969, the Treasury published a study indicating that in 1966, 154 very high-income individuals had paid no taxes due to the extensive use of tax preferences. Congress believed that the fact that a small minority of high-income individuals were permitted to escape tax on a large proportion of their income had seriously undermined taxpayer belief that all were paying their fair share of the tax burden.\textsuperscript{171} These concerns over taxpayer morale prompted the enactment of the first minimum tax in 1969.

A major feature of the Tax Reform Act of 1986\textsuperscript{172} was an expanded alternative minimum tax for individuals.\textsuperscript{173} The goal, as expressed in the Senate Finance Committee Report, was "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and

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\textsuperscript{168} I.R.C. § 469(i)(3)(B) (CCH 1989), amended by OBRA 1989 § 7109, 103 Stat. at 2922. Because of the investor income limitations, it was necessary to find investors who were certain that they would not make over $200,000 anytime in the next ten years. Benson F. Roberts, Local Initiatives Support Corporation, called it "the tax credit for the downwardly mobile." Roger Lowenstein, \textit{Tax Credit to Spur Low-Income Housing Goes Begging}, WALL ST. J., July 19, 1988, § 1, at 32.

\textsuperscript{169} I.R.C. § 38(c) (CCH 1993). General business tax credits include such credits as the investment credit, the targeted jobs credit and the low-income housing credit. I.R.C. § 38(b).

\textsuperscript{170} I.R.C. § 55(c)(2). Regular corporations that invest in low-income housing credit projects are only subject to the general business credit and alternative minimum tax provisions. For a discussion of limitations placed on individuals, personal service corporations and closely held corporations, see supra notes 93-94 and accompanying text.

\textsuperscript{171} S. REP. No. 552, 91st Cong., 1st Sess. 13 (1969). According to the Senate report, certain tax preferences that may have been justified at the time of their creation were no longer desirable, or even necessary. \textit{Id}. The problems created by these provisions were evidenced by a 1966 study that showed 100 out of 154 individuals paying no taxes had incomes in excess of $1 million. \textit{Id}. The report concluded that "[i]t is essential that tax reform be obtained not only as a matter of justice but also as a matter of taxpayer morale. . . . For this reason alone, the tax system should be improved." \textit{Id}.

\textsuperscript{172} Tax Reform Act of 1986, 100 Stat. at 2085.

\textsuperscript{173} \textit{Id.} § 701, 100 Stat. at 2321.
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Once again, the concern was raised that the ability of high-income individuals to pay little or no tax would undermine respect for the entire tax system. Thus, the individual alternative minimum tax was raised to twenty-one percent and its base was expanded to include twelve additional tax preferences. OBRA 1990 raised the individual alternative minimum tax rate to twenty-four percent and effective retroactively to January 1, 1993, the 1993 Tax Act increased this rate to a two-tier rate structure of twenty-six percent and twenty-eight percent.

Similar concerns led to the enactment of the passive activity rules in the Tax Reform Act of 1986. The Senate Finance Committee Report stated "that taxpayers are losing faith in the federal income tax system." The report cites another Treasury study showing that in 1983, out of 260,000 tax returns reporting "total positive income" in excess of $250,000, eleven per-

174. S. Rep. No. 313, supra note 25, at 518. The objective of the minimum tax was to prevent high-income individuals from avoiding significant tax liability. Id. The Committee on Finance found, however, that the minimum tax under current law did not adequately address the problem of tax avoidance. Id. at 519. The Committee stated that, "[b]y leaving out many important tax preferences, or defining preferences overly narrowly, the individual and corporate minimum taxes permit some taxpayers with substantial economic incomes to report little or no minimum taxable income and thus to avoid all tax liability." Id. The Committee on Finance recommended that certain items, currently not treated as preferences, be added to the minimum tax base. Id.

175. Id. The Committee on Finance stated that "it is inherently unfair for high-income individuals and highly profitable corporations to pay little or no tax due to their ability to utilize various tax preferences." Id. at 519.


182. S. Rep. No. 313, supra note 25, at 713. According to the report, taxpayer loss of confidence in the tax system is largely a product of the interaction between: (1) the high marginal rates; and (2) the potential to offset income from one source with tax shelter deductions and credits from another source. Id.


184. Id. The Treasury Department defined total positive income as the sum
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of wages and salary, interest, dividends and income from profitable businesses and investments, as reported on tax returns. *Id.*

185. *See Joint Comm. on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Shelters and Minimum Tax* (Comm. Print 1985). The concern was that as the tax base erodes due to tax shelters, tax rates must be increased if revenue levels are to be maintained. *Id.* at 16. This in turn increases the demand for tax shelters, and directly results in increased tax burdens falling on those who are unable to take advantage of tax shelters. *Id.*

186. I.R.C. § 469 (CCH 1993). Prior to 1994, rental activities were treated as passive activities regardless of the level of the taxpayer's participation. I.R.C. § 469(c)(2) (CCH 1993). Effective for tax years beginning after 1993, however, the 1993 Tax Act changes the passive activity loss rules with respect to the rental real estate activities of individual owners who spend more than 50% of their working time (a minimum of 750 hours) in real property trades or businesses. I.R.C. § 469 (c)(7), enacted by OBRA 1993 § 13143, 107 Stat. at 440-41. An eligible taxpayer's losses and credits from the activities in which the taxpayer materially participates may be used to offset nonpassive income. *Id.* A closely held C corporation will be eligible for this rule if more than 50% of the corporation's gross receipts for the taxable year are derived from real property trades or businesses in which the corporation materially participates. I.R.C. § 469(c)(7)(D). All losses and credits from 1993 and all prior years will continue to be treated as under prior law. OBRA 1993 § 13143, 107 Stat. at 440-41.

187. I.R.C. § 469(i) (CCH 1993). An individual may offset up to $25,000 of nonpassive income by utilizing losses and credits from rental real estate activities in which such individual actively participates. I.R.C. § 469(i)(1). The $25,000 allowance is phased-out by 50% of the amount by which the taxpayer's adjusted gross income for the year (determined without regard to passive activity losses, IRA contributions, or taxable social security benefits) exceeds $100,000. I.R.C. § 469(i)(3).

188. I.R.C. § 469(i)(6)(B).


likely investors in low-income housing property."

The Tax Reform Act of 1986 also tightened the general business credit limitations. Citing the ability to reduce tax liability to very low percentages, the Senate Finance Committee recommended limiting to seventy-five percent the amount of income tax liability (in excess of $25,000) that may be offset by all general business credits. Once again, the Senate Finance Committee’s justification for the change was concern over confidence in the equity of the tax system.

2. Reconciling Low-Income Housing Investment with Vertical Equity Concerns

The application of the passive activity, general business credit and alternative minimum tax provisions essentially precluded a majority of the most likely individual investors from using the low-income housing credit as it was originally enacted. A special exception permitted taxpayers with adjusted gross incomes under $200,000 to use up to the equivalent of a $25,000 deduction ($7,000 of the tax credit for taxpayers in the 28% bracket) to offset nonpassive income. Due to their income levels, however, this exception was inapplicable to a majority of the former investors in such real estate transactions.

(providing that phase-out of $25,000 allowance is not applicable to any portion of passive activity credit that is attributable to low-income housing credit).

191. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1188 (1989) [hereinafter H.R. Rep. No. 247]. The House of Representatives report stated that “[t]he committee believes that encouraging the provision of low-income housing is an important goal of national housing policy. The Federal government can foster this goal through... providing tax incentives to private investors to invest in low-income housing projects...” Id. For further discussion of how the passive activity, general business credit and alternative minimum tax provisions essentially precluded a majority of the most likely investors from using the low-income housing credit as it was originally enacted, see infra notes 196-99 and accompanying text.


193. Id. (providing for reduction in tax liability that may be offset by general business credits).

194. S. Rep. No. 313, supra note 25, at 260. The low-income housing credit is considered a general business credit. Id. Formerly, general business credits could be used to reduce tax liability up to $25,000 plus 85% of tax liability in excess of $25,000. Id.

195. Id.

196. I.R.C. § 469(i)(3)(B) (CCH 1989), amended by OBRA 1989 § 7109, 103 Stat. at 2922. This special provision related to any portion of the passive activity credit attributable to the low-income housing or rehabilitation credit. For a discussion of the removal of this income limitation, see supra notes 189-91 and accompanying text.

Furthermore, low-income housing projects had often been structured as private placements under the Regulation D exemption from the public offering registration requirements of the Securities Act of 1933. Regulation D requires that for offerings in excess of $1,000,000, all but thirty-five investors must be "accredited." Accredited investors are individuals with annual incomes exceeding $200,000 or net worths exceeding $1,000,000. As most such accredited investors could not qualify for the special credit exception from the passive activity rules, private placements were predominantly replaced by registered public offerings as the main investment alternative. This has led to increased transaction costs primarily due to the significantly higher syndication costs associated with public offerings.

The Community Revitalization Tax Act of 1989— as introduced but not enacted—sought to increase the pool of investors eligible to use the low-income housing credit and to expand the number of practical financing mechanisms available to project sponsors. These goals were to be accomplished by modifying

that "Congress is giving tax breaks to draw capital into low-income housing, but doesn't want people with capital to have tax breaks. [T]he credit is of little use to the high-income individuals who would be suitable investors in these potentially high risk deals." Id.


199. Commodity and Securities Exchanges, 17 C.F.R. §§ 230.505(b)(2)(ii) (1993). For the purposes of calculating the number of investors limited under Regulation D, accredited investors are not included. 17 C.F.R. § 230.501(e)(1)(iv). Moreover, an issuer under Regulation D must limit the number of "purchasers" to 35. 17 C.F.R. § 230.505(b)(2)(ii). Thus, all but 35 investors under Regulation D must be accredited investors, or excluded from the calculation of "purchasers" for some other reason. Id. For a list of other exclusions, see 17 C.F.R. § 230.501(e)(1)(i)-(iii).

200. 17 C.F.R. § 230.505. To be an "accredited investor" based on annual income, a natural person must have earned in excess of $200,000 in each of the two most recent years, or have joint income with a spouse in excess of $300,000 in each of the two most recent years and reasonably expect to maintain this income. Id. Status as an "accredited" investor allows a person to be excluded from the calculation of the number of purchasers. Id. For other categories of qualified investors, see 17 C.F.R. § 230.501(a) (defining term "accredited investor").

201. See ICF STUDY, supra note 32, at 9. This study, drawn from data describing projects developed in 1987 and 1988, found that public syndications raised only about 67 cents per tax credit dollar as compared to 87 cents for private placements. Id.


203. 135 Cong. Rec. S1095-96 (daily ed. Feb. 2, 1989) (floor statement of Senator Danforth). Senator Danforth hoped to restore vitality to the rehabilitation and low-income housing credits "by shifting the credit use limitations for
the passive activity rules to limit their scope to include only losses, not credits from low-income housing credit investments.\textsuperscript{204} Congress acknowledged the concern that some individuals were being excluded from the pool of likely investors, by removing the income limitation on the use of the special exception from the passive activity rules for the low-income housing credit.\textsuperscript{205} However, because OBRA 1989 did not remove the credit completely from the passive activity rules, a taxpayer’s inability to use more than $7,000 of the credit annually limits the amount a taxpayer will invest in low-income housing.\textsuperscript{206} Thus, private placements are still very difficult to negotiate because of the number of investors required to raise the requisite amount for the project.

Another significant problem with the low-income housing tax credit is that any taxpayer subject to the alternative minimum tax will be unable to fully utilize the credit because the credit cannot be used against the alternative minimum tax.\textsuperscript{207} The Joint Committee on Taxation estimated that 130,000 noncorporate taxpayers would be subject to the alternative minimum tax in 1990.\textsuperscript{208} In 1991, with the increased alternative minimum tax rate of twenty-four percent, the Joint Committee on Taxation estimated that 317,000 noncorporate taxpayers would be subject to the alternative minimum tax.\textsuperscript{209} With respect to corporate taxpayers, the number of taxpayers affected by the alternative minimum tax had grown from 17,000 in 1987 to 32,000 in 1990. Although all

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\textsuperscript{204} S. 342, supra note 18. To sell this departure from the Tax Reform Act of 1986, the legislation tightened the general business credit limitation on individuals to the sum of the first $20,000 of a taxpayer’s net tax liability plus 20\% of the liability exceeding $20,000. \textit{Id.} In addition, the alternative minimum tax system was left in place. \textit{Id.}

\textsuperscript{205} I.R.C. § 469(i)(3)(B) (CCH 1989), \textit{repealed by OBRA 1989 § 7109, 103 Stat. at 2322; see H.R. REP. No. 247, supra note 190, at 1188.}

\textsuperscript{206} For 1991 and future years, it is possible to use $7,750 for those taxpayers in the 31\% bracket. For 1993 and future years, the $25,000 deduction equivalent equals $9,000 ($25,000 x 36\%) for those taxpayers in the 36\% bracket and $9,900 ($25,000 x 39.6\%) for those in the 39.6\% bracket.

\textsuperscript{207} For a discussion of the alternative minimum tax, see supra notes 173-80 and accompanying text.

\textsuperscript{208} Letter from Joint Comm. on Taxation to Senator Danforth (Oct. 11, 1990) (on file with author).

\textsuperscript{209} Letter from Joint Comm. on Taxation to Senator Danforth (Oct. 23, 1990) (on file with author).
ternative minimum tax taxpayers comprised less than one percent of total corporate tax returns between 1987 and 1990, they did represent approximately twenty to twenty-five percent of corporations with assets of $500,000. Such a reduction in the pool of eligible investors increases the cost of raising equity capital. If there is an insufficient number of potential investors relative to the supply of low-income housing credit investments, the investors will pay less for the tax benefits. Thus, the alternative minimum tax rules, as well as the passive activity and general business credit restrictions, blunt the effectiveness of this tax expenditure. In fact, the alternative minimum tax system is inconsistent with the concept of tax expenditures.

a. Tax Expenditure Analysis

The tax expenditure concept recognizes that the tax system contains two conceptually and functionally distinct components—structural provisions necessary to implement the income tax and tax expenditure provisions chosen to implement government spending programs. "The tax expenditure concept in essence considers these special provisions as composed of two elements: the imputed tax payment that would have been made in absence of the special provision . . . and the simultaneous expenditure of that payment as a direct grant to the person benefitted by the special provision." Thus, under this concept, the low-income housing credit works as follows: the taxpayer determines his tax liability in the absence of the special incentive for investment in qualified low-income housing projects and the government gives the taxpayer a subsidy to compensate him for making the desired investment. This subsidy payment is accomplished by allowing

210. Geraldine Gerardi et al., Department of the Treasury, Temporal Aspects of the Corporate Alternative Minimum Tax: Results Corporate Panel Data for 1987-1990 5. Note that the data used for 1990 is preliminary data.

211. For a discussion of the consequence of the supply of credit properties exceeding the demand for the low-income housing credit investments, see supra note 167 and accompanying text.

212. Surrey, supra note 1, at 6. According to Surrey:
The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures.

Id.

213. Id. at 6-7.
the low-income housing credit to offset the taxpayer’s regular tax liability on a dollar-for-dollar basis.\textsuperscript{214}

When a taxpayer is subject to the alternative minimum tax, the government cannot make the subsidy payment until the taxpayer is subject to the regular tax at some point in the future—if ever. Given the uncertainty of the applicability of the alternative minimum tax, many investors are leery of making an investment in low-income housing. This wariness may become heightened if the increases in the alternative minimum tax rates for noncorporate taxpayers negatively affect taxpayers who have already invested in low-income housing. If these investors become subject to the alternative minimum tax because of its broadened applicability, the subsidy payments due them will be delayed either in whole or in part. Thus, for the tax expenditure mechanism to work, the low-income housing credit must be allowed to offset the alternative minimum tax. Otherwise, recognition of the possibility of a deferral in the ability to use the low-income housing credit will deter investment in low-income housing.\textsuperscript{215} Therefore, the alternative minimum tax rules frustrate the goal of attracting investment in low-income housing for the purpose of solving a perception problem—that wealthy investors are not paying their fair share of taxes.\textsuperscript{216}

\textsuperscript{214} See id. at 7.

\textsuperscript{215} The Senate Finance Committee recognized the possibility that a deferral in the ability to use the credit would deter investment in low-income housing and, thus, during OBRA 1990 conference negotiations attempted to insure that past investors would receive the benefits they were promised. Unfortunately, however, the House Ways and Means Committee was unwilling to tinker with the alternative minimum tax, and, as a result, a compromise was reached that did not directly deal with the problem.

Section 11407(c) of OBRA 1990 permits individual taxpayers, who held an interest in low-income housing on October 26, 1990, to increase the credit claimed in 1990 by up to 50\% of the otherwise allowable credit. See OBRA 1990 § 11407(c), 104 Stat. at 1388-1476. However, because the passive activity rule special exception was not increased, taxpayers already deducting the maximum credit (generally $7,000) will receive no benefit from this special provision. See id. Thus, a taxpayer who loses some of the benefits of the low-income housing credit in the future due to the application of the alternative minimum tax is not necessarily able to take advantage of this 1990 election to accelerate the credit. See id.

In all fairness, one must recognize that the Joint Committee on Taxation (as advisors to the House Ways and Means Committee and the Senate Finance Committee) was given only one hour to devise a solution to this problem. Telephone Interview with Thomas Barthold, Joint Committee on Taxation staff member (March 12, 1993). At approximately 2:00 a.m., they were given the assignment to draft a solution by 3:00 a.m. \textit{Id.}

Most direct expenditures are given on a pre-tax basis and must be included in the gross income of their beneficiaries. For example, agricultural subsidies, land and forest conservation payments and unemployment compensation are all included in the gross income of their recipients. Some direct expenditures, however, are only partly taxable; a designated percentage of the social security benefits received during the taxable year must be included in a recipient's gross income under certain circumstances. Other direct expenditures—such as food stamps, housing vouchers and certain pay to members of the armed forces—are specifically excluded from gross income.

In contrast to direct expenditures, most tax expenditures are not included in the gross income of the beneficiary. When a non-taxable tax expenditure is structured as a deduction or an exclusion, it is worth more to the high-bracket taxpayer than to the lower-bracket taxpayer. A tax credit is also more valuable to a lien on perceptions to justify a substantive tax provision is disturbing." Id. at 98.

218. Id.
220. See Surrey, supra note 1, at 137 (stating that "[m]ost direct Government economic assistance for business activities is given on a before-tax basis and in one way or another enters as a plus in the income accounts of the person benefitted").
221. For taxable years beginning in 1994, the 1993 Tax Act establishes a two-tier system for taxing Social Security benefits. I.R.C. § 86 (CCH 1993), enacted by OBRA 1993 § 13215, 107 Stat. at 475-77. First, the present tax on 50% of the benefits for individuals with income above existing thresholds is retained. Id. Second, a new tax on 85% of the benefits for individuals with incomes above higher threshold amounts is added. Id.
222. See Rev. Rul. 74-74, 1974-1 C.B. 18, 19 (stating that "disbursements from a general welfare fund in the interest of the general public which are not made for services rendered are not includable in gross income") (citations omitted).
223. Klein et al., supra note 17, at 153; see also Rev. Rul. 74-205, 1974-1 C.B. 21 (stating that "replacement housing payments made prior to January 2, 1971, pursuant to the 1968 Act are not includable in the gross income of the recipient").
224. I.R.C. § 112(a)-(b) (CCH 1993). Although Congress excludes some direct expenditures from gross income, the benefit of the tax exclusion for military allowances and other governmental benefits is probably taken into account by Congress when establishing the payment levels. Bittker & Loken, supra note 25, at ¶ 3.3.3, 3-30. Thus, if Congress were to repeal the exclusions, it would most likely compensate the recipients by increasing the amount of such benefits. Id. However, there would still be an impact to the extent that the marginal tax rates of the recipients differ. Id.
225. For discussion of the true value of a tax preference, see Marvin A. Chirelstein, Federal Income Taxation 356 (6th ed. 1991). Chirelstein argues that the market for tax preferences does not work perfectly and, thus, there is
high-bracket taxpayer because "the credit is, in effect, after-tax income and is therefore equivalent to a larger amount of regular income to the higher tax bracket recipient." Thus, equity issues concern and surround both tax and direct expenditure programs.

These inequities can be remedied by including the tax expenditure (or direct expenditure) in gross income either directly or indirectly through the basis reduction mechanism. Indeed, many of the tax credits in the Internal Revenue Code are taxable. For example, section 87 requires the amount of the alcohol fuel credit to be included in income. To the extent that an employer uses the targeted jobs tax credit provision, he is required to reduce the deduction for wages by the amount of the credit. The result is the same as if the credit amount was included in the tax base and a full deduction for wages was allowed. The present tax treatment for a tax expenditure that is analogous to a direct government contribution to capital is not to include it in income directly but rather to reduce the basis of property related to the contribution. Thus, a taxpayer utilizing the rehabilitation tax credit must reduce the basis of the building by the amount of the rehabilitation tax credit.

The low-income housing credit appears to be partly taxable because of the use of an after-tax interest rate in the low-income housing credit formula. For example, an after-tax interest rate of 5.85% generates a seventy percent present value credit of

some loss of equity among taxpayers. Id. at 361-62; see also Surrey, supra note 1, at 50 (discussing effects of tax expenditures on taxes paid). Note that a nontaxable direct expenditure is also more valuable to the high-bracket taxpayer than to the lower-bracket taxpayer.


227. I.R.C. § 87 (CCH 1993); see also I.R.C. § 40(a) (determining amount of alcohol fuel credit that must be included as income).

228. Id. § 280C(a).


230. Basis reduction in lieu of income inclusion is also the tax law treatment for direct expenditure grants designed as contributions to capital rather than as operating subsidies. See Surrey, supra note 1, at 329 n.37; see also I.R.C. §§ 118, 362(c) (CCH 1993); Thomas L. Evans, The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis, 45 Vand. L. Rev. 1457 (1992) (providing critical analysis of current tax treatment of nonshareholder contributions to capital).

231. I.R.C. § 50(c)(1) (CCH 1993); see also McDaniel, supra note 229, at 275.

232. For a description of the formula used to calculate the credit rate, see supra note 45.
8.92%. By substituting a pre-tax interest rate of 8.13%, the formula yields a seventy percent present value credit of 9.7%. Because this equals a 7% after-tax credit, as compared to the 8.92% credit computed using the after-tax interest rate, the use of an after-tax interest rate in the formula results in a partly taxable credit. Thus, in effect, an 8% tax is being paid on the credit.

In order to accommodate tax policy concerns, the low-income housing credit should be made completely taxable instead of inappropriately using the passive activity, general business credit and alternative minimum tax provisions to accomplish the goal of ensuring tax equity. Because the low-income housing credit is analogous to a direct government contribution to capital, the proper tax treatment is to reduce the basis of the low-income housing credit property. Moreover, because adjusting the property’s basis annually as the credit is received seems unduly complex, perhaps in the case of the seventy percent present value credit, the depreciable basis should simply be reduced by seventy percent.

In general, there will be no effect on an individual taxpayer’s income until the low-income housing investment is sold because the passive activity rules usually restrict individual taxpayers from deducting depreciation expenses. At the point of sale, the basis

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233. 5.85/(1 − .28) = the pre-tax interest rate of 8.13%.
234. (.70 × .0813)/[(1.0813 − 1)/(1.0813)^9] = 9.7%. For a description of the formula used to calculate the credit rate, see supra note 45.
235. 9.7 × (1 − .28) = 7% after-tax.
236. 8.92/9.7 = 92%. Thus, the tax rate equals 8%.
237. Taxation of the tax credit is unnecessary, however, if one believes that the tax preference for low-income housing credit investments is fully capitalized. The low-income housing credit is fully capitalized when investors pay a sufficient premium for the after-tax income such that the yield equals that of a comparable taxable investment taking into consideration liquidity, risk, etc. For a discussion of capitalization, see infra notes 242-55 and accompanying text.
238. For a discussion of nonshareholder contributions to capital, see Evans, supra note 230.
239. In the case of the 30% present value credit, the depreciable basis should be reduced by 30%. Note that the annual credit amount provides a stream of benefits with a net present value of either 70% or 30% of the basis attributable to qualifying low-income units, depending on the type of low-income housing expenditure. See Bluebook, supra note 45. A remaining question, however, is whether the interest rate used in the formula—the average of the annual AFR for mid-term and long-term obligations—is appropriate? For a description of the formula used to calculate the credit percentage, see supra note 45 and accompanying text.
240. For a discussion of amendments to the passive activity rules, see supra note 186 and accompanying text.
sis reduction will play a role in calculating gain or loss on the sale or exchange of the asset. As most corporate taxpayers are not subject to the passive activity rules, the basis reduction will have an immediate effect on the taxable income of the corporation by virtue of reduced depreciation deductions. However, in both cases, Congress will need to increase the rate of the tax credit in order to provide the same after-tax rate of return that it intended when it created the credit in 1986.241 Once the low-income housing credit is explicitly taxable through the mechanism of basis reduction, there is no justification for the passive activity, general business credit or alternative minimum tax provisions with respect to the credit. These limitations on the use of the low-income housing credit should therefore be repealed.

The restrictions on the use of the low-income housing credit are also unjustified if this tax expenditure is proven to be fully capitalized. If the investor in low-income housing credit properties has paid adequate implicit taxes,242 then horizontal and vertical equity issues have already been resolved.243 The market responds to under-measurement of taxable income from a particular investment with increased demand for the tax-preferred investment at the expense of demand for alternative uses of funds.244 Because the low-income housing credit yields after-tax

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241. The basic objective in the design of the low-income housing credit formula was to compensate the future investor for the loss of the tax incentives that existed in the pre-1986 Internal Revenue Code, such as special accelerated depreciation, five-year amortization of certain rehabilitation expenditures and special deductions for interest and taxes paid during the construction period. For further discussion of the basic objectives underlying the low-income housing credit, see supra notes 61-63. The formula was also designed to give a 28% bracket taxpayer sufficient incentive to attract his investment in low-income housing when compared to alternative investments. Telephone Interview with Professor Andrew Lyon, formerly staff of the Joint Committee on Taxation 1985-1987, staff member of the Council of Economic Advisors (August 27, 1992). Thus, the goal was to design a credit formula that would generate an after-tax rate of return for investment in low-income housing credit properties that was competitive with alternative investments. Id. Given this goal, if the tax credit had originally been taxable, then the formula would have been adjusted to increase the rate so that the same incentive effect would be achieved. Id.

242. For a more detailed discussion of implicit taxes, see infra note 267.

243. Horizontal equity refers to the principle that similarly situated taxpayers should be taxed similarly. For a more detailed discussion of horizontal and vertical equity principles, see Ghirelstein, supra note 225, at 359.

244. Shaviro, supra note 167, at 1221-22 (stating that "[p]reference capitalization is a result of market responses to the prescribed under-measurement of taxable income from a particular investment"); see also Bittker & Lokken, supra note 25, at ¶ 3.3.3, 3-27 to 3-28 (analyzing congressional effort to stimulate investment in equipment by providing tax treatment for equipment costs that effectively exempts income from such property from tax); Alvin C. Warren, Jr.,
income, investors will be willing to pay a premium for this tax-exempt stream of income. This premium lowers the yield on the investment when compared to an identical taxable stream of income; such sacrificed yield is considered an implicit tax payment.\footnote{245}

If the low-income housing credit is fully capitalized, the after-tax return for taxpayers in the same tax bracket is identical regardless of whether they invest in this tax-preferred asset or in some other taxable asset. This satisfies horizontal equity concerns because similarly situated taxpayers are being treated alike. Furthermore, if the tax expenditure is fully capitalized, it does not violate vertical equity either. The progressivity of the rate structure will be unaffected if a 15% taxpayer who invests $1000 in a taxable instrument yielding $100 pays tax of $15 whereas a 31% taxpayer invests the same amount in an instrument that only yields after-tax income of $69. The 31% taxpayer has paid an implicit tax of $31 equal to the sacrificed yield, so that the vertical relationship (15%/31%) between high- and low-bracket taxpayers is preserved despite the tax credit. Thus, the progressivity of the rate structure is unaffected and vertical equity concerns are satisfied.\footnote{246} This phenomenon only occurs, however, when all the tax-exempt instruments are purchased by investors subject to the highest marginal rate of tax.\footnote{247}

The problem is discerning whether the low-income housing credit has been fully capitalized. Under the compressed tax rate schedule in effect for the 1991 and 1992 tax years,\footnote{248} it appeared

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\footnote{245. For a more detailed discussion of implicit taxes, see infra note 267.}

\footnote{246. For further discussion of how vertical equity concerns are satisfied, see Chirelstein, supra note 225, at 359; Warren, supra note 244, at 559-60; and Warren, supra note 97, at 990-91.}

\footnote{247. For a discussion of who invests in low-income housing credit projects, see infra notes 252-54 and accompanying text. See also Boris I. Bittker, Equity, Efficiency, and Income Tax Theory, in THE ECONOMICS OF TAXATION 19, 26-27 (Henry J. Aaron & Michael J. Boskin eds., 1980) (stating that “[i]f the trickle-up theory is valid, an upside-down subsidy (that is, one that goes exclusively to taxpayers subject to the highest marginal tax rate) causes a misallocation of resources but no vertical inequity”).}

\footnote{248. I.R.C. § 1 (CCH 1992) (prior to amendment by OBRA 1993 § 13201, 107 Stat. at 457-61). For the 1991 and 1992 tax years, the tax rate schedule contained only three brackets: 15%; 28%; and 31%. Id. For the 1993 tax year, the 1993 Tax Act adds a 36% bracket and a surtax on taxpayers with taxable incomes greater than $250,000, which results in an additional 39.6% bracket. I.R.C. § 1 (1993), enacted by OBRA 1993 § 13201, 107 Stat. at 457-61.}
that the benefits of tax-exempt bonds were partially capitalized. For 31% tax bracket taxpayers, tax-exempt bonds only yielded after-tax returns fourteen percent higher than comparable taxable financial instruments.\(^\text{249}\) However, it is difficult to determine empirically the extent of capitalization of the low-income housing credit because there is no similar taxable investment that would permit the direct comparison of yields that is possible with taxable and tax-exempt bonds.\(^\text{250}\)

In order for the market to work perfectly, however, top bracket taxpayers must acquire all the low-income housing credit investments. Otherwise, the credit investments must be priced to attract lower bracket investors, leaving a residual windfall for those in the highest brackets.\(^\text{251}\)

Based on statistics of income data, one may reasonably assume that taxpayers in the 28% tax bracket as well as the highest tax bracket are investing in low-

\(^\text{249}\) The yield on AA ten-year obligation tax-exempt bonds was 5.4% on November 24, 1992. Anita Raghavan, *Yield Comparisons*, WALL ST. J., Nov. 25, 1992, at C19. The yield on similarly rated 1-10 year taxable corporate bonds was 6.87% on the same day, which after adjusting for a 31% marginal income tax rate, is 4.74%—almost 88% of the tax-exempt yield. *Id.* For a taxpayer in the 28% marginal income tax bracket, the after-tax yield is 4.95%—almost 92% of the tax-exempt yield. *Id.; see also* Shaviro, *supra* note 167, at 1230-31 (stating that tax-exempt bonds now offer many taxpayers approximately same after-tax return as similar taxable financial instruments). *But cf.* George Cooper, *The Taming of the Shrewd: Identifying And Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 637, 698-701 (1985). Professor Cooper argues that it does not make sense to compare the implicit tax on exempt bonds to the ordinary income tax rate when high tax bracket investors have so many lower rate opportunities available to them. *Id.* at 698-701. He suggests a comparison to the maximum capital gains rate on other low-taxed investment alternatives that are the real options for exempt-bond investors. *Id.* at 699. Judged against these rates, Professor Cooper would find that exempt bonds are subject to a competitive level of taxation. *Id.*

Professor Yorio rebuts Cooper’s assertion by pointing out that for many taxpayers, income consists solely or primarily of salary or other earned income. Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 401 (1987). Because the implicit tax on tax-exempt bonds is lower than the highest marginal tax bracket, purchasers of these bonds receive a tax advantage compared to taxpayers with salary or other earned income. *Id.*

\(^\text{250}\) Specifically, in order to make a valid comparison, the low-income housing credit investment and taxable investment must be equally risky and liquid. For a discussion of the relationship between the risk of an investment and an investor’s indifference curve, see Jack Hirshleifer, *Price Theory and Applications* 70-71 (1992).

\(^\text{251}\) Susan Ackerman & David Ott, *An Analysis of the Revenue Effects of Proposed Substitutes for Tax Exemption of State and Local Bonds*, 23 NAT’L TAX J. 397, 398-99 (1970); *see also* CHIRELSTEIN, *supra* note 225, at 360-61. *But cf.* Cooper, *supra* note 249, at 699. Professor Cooper argues that exempt bonds are priced as favorably as they are relative to taxable ones because they must compete in a market rich with tax-reduction opportunities rather than because the exempt bonds must attract lower bracket investors. *Id.*
income housing credit projects. The investor examples in the prospectuses for low-income housing credit investments make it clear that they are targeting investors in the 28% tax bracket. Finally, corporations that are in the 34% tax bracket invest in credit projects. Thus, because all low-income housing credit investments were not being purchased by corporations—the investors in the highest marginal tax bracket before 1993—one can presume, theoretically, that the low-income housing credit is not fully capitalized. The implicit taxes that are paid on low-income housing credit investments mitigate the equity concerns, but making the credit taxable should eliminate these concerns.

b. Solving the Perception Problem

As tax expenditure analysis demonstrates, all that should be necessary to eliminate tax policy concerns is to treat tax expenditures correctly for income measurement purposes. Unfortunately,

252. For 1990, 26,695 individual income tax returns with adjusted gross incomes of between $45,000 and $1,000,000 claimed low-income housing credits. STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERVICE (unpublished information for Tax Year 1990). One may reasonably assume that these returns reflect taxpayers in both the 28% and 33% tax brackets. Under the rate structure from 1988 through 1990, there were only two brackets, one at a 15% tax rate, and the other at a 28% tax rate. KLEIN ET AL., supra note 17, at 35-36. As a taxpayer’s income exceeded a certain threshold, however, the benefits of the 15% rate and personal exemptions were phased-out. Id. These benefits were phased-out by imposing an extra tax of 5% until the benefits of the 15% tax bracket and personal exemptions were eliminated. Id. This produced a 33% marginal rate over a certain range of income that varied among taxpayers. Id. For the 1991 and 1992 tax years, the tax rate schedule contained three tax brackets: 15%; 28%; and 31%. I.R.C. § 1 (CCH 1992) (prior to amendment by OBRA 1993 § 13201, 107 Stat. at 457-61). For tax years after 1992, there are two additional tax brackets: 36% and 39.6%. I.R.C. § 1 (CCH 1993).

253. See BOSTON CAPITAL SERVICES, INC., BOSTON CAPITAL TAX CREDIT FUND III L.P. (July 1, 1992) (providing examples of prospectuses for low-income housing credit investments); BOSTON FINANCIAL SECURITIES, INC., BOSTON FINANCIAL QUALIFIED HOUSING TAX CREDITS L.P. III (November 23, 1988) (same).

254. For taxable years beginning after 1992, the 1993 Tax Act adds a new 35% tax bracket for corporations with taxable income greater than $10,000,000. I.R.C. § 11 (CCH 1993), enacted by OBRA 1993 § 13221, 107 Stat. at 477. The benefit of the 34% bracket is phased-out through the use of a 38% bracket for corporate taxpayers with taxable incomes between $15,000,000 and $18,333,333. Id.

nately, however, the public becomes outraged when it learns that an individual or a corporation has paid no income taxes. After release of the IRS's income statistics for 1987, a headline in the Wall Street Journal read: "IRS Says 472 Rich People Didn't Pay Taxes in 1988." Data depicting high-income families paying no taxes undermines public confidence in the tax system. In a voluntary tax system like the U.S. regime, widespread perceptions of tax inequity could lead to serious compliance problems.

256. See, e.g., Jeffrey H. Birnbaum & Alan S. Murray, Showdown at Gucci Gulch 12 (1987) (describing public outcry following publication of 1984 Citizens for Tax Justice study by Robert McIntyre that demonstrated that 128 out of 250 of largest corporations paid no federal income taxes for at least one year between 1981 and 1983); see also Steven M. Sheffrin, Perceptions of Fairness in the Crucible of Tax Policy, in Tax Progressivity and Income Inequality (Joel Slemrod ed., 1993).

257. The Tax Reform Act of 1976 requires the annual publication of data on individuals with high incomes including the number who did not pay any income tax. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2123, 90 Stat. 1520, 1915-16. The data must illustrate the significance of various tax provisions in making those individuals nontaxable. Id. The high-income tax return data is required to be selected and classified on the basis of two different definitions of income: adjusted gross income (AGI) and expanded income. Id., amended by Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 441, 98 Stat. 494, 815.

Expanded income is defined as AGI plus certain tax preferences less investment expenses not exceeding investment income. Statistics of Income Division, Internal Revenue Service, Individual Income Tax Returns 1988 67-74 (1991) [hereinafter Tax Returns-1988]. The tax preferences that were considered for 1988 were those items that comprise the alternative minimum tax base such as the excess of accelerated over straight-line depreciation on some property and unrealized gain on the exercise of stock options. Id. Because expanded income is based on tax return data, it includes those tax expenditures that can be found on Form 6251, Alternative Minimum Tax Computation, and tax-exempt interest income from state and local government bonds. Id. But the expanded income concept excludes other tax expenditures such as the value of most employee fringe benefits. Id. Itemized deductions are also not taken into consideration for the purposes of either expanded income or AGI. Id.


259. Richard Gephart & Elaine G. Bryant, The Fair Tax Act: A Plan for a Simple, Fair, and Economically Rational Tax, 12 NOTRE DAME J. LEGIS. 129, 131 (1985) ("It is clear that taxpayer perceptions of an unjust and inequitable tax system contribute to the increasing level of noncompliance."); David I. Kempler, Transitional Rules as a Tool for Effective Tax Reform, 56 BAYLOR L. REV. 765, 770 (1984) ("For many taxpayers, the complexity of the system, and its perceived unfairness encourage them to play the 'audit lottery' by failing to report income, by overstating deductions, or by taking aggressive positions on disputed tax issues."); Dean Phyners, A Businessman's View of Tax Reform, 38 NAT'L TAX J. 285, 285 (1985) ("[T]he perception of fairness, in a system of voluntary compliance, is critical.").

Although the above commentators blame public perceptions of tax inequity for the decline in income tax compliance during the 1980's, other commentators assert that the decrease in compliance can be accounted for by the decrease in auditing over the same period. Jeffrey A. Dubin et al., Penny-Wise and Pound-
Concern over public perceptions of tax inequity continue to be an important consideration today. For example, data on the effective tax rates paid by individuals played a key role in the fiscal year 1991 budget debate. Thus, it is imperative that the public understand how these effective tax rates are computed.

Professor McDaniel’s theory is that tax expenditures do not erode the tax base.

The check which the taxpayer actually sends to the government is generally thought of as the taxpayer’s tax liability. But, as tax expenditure analysis makes clear, the amount of the check is not the taxpayer’s “tax” at all. It is simply a number which represents the net of the taxpayer’s tax on economic income minus the sum of the subsidies delivered through the tax system for which the taxpayer has qualified. As such, the amount of the check paid by the taxpayer has no particular economic or pol-

Foolish: New Estimates of the Impact of Audits on Revenue, 35 Tax Notes 787, 789-90 (1987) (stating that “estimates imply that the entire estimated increase in individual noncompliance during the 1975-1985 period is much more than accounted for by the decrease in auditing over the same period, other things equal”); see also Steven E. Kaplan & Philip M.J. Reckers, A Study of Tax Evasion Judgments, 38 Nat’l Tax J. 97, 102 (1985) (arguing that taxpayer attitudes towards compliance are not significantly affected by perceptions of fairness); Shaviro, supra note 216, at 98-99 (stating that “there is little evidence that the public’s level of concern about tax avoidance was great enough to influence behavior significantly”). Professor Zelinsky asserts that “[i]f there is a problem, it is that the federal government is selectively subsidizing some persons and not others, not the form in which the subsidy is occurring.” Zelinsky, supra note 5, at 1028.

260. For purposes of summarizing the distributional effects by income category of OBRA 1990, the Joint Committee on Taxation added such tax expenditures as tax-exempt interest, employer contributions for health plans and life insurance, nontaxable social security and workers’ compensation to adjusted gross income. Joint Comm. on Taxation, 101st Cong., 2d Sess., Summary of Distributional Effects, by Income Category (Comm. Print 1990). Direct subsidies such as Medicare, housing assistance, Aid to Families with Dependent Children and food stamps were ignored. Id.; see Joint Comm. on Taxation, 103d Cong., 1st Sess., Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens 2 (Comm. Print 1993) (explaining why Joint Committee on Taxation staff does not pursue more comprehensive approach of reflecting both direct and tax expenditures). See generally Senator William V. Roth, Jr., What’s Missing in the Budget Debate? Accurate Information, 49 Tax Notes 577 (1990) (calling into question accuracy of Joint Committee data).

icy significance; it is simply a number that has resulted from the subtraction process required by the tax expenditure mechanism.\footnote{262}{For a discussion of the theory that tax expenditures do not erode the tax base, see McDaniel, \textit{supra} note 229, at 273.}

The thrust of McDaniel's article is that there is a conceptual inconsistency between tax expenditure analysis and effective tax rate analysis. "Under the former, the 'tax' is the taxpayer's liability based on economic income; under the latter, the 'tax' is the amount of the check a taxpayer remits to the government."\footnote{263}{\textit{Id.} at 274.} Effective tax rate analysis starts with the amount of the check the taxpayer sends in and divides it by economic income to derive an average effective tax rate. According to tax expenditure analysis, the average effective tax rate is a meaningless number because many tax expenditures have been added back to the denominator to arrive at "economic income" but have been excluded from the numerator. Thus, the effective tax rate analysis is using an "economic income" concept but not an "economic tax liability" concept.\footnote{264}{\textit{Id.} at 273-74.}

Tax expenditures in fiscal 1993 are estimated at $354 billion.\footnote{265}{\textit{Joint Comm. On Taxation}, 102d \textit{Cong.}, 2d \textit{Sess.}, \textit{Estimates of Federal Tax Expenditures For Fiscal Years 1993-1997} 11-17 (Comm. Print 1992).} If these tax expenditures were replaced with direct expenditures designed to place the taxpayers in the same after-tax position, the effective tax rates of these identically situated taxpayers would be dramatically increased even though there would be absolutely no change in their economic position.\footnote{266}{See McDaniel, \textit{supra} note 229, at 274.} Obviously, present effective tax rate analyses are misleading. The following examples illustrate this point.

Assume that an individual with other taxable income of $1,000, purchases $100 of health insurance. In example A, there is a ten percent tax credit available with respect to the purchase. In example B, the credit is replaced with a direct expenditure equal to ten percent of the cost of the health insurance. Neither the tax expenditure nor the direct expenditure is subject to tax.
The effective tax rate results under each alternative are as follows:

<table>
<thead>
<tr>
<th></th>
<th>A Nontaxable Tax Expenditure</th>
<th>B Nontaxable Direct Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>(2) Subsidy</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>(3) Economic Income</td>
<td>$1,010</td>
<td>$1,010</td>
</tr>
<tr>
<td>(4) Taxable Income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>(5) Tax (20%)</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td>(6) Tax Credit</td>
<td>−10</td>
<td>0</td>
</tr>
<tr>
<td>(7) Tax Liability</td>
<td>$190</td>
<td>$200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>(7) − (3)</th>
<th>19%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>(8) Effective Tax Rate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(9) Tax Expenditure Analysis</td>
<td>(5) − (3)</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>

The taxpayer is in an identical economic position in both examples A and B; in each case, he has economic income of $1,010. Yet the effective tax rate analysis shows a higher effective tax rate when the taxpayer receives the direct expenditure. This analysis overlooks the fact that by using a tax expenditure, economically, the taxpayer has written a $200 check to one branch of the Treasury and received a $10 check back from another branch of the Treasury. This same result occurs mechanically in the direct expenditure approach. Thus, to show a nineteen percent effective tax rate for the taxpayer receiving the tax credit is incorrect because it adds the implicit Treasury check to economic income but fails to give the taxpayer credit for the implicit tax payment.267

All that should be necessary to eliminate tax policy concerns is to treat tax expenditures correctly for income measurement purposes. However, even when a tax expenditure is included in taxable income, effective tax rate analysis shows a higher effective rate for a direct expenditure program.268 Returning to the preceding example, assume that both the tax credit and the direct

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267. Because of tax benefits providing either an exclusion, credit, reduced rate or deferral of taxation, individuals may be willing to accept lower rates of return on investments yielding this tax-preferred income. In effect, the reduction in potential income is an implicit tax on that income—foregone income in lieu of ordinary tax. The implicit tax is equal to the amount by which income has been reduced because of the availability of tax preferences. See Tax Returns-1988, supra note 257, at 71; see also McDaniel, supra note 255, at 409.

268. For a general discussion of effective tax rates, see McDaniel, supra note 229, at 275.
expenditure are subject to tax. The effective tax rate results under each alternative are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Taxable Tax Expenditure</th>
<th>Taxable Direct Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Income</td>
<td>$1,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Subsidy</td>
<td>10</td>
</tr>
<tr>
<td>(3)</td>
<td>Economic Income</td>
<td>$1,010</td>
</tr>
<tr>
<td>(4)</td>
<td>Taxable Income</td>
<td>$1,010</td>
</tr>
<tr>
<td>(5)</td>
<td>Tax (20%)</td>
<td>$202</td>
</tr>
<tr>
<td>(6)</td>
<td>Tax Credit</td>
<td>-10</td>
</tr>
<tr>
<td>(7)</td>
<td>Tax Liability</td>
<td>$192</td>
</tr>
<tr>
<td>(8)</td>
<td>Effective Tax Rate</td>
<td>19%</td>
</tr>
<tr>
<td></td>
<td>((7) ÷ (3))</td>
<td></td>
</tr>
<tr>
<td>(9)</td>
<td>Tax Expenditure Analysis</td>
<td>19%</td>
</tr>
<tr>
<td></td>
<td>((5) ÷ (3))</td>
<td></td>
</tr>
</tbody>
</table>

Perceptions of equity are very important to a self-assessed tax. The Treasury influences those perceptions by the manner in which it presents data on high-income individuals. For example, the Treasury report on high-income taxpayers makes no mention of the tax expenditure concept. It does discuss the concept of implicit taxes and acknowledges that the reporting of fully taxable and tax-preferred income is not consistent. According to the report: "Fully taxable income is being reported on a pre-tax basis, whereas tax-preferred income is being shown on an after-tax basis." The Treasury made no attempt, however, to measure implicit taxes or to gross up incomes to reflect the value of implicit taxes. Thus, both taxes paid and gross income are understated because of the implicit taxes on tax-preferred income.

The Treasury report does present two different treatments of the foreign tax credit: 1) as an item of tax preference; and 2) as an...
Thus, one set of tables includes, as taxes, only U.S. income taxes net of the foreign tax credits. The Treasury decided, however, that if all income taxes were considered—U.S. as well as foreign income taxes—a more accurate measure of the tax burden would result. Therefore, to present a more realistic picture of the number of nontaxable, high-income taxpayers and the reasons they are nontaxable, the Treasury prepared alternative tables that redefine income tax liability to consist of the total amount of U.S. income taxes (income taxes after credits plus the alternative minimum tax) plus the amount of foreign tax credits. For similar reasons, the Treasury should also prepare alternative tables consistent with the tax expenditure concept.

Presenting such alternative tables will require a new definition of "tax expenditures" or at least a new category of tax expenditures that are clearly not part of the system of measuring taxable income and tax burden. As Professor Thuronyi points out, preparing tax burden distribution tables that disregard tax

274. Id. at 75.
275. Id.
expenditures will sometimes produce misleading results.\textsuperscript{277} He presents, as a hypothetical example, Congress repealing the deduction for home mortgage interest and then reducing tax rates proportionately.\textsuperscript{278} Currently, the distribution tables would show no change. Under McDaniel's approach, however, the tables would show a sharp reduction in tax for wealthier taxpayers, as the pre-change tax burden would not reflect the deduction for home mortgage interest.\textsuperscript{279}

The result under McDaniel's approach is appropriate if the deduction for home mortgage interest is a substitute for a direct expenditure.\textsuperscript{280} Conversely, if the deduction is a component of the tax rate structure (rates would be intentionally set lower if this deduction were not allowed), the result is inappropriate and the current distribution tables are correct. Thus, in order to prepare meaningful tax burden distribution tables, it is necessary to define a narrow class of tax expenditures that are clearly a substitute for direct expenditures.

Thuronyi develops a concept called substitutable tax provisions—tax provisions "whose purposes a non-tax-based federal program can achieve at least as effectively."\textsuperscript{281} While there are probably many ways to define this list, any tax expenditure motivated by both tax and subsidy purposes must remain in the tax burden distribution tables. For example, the fiscal year 1991 budget debate demonstrated that a reduction of the total amount of itemized deductions allowed to taxpayers with adjusted gross incomes in excess of $100,000 is implicitly considered by Congress to be a substitute for a rate increase.\textsuperscript{282} Thus, to create an

\begin{flushleft}
\textsuperscript{278} Id.
\textsuperscript{279} Id. at 1200.
\textsuperscript{280} For further discussion of McDaniel's approach, see McDaniel, supra note 229, at 276-77.
\textsuperscript{281} Thuronyi, supra note 277, at 1156. Professor Thuronyi developed the substitutable tax provision concept "to facilitate the replacement of tax expenditures with non-tax-based programs and to guide budgetary choices between tax-based and non-tax-based assistance." Id. at 1186. I borrow Thuronyi's concept for a different purpose—to facilitate the production of information that will prevent tax policy concerns from inappropriately interfering with the implementation of social policy.
\textsuperscript{282} I.R.C. § 68(b) (CCH 1992), enacted by OBRA 1990 § 11103(a), 104 Stat. at 1588-406. In lieu of an approximately one percent rate increase, OBRA 1990 used a reduction of the total amount of itemized deductions that a taxpayer with adjusted gross income in excess of $100,000 could deduct. Id. Itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) are reduced by an amount equal to three percent of the amount
\end{flushleft}
The Low-Income Housing Credit

alternative list, it will be necessary to cull through current tax expenditure lists and select those items that can clearly be considered substitutes for direct expenditure programs.

Congress should begin this process by requiring the Treasury to make the appropriate adjustments for tax credits—the most obvious substitutes for direct expenditure programs. Taxable credits like the targeted jobs tax credit need only be added back to the amount of "tax" to determine the "economic tax liability." Nontaxable credits like the low-income housing credit would require adjustments to both the income and tax amounts. As the low-income housing credit is essentially tax-preferred income, both taxes paid and gross income are understated because of the implicit taxes on tax-preferred income. Once the housing credit is made fully taxable, however, the market will adjust and investors will no longer pay implicit taxes. For ease in preparation of the tax burden tables, the substitutable tax provisions that are structured as deductions or exclusions should be reformulated as taxable credits. By the affirmative action of restructuring a tax expenditure as a taxable credit, Congress will also explicitly acknowledge that the provision should be treated as a direct expenditure program for all purposes.

Because of the important policy implications, one must recognize the conceptual inconsistency between tax expenditure analysis and effective tax rate analysis. Effective tax rate analysis should treat as the "tax" the amount of the liability that would be due if statutory rates were applied to economic income. The amount of tax due pursuant to a taxpayer's tax return is irrelevant because it is simply a number that has resulted from the subtraction process required by the tax expenditure mechanism. Thus, tax expenditures should have no impact on effective tax rates; effective tax rate analyses that imply to the contrary are de-

of a taxpayer's adjusted gross income in excess of $100,000. Id.; see also 136 Cong. Rec. S15,711 (daily ed., Oct. 18, 1990) ("Thus, the Committee believes that the goal of personalizing the Federal income tax based on each individual's ability to pay taxes is enhanced by adoption of a rule that imposes some limitation on deductibility of amounts paid . . . by high-income individuals, yet generally allows full deductibility at the margin.").

283. Reformulating the substitutable tax provisions as taxable credits will also remedy a fairness problem. Tax expenditures structured as deductions, exclusions or nontaxable credits result in the value of the benefit increasing with the recipient's marginal tax rate. For a discussion of the effect that tax expenditures have on effective tax rates, see supra note 267 and accompanying text.

284. For a discussion of the perception problems caused by the current effective tax rate analyses, see supra notes 256-61 and accompanying text.

flective both in concept and in policy implications. The imposition of the alternative minimum tax is an unfortunate outgrowth of these effective tax rate analyses and the perception problems that they caused.

The minimum tax has also historically been used as a back-door means of trimming tax expenditures. There are many examples where an attempt to repeal a tax expenditure has resulted in compromise—inclusion of the expenditure in the minimum tax base. As one commentator stated: "The minimum tax is a roundabout way to undermine citadels that cannot be stormed directly." However, if tax expenditures are analogous to direct expenditure programs, any programmatic concerns should be addressed directly and not surreptitiously, through the minimum tax. Congress needs to ask questions appropriate to direct expenditure programs: 1) Is the given program needed or desirable? 2) How should the program be designed? and 3) Who should benefit from the subsidy? In particular, Congress must be especially careful in examining who is benefitting from the program. But when Congress is trying to induce certain taxpayer behavior, it must recognize who is capable of that behavior. Wealthy investors are the taxpayers who have the capital for risky investments in low-income housing.

Thuronyi believes that the concept of substitutable tax provisions should lead policy makers to treat tax and direct expenditure programs alike for budget-making purposes. Thus, whenever Congress contemplates budget reductions, it should subject tax expenditures to the same scrutiny as direct expenditure programs. Although this is not happening formally, in some cases tax and direct expenditure programs are being treated alike, informally. For example, while tax expenditures were not subject to the sequestration procedures of the Gramm-Rudman-Hollings

286. Id. at 276.
287. Michael J. Graetz & Emil M. Sunley, Minimum Taxes and Comprehensive Tax Reform, in Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 412 (1988) (recognizing that minimum tax has been used to mitigate demands for repeal of tax expenditures).
290. For a discussion of Thuronyi's concept of substitutable tax provisions, see Thuronyi, supra note 277, at 1156.
Act,291 neither were many federal spending programs.292 Accounts exempt from sequestration cover about sixty-four percent of all outlays.293 The major exemptions are social security, federal retirement and disability programs, certain low-income programs and net interest. Most of these exemptions are entitlement programs.294 Many, if not most of the tax expenditures are analogous to entitlement programs in that if taxpayers are eligible, they receive the benefits. The low-income housing credit program is an important exception to this general rule because it is subject to an unusual volume cap and thus more closely resembles discretionary spending.

Moreover, the automatic sequestration process was never intended to take effect. This explains the draconian formula of arbitrary across-the-board cuts on limited items. The Gramm-Rudman-Hollings Act envisioned a continuing reliance on the reconciliation process for deficit reduction in conjunction with discretionary spending cuts through annual appropriation bills.295 And indeed, reconciliation bills have been used to cut both entitlement spending and tax expenditures. The Omnibus Budget Reconciliation Acts of 1987, 1989, and 1990 have repealed, modified or limited such tax expenditures as vacation pay reserves, installment method of accounting for dealers, completed contract method of accounting, various itemized deductions and the ocean thermal energy tax credit. There is, however, no formal recognition of the portion of the tax-writing commit-

292. Id. Known as the Gramm-Rudman-Hollings Act, this Act created a new budget procedure—sequestration. Id. Pursuant to this Act, if the President and Congress did not reduce the deficit to the target deficit amount, then spending was cut in accordance with a preset formula. STANLEY COLLENDER, THE GUIDE TO THE FEDERAL BUDGET FISCAL 1988 50 (1987). All programs subject to sequestration would be cut by the same across-the-board percentage. Id.
294. Entitlement programs are direct expenditure programs that have no spending limits and are available as entitlements to those who meet the statutory criteria established for the programs. See JOINT COMM. ON TAXATION, 103d CONG., 1ST SESS., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 2 (Comm. Print 1993).
295. STANLEY BACH, CONGRESSIONAL RESEARCH SERVICE, AN INTRODUCTION TO THE SPENDING AND BUDGET PROCESS IN CONGRESS, CRS ISSUE BRIEF CRS-23 (1990) (stating that "Gramm-Rudman-Hollings Act envisioned a continuing reliance on reconciliation as a means for Congress and the President to agree on deficit reduction legislation as a preferred alternative to the automatic sequestration process it also created").
tees' deficit reduction accomplished through cutbacks in tax expenditures versus increased taxes.\(^\text{296}\) This leads to the notion that when Congress reduces tax expenditures, taxes are increased. This is simply not the case; this correlation is no more true than when a direct expenditure is reduced.\(^\text{297}\)

The Budget Enforcement Act of 1990 (BEA)\(^\text{298}\) complicated matters even more.\(^\text{299}\) For fiscal 1991-1993, the BEA separated all discretionary spending into three categories—domestic, defense and international—and established spending limits for each one.\(^\text{300}\) Although the Act retained the sequestration process that enforced the revised deficit targets in Gramm-Rudman-Hollings,\(^\text{301}\) it also established sequestration procedures to enforce the discretionary spending limits of each category and pay-as-you-go requirements for mandatory spending and revenues. The pay-as-you-go sequester system requires that any increases in direct spending or decreases in revenues due to legislative action be offset by either an equal mandatory spending cut, revenue increase or both so that there is no deficit effect.\(^\text{302}\) Otherwise, a sequester will be triggered.\(^\text{303}\) Interestingly, discretionary spending in any

\(^{296}\) Regardless of whether a member of Congress considers the repeal or the curtailment of tax expenditures as decreases in spending, the President's annual budget contains a list of tax expenditures and the Joint Committee on Taxation also prepares such a list. For an example of such a list, see \textit{Federal Budget Fiscal 1993}, supra note 10, at 102-03. Thus, it would be relatively easy to provide Congress with information regarding tax expenditure cuts during budget debates.

\(^{297}\) McDaniels, \textit{supra} note 229, at 274-75 ("[E]ffective rate analysis fosters the erroneous impression that a tax increase is involved because ... a cutback in tax expenditures would be reflected in higher effective tax rates.").

\(^{298}\) \textit{OBRA 1990 Title XIII, 104 Stat. at 1388-573.}

\(^{299}\) \textit{Id.}

\(^{300}\) \textit{Federal Budget Fiscal 1993, supra note 10, at 13.} Discretionary spending is budgetary resources provided in appropriations acts. This means that Congress and the President must enact legislation each year providing for these funds to be spent. \textit{Id.} at 6. Mandatory spending is budget authority provided by laws other than appropriations. This means that the funds will be expended even if Congress enacts no new legislation. \textit{Id.} at 6-7. Mandatory spending consists chiefly, but not exclusively, of entitlement programs. \textit{Id.} at 36.

\(^{301}\) Gramm-Rudman-Hollings deficit targets were revised by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987. Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, Pub. L. No. 100-119, 101 Stat. 754. Because of extensive changes by the BEA, however, there is little chance of an excess-deficit type of sequester. \textit{Federal Budget Fiscal 1993, supra note 10, at 17, 28.}


\(^{303}\) BEA retained all the entitlement exemptions that existed under
of the three categories cannot be increased above the limits even if paid for with increased revenues. Furthermore, through fiscal 1993, spending in one category cannot be reduced to pay for increases in another category. This means that the tax-writing committees again have the advantage of paying for a new social program in the tax code with either tax increases or spending cuts. Thus, tax expenditures analogous to entitlement programs continue to be treated like exempt federal spending programs; tax expenditures that more closely resemble discretionary spending, such as the low-income housing credit, continue their exemption from sequestration, unlike their spending counterparts.

Another problem is the lack of coordination among the tax-writing committees and the relevant authorization and appropriations committees with respect to the various spending programs implemented through the tax code. This could be remedied by having the Budget Committee serve as an ombudsman between the various Committees during consideration of budget reconciliation and appropriations bills, or formal coordinating councils could be established where multiple committees pursue initiatives in the same policy area. The Senate Committee on Banking, Housing, and Urban Affairs recommended the establishment of a Tax and Housing Coordinating Council (consisting of the Secretaries of HUD, Treasury and Agriculture along with the President’s Chief Domestic Policy Advisor) as part of the Cranston-Gonzalez National Affordable Housing Act. “The Committee [believed] that low-income families would be better served at lower overall cost if tax and spending incentives operated in tandem to encourage the expansion of the supply of affordable housing.”

III. Conclusion

The view that the tax system is a poor vehicle for social policy is probably the dominant opinion today among Treasury officials,

Gramm-Rudman-Hollings, as amended. As a result, if a pay-as-you-go sequester occurs, the cuts that can be made in mandatory programs are quite limited—only about $26 billion in total. Federal Budget Fiscal 1993, supra note 10, at 26.

304. Id. at 25. The discretionary caps (spending limits) will be merged into a single category for fiscal 1994 and 1995 so that the appropriations committees will again be able to shift funds among the various programs. Id. at 28.

academic tax lawyers and tax economists. However, there are many reasons the tax system is used for social programs—political, historical, philosophical—as well as expediency, and the targeted constituency. Almost annually, Congress and the Administration use the tax system to encourage particular economic or social activities and will continue to do so, particularly given the budget process. Congress' passage of H.R. 2264 demonstrates a continuing interest in utilizing the tax code to accomplish social policy by including tax expenditure provisions such as empowerment zones, enterprise communities and other development incentives. Of course, it is always appropriate to analyze whether program benefits should be provided through direct or tax mechanisms but once the vehicle is chosen, it is important to implement the social policy in the best way possible.

The grant of a below-market purchase option by investors to nonprofit organizations in order to facilitate transfer of ownership to those organizations dedicated to preserving the affordable housing stock entails the forfeiture of one of the benefits of ownership, the right to appreciation. Tax law limits the availability of tax benefits to one possessing sufficient ownership attributes of the property, the true owner. Thus, housing policy is in conflict with tax policy. However, there is statutory and administrative precedent for allowing tax benefits independent of tax ownership. Tax policy concerns should not frustrate congressional intent in accomplishing housing policy objectives when Congress has clearly enacted an incentive to induce certain taxpayer behavior such as investment in low-income housing.

Encouraging investment in low-income housing entails attracting capital from wealthy investors who can afford such a risky investment. Some taxpayers perceive that the use of the low-income housing credit by wealthy taxpayers to offset their taxes impairs the equity of the tax code. The tax expenditure concept, however, recognizes that the taxpayer has made an imputed tax payment (computed in the absence of the special provision) and received simultaneously a direct grant for making the desired investment. Tax policy analytic tools, such as effective tax rate analysis, need to be modified to incorporate tax expenditure theory. Unless tax burden distribution tables are prepared in light of tax expenditure analysis, misleading information will continue to have a destructive impact on the legislative process.

Tax expenditure analysis must also be more fully integrated into the process so that tax policy concerns do not inappropriately interfere with attempts to implement social policy. As long as tax expenditures are treated properly for income measurement purposes, the tax equity of the code is not jeopardized. The passive activity, general business credit and the alternative minimum tax provisions are an inappropriate means of ensuring the equity of the tax system with respect to the low-income housing credit. Instead, the low-income housing credit should be adjusted and made completely taxable through the basis reduction mechanism. Tax expenditures need not be backdoor spending through the tax system if recognized for what they are, another form of subsidy, and subjected to the same analysis. Congress should evaluate these tax expenditure programs based on direct expenditure criteria—that is, whether they are necessary, properly designed and benefitting the proper constituency.

Congress has affirmed its support of the low-income housing credit program by permanently extending this credit in the 1993 Tax Act. As the tax system has been chosen as the vehicle for this housing program, it is imperative to implement the desired housing policies properly.