

# **Affordable Housing State Tax Credit Models for Minnesota**

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## I.) Affordable housing tax credit research goals

HousingMinnesota is exploring policies that could increase dependable funding for the development of affordable housing in the State of Minnesota. We are researching how other states use different tax credit models to fund the development of affordable housing. We have chosen to focus on tax credits because budget appropriations are at risk in tight budgetary times, whereas tax policy and tax expenditures tend to be more stable. HousingMinnesota completed preliminary research on a charitable tax credit for affordable housing in 2000. In 2002, Representative Karen Clark devoted a part-time intern to do further research on the status of similar credits in other states. This research is an expansion on those earlier reports.

The primary goal of this research project is to analyze affordable housing tax credit policies enacted in other states and to make recommendations for models Minnesota might replicate. Research included literature reviews, but relied most heavily on interviews with interested parties, key Minnesota stakeholders, and industry experts who work with the programs in other states.<sup>1</sup>

Three models were examined:

1. Investment tax credits used in Missouri,
2. The Tax-Linked Bonus used in North Carolina,
3. Charitable tax credits used in Missouri and Illinois.

## II.) Principles for affordable housing funding sources

This evaluation of affordable housing tax credit models is based on the following principles:

### A.) Dependability

Funding sources and programs should be dependable and relatively consistent from year to year.

### B.) Simplicity

Housing development is very complicated, and each complication increases the cost of development. Any program designed to encourage the production of affordable housing should be as simple as possible, both for developers and administrators. Use preexisting programs and administrative structures that are familiar to developers and administrators.

Simplicity also appeals to other affordable housing supporters. Legislators prefer to support a program they can understand. Donors, investors and development partners are more comfortable working with processes they comprehend.

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<sup>1</sup> Including administrators, developers, legal experts, donors and investors.

### C.) Flexibility

No one approach meets the broad range of housing needs throughout Minnesota. Smaller communities in Greater Minnesota may need rental development but the market may support no more than 10 units while larger population centers may support buildings with dozens of units. Some communities need new starter homes while other areas have enough housing but it is in need of rehabilitation. Others communities' greatest concern is the preservation of existing affordable housing. Minnesota needs a balanced approach to affordable housing, and any new affordable housing funding source should be flexible enough to respond to changing housing needs.

Similarly, there are many existing affordable housing funding sources, such as the federal Low Income Housing Tax Credit (LIHTC), that provide important dollars, but they often require additional gap financing to complete development projects. New funding should expand the capacity of existing tools to support the development of affordable housing. Additionally, a program that permits resources to come from a variety of sources in different forms would add more flexibility.

### D.) Efficiency

State resources are valuable and should be used selectively. State investment should be maximized and used to leverage private funding. Any new affordable housing funding should result in net additional dollars rather than shifting sources or replacing other dollars. Programs should also be designed to minimize administrative costs.

### E.) Effectiveness

State resources supporting affordable housing should be targeted to well-planned, quality housing that is financially viable and serves unmet needs. Once built, it should house the people for whom it was intended. Affordable housing funding should be allocated to appropriate developments. Monitoring should verify that targeted households are served.

Not only should individual developments be held accountable in their use of state resources, but any state program should also be evaluated to ensure that it is meeting a need the market is unable or unwilling to meet as effectively as possible.

## III.) Three affordable housing tax credit models

This report discusses three affordable housing tax credit models.

**Investment tax credit:** An affordable housing developer submits a project application to the state seeking federal tax credits. Any project approved for LIHTC is also allocated state tax credits. The developer sells the credits, usually through a syndicator, to an investor who gains an ownership stake in the project. The sale value of the credits provides equity in the project. This model is used in many states. For a detailed description of how it is applied in Missouri, see Appendix A.

**Tax-Linked Bonus:** An affordable housing developer submits a project application to the state seeking gap funding. Any project that meets state requirements is eligible for a formulaic, one-time tax bonus from the state. As the project has no tax liability, the bonus provides the project with equity. It resembles an appropriation in that funding is direct from the state to the project. It is a tax credit because it is implemented through the tax code; the Housing Finance Agency verifies bonus eligibility and informs the Department of Revenue, which then sends a check. This model, used only in North Carolina with LIHTC developments, is described in Appendix B.

**Charitable tax credit:** A non-profit affordable housing developer submits a project application to the state seeking a reservation of tax credits. The agency approves them. The developer locates a charitable donation. The donor receives the approved, one-time credit and the donation provides equity in the project. This model is used in Illinois and Missouri and is described in Appendices C and D.

**A.) Efficiency of use of foregone state revenue (tax expenditure)**

Considering only the direct loss of state revenue per dollar available for a project, the charitable credit is the most efficient and the investment credit the least efficient. Administrative costs are not included.

	Charitable	Tax-Linked Bonus	Investment
State tax expenditure	1	1	1
Project gets	2	1	.40
Investor/Donor net cost	.52 <sup>2</sup>	NA (no third party involved)	.40 <sup>3</sup>

Recapture of credits is an important consideration. With the investment and bonus tax credits, once federal tax credits are approved, the state credit is used. With charitable credits, there are scenarios where all credits are reserved for specific projects but some go unused. If credits are approved before other financing is in place, some projects may not be completed. Projects may be unable to locate donations within the required timeline. Developers may find other sources of funding and determine they do not need the credits. Projects may run into problems at closing time and miss the program deadline. If legislation does not allow for recapturing and reassigning credits, they are permanently lost.

<sup>2</sup> This number is very dependent on state tax rates. This is based on Minnesota’s Corporate Franchise Tax. For a calculation explaining the net donor cost, see Appendix H.

<sup>3</sup> State tax credits sell for significantly less than federal tax credits. Because state taxes reduce federally taxed income, reducing state tax liability increases federal tax liability, typically by 35 percent for corporations. Credits serve to increase federal tax liability so their price is always reduced by the tax rate a buyer pays at the federal level. For greater detail on other reasons the price is lower, see Appendix I. State tax credit prices vary widely. Typically they sell for between 30 and 50 cents for one dollar of credit, but some sell for as little as 25 cents and in one state they sell for as much as 62 cents.

There are cost considerations that determine the efficiency of the models on the part of the housing developer. The complex nature of the investment credit increases soft costs for a project because it introduces another layer of lawyers, accountants, and investors into a project. There are some legal costs introduced with the tax-linked bonus, but they are minimal, as the process is simple and direct. The charitable credits are somewhere in the middle but vary significantly. For a smaller project with a ready donor, the process is simple and costs minimal. However, if developers spend significant amounts of time locating donations or credits are transferred, costs can be quite high.

## B.) Evaluations of state affordable housing tax credit models

No evaluations of state affordable housing tax credit models have been found during this study either through literature searches or through contacts in states using credits. Missouri recently put out a Request for Proposals for an evaluation, but determined that the cost was too great to complete the study. There was an evaluation of Neighborhood Assistance Program (NAP) legislation, which uses the charitable credit model, by the Union Institute in 1995;<sup>4</sup> when the author was contacted she reported that there were no more comprehensive or more recent similar studies available. The NAP study found that states with reasonably simple administrative processes typically use all the available credits and asserted it was effective in developing communities and increasing the services available and the numbers of assisted clients.

North Carolina's State Tax Credit (the tax-linked bonus model) and Illinois' Affordable Housing Tax Credit (IAHTC) program are both very new, implemented within the last two years. Both have reserved the full state allocation of credits to projects, but it is as yet unclear how many of those credits have been used or how many units will be built. It is almost certain that nearly all of North Carolina's credits will be used, as they are given directly to projects and allocated competitively. It is likely that not all of the first year of credits will be used in Illinois because developers and corporations are still learning how to use the program. When I spoke with the Director of Tax Credits in Illinois<sup>5</sup> it seemed likely that at least two approved projects would not use their credits because they had found alternative sources of funding and that two more would not use them because they had been unable to secure donations.

Both Missouri's investment and charitable credits have been in place since the early 1990s. The investment credit has been such a success that the state has increased the amount of the credit twice.<sup>6</sup> The Missouri Housing Development Commission (MHDC) calculated that state investment tax credits allowed them to fund an additional six developments including 262 units in 2002.<sup>7</sup> The charitable credit, called the Affordable

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<sup>4</sup> View, Jenice L. and Carol E. Wayman. Neighbors Building Community: A Report of the Neighborhood Assistance Act Project. The Union Institute, October 1995, Office for Social Responsibility Center for Public Policy, Washington, D.C.

<sup>5</sup> Charlotte Flickinger, interview, November 25, 2003.

<sup>6</sup> The credit was equal to 20% of the federal LIHTC as enacted. It was increased to 40% in 1995 and increased again to 100% in 1997.

<sup>7</sup> Ramsel, Pete. Memo to Erica Dobreff. "The Consequences of No State Low-Income Housing Tax Credit?" November 18, 2003.

Housing Assistance Program (AHAP) resulted in the production of 798 units in 2002. It has also been used for preservation of affordable housing.

### C.) Administration

All three types of credits are administered through each state's Housing Agency. The investment tax credit in Missouri and the tax-linked bonus as implemented in North Carolina take advantage of existing LIHTC administrative infrastructure; they use the same requirements, underwriting procedures and monitoring procedures. In Illinois the charitable credit application for multi-family housing is the same as for the LIHTC, but they have a simpler application for ownership and Employer Assisted Housing projects. Monitoring for rental projects is the same as for the LIHTC; for ownership housing monitoring is the responsibility of the developer. The developer recaptures the credit value from the homeowner beneficiary of the credits if income requirements are not met.

### D.) Credit Transferability

In all tax credit programs, the ability to transfer credits increases the flexibility and value of the credit. In Missouri, where there are many different credits, US Bank has created a Tax Credit Clearinghouse to purchase and resell the different state tax credits. In Illinois, transferability provides an incentive to municipalities and non-profits - which do not have tax liability - to make donations, typically of land. Not only does this encourage placing underutilized land back into use, but because they can sell the credits, they can also leverage their donations with sale proceeds. In both states, the main purchasers of credits have been banks.<sup>8</sup>

### E.) Investor considerations and credit pricing<sup>9</sup>

With investment credits, there are numerous considerations which affect the price paid for the credits. Credit buyers are usually interested in them purely as a financial investment. Typically, credits sell for between 30 and 50 cents for one dollar of credit, some for as low as 25 cents and in California for as much as 62 cents. (In Missouri, they are currently selling for approximately 35 cents.)<sup>10</sup>

There are no investor considerations or credit pricing with the tax-linked bonus as no investors are involved.

With charitable credits, there are simpler investor considerations because rather than an investor there is a donor. Donor motivations may be charitable or they may include an aspect of investment, such as supporting a housing development for employees and reducing tax liability. If credits are not transferable, donors need a state tax liability of a tax type the credit is allowed to offset. Donors want to be sure that their donation will be eligible for the credit, that donating is simple with minimal paperwork, and that once a donation has been made there is no responsibility for monitoring the project or danger of recapture of the credits. Donors may also want to ensure their donation is being used

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<sup>8</sup> Sarah Bull. Personal communication. January 8, 2004.

<sup>9</sup> For examples of how these credits work in a project, see Attachment 2.

<sup>10</sup> For further detail on investment credit pricing, see Appendix I.



locally – if a motivation is housing for employees, the housing must be built near the employment. If charitable credits are transferable, because of different federal tax treatment and their one-time nature, they tend to command a higher price.<sup>11</sup> (See calculations in Appendix G and Attachment 16.)

## IV.) Tax credit models that increase funding to increase production

One of the greatest limits on the production of affordable housing in Minnesota is limited subsidy to write down the high costs of production. Without gap funding, it is nearly impossible to build housing that is affordable to low-income households.

There is consensus among non-profit affordable housing developers throughout the state that there is capacity to build more housing if given the funding to fill financing gaps. Any of these models would provide additional dollars for affordable housing production.

Additional funding resources from tax credits is not likely to provide deeper subsidy to specific projects. While the dollars may make some difficult projects feasible, they are more likely to increase the number of projects funded throughout the state.<sup>12</sup> Missouri calculated that state investment tax credits allowed them to fund an additional six developments including 262 units.<sup>13</sup>

In Missouri, state Low Income Housing Tax Credits reduce rents. When they calculated the rent differences in two projects, they estimated the credits reduced rents \$88 to \$92 per month.<sup>14</sup> In North Carolina a federal tax credit project without state tax-linked bonus would have rents \$153 higher than a project with the bonus.<sup>15</sup>

## V.) Effects of tax incentives on charitable giving

There is concern that creating a charitable tax credit will simply shift donations from one sector to another, or that contributions will remain at current levels but be subsidized by tax credits. It is difficult to assess the effects of tax credits that encourage charitable giving because there are so many factors involved.

In Illinois, organizations that generally do not make charitable donations are now doing so. The expected categories of significant donors include individuals, corporations and banks. However, because of credit transferability, municipalities and non-profits are

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<sup>11</sup> In Illinois, they are selling for approximately 80 cents.

<sup>12</sup> Faber, Amy M. and Carl R. Desenberg. "Taking Credit: State Tax Credits in Real Estate Development Partnerships." *Journal of Passthrough Entities* V4n5pp23-30, 49. September-October 2001.

<sup>13</sup> Ramsel.

<sup>14</sup> Ibid.

<sup>15</sup> National Council of State Housing Agencies summary of the program [http://www.ncsha.org/uploads/NC\\_Credit.pdf](http://www.ncsha.org/uploads/NC_Credit.pdf), accessed November 17, 2003. P. 4.

also significant donors.<sup>16</sup> In Missouri, the range is narrower. Individuals have been very important donors, as well as small and large businesses. Because of donor eligibility requirements, municipalities and non-profits have not been able to participate.<sup>17</sup> The Illinois experience suggests that if legislation were drafted broadly, there is opportunity to reach new categories of donors.

Non-profit support organizations generally encourage incentives for charitable giving. There is consistent anecdotal evidence that suggests such incentives are productive and encourage greater giving. For example, Pat Read of Independent Sector, a national organization that promotes philanthropic and non-profit initiative, commented that in Colorado, charitable tax credits “probably encouraged several of us to give a little more to get the tax credit.”<sup>18</sup>

Non-profit umbrella organizations in Illinois do not yet have information on the effect of the IAHTC on giving in Illinois as taxes have not yet been filed for the first year of the program.<sup>19</sup> A non-profit staff person from Missouri felt very strongly that there had been a net increase in donations her organization had received as a result of the AHAP credit. She told of a doctor who had been donating \$10,000 annually who believed that he was ineligible for the AHAP charitable credit, as he had no business income. Since he learned that income from public speaking is business income, he both began taking the credit and has increased his annual donation to \$45,000. The same organization reported that there were between 5 and 10 regular donors who had significantly increased their donations as a result of receiving the charitable tax credit.<sup>20</sup>

There is statistical research that suggests tax incentives do increase net charitable giving. A report published by Independent Sector examined the effect of itemizing charitable deductions on giving. It finds that the tax incentive of itemizing encourages households at all income levels to increase their giving by 40 percent or more.<sup>21</sup> The Congressional Budget Office also found that decreasing the cost of charitable giving through tax deductions, where donating a dollar also reduces tax liability, results in a predictable increase in giving, and higher income individuals are significantly more sensitive to it.<sup>22</sup> These reports suggest that the stronger incentive of a charitable tax credit would be effective and would result in a net increase in charitable giving.

It should be stated that any tax credit assumes that people are rational economic actors and will therefore take advantage of such a credit. Passing a tax credit communicates

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<sup>16</sup> Sarah Bull. Personal communication, January 8, 2004.

<sup>17</sup> Jane Anderson. Interview, December 5, 2003.

<sup>18</sup> Interview, December 3, 2003.

<sup>19</sup> Ruth Cardella Klann, e-mail, December 17, 2003. For updated information, contact Barbara Kemmis, librarian for the Donors Forum, 312-578-0175.

<sup>20</sup> Joyce Pace, interview, December 6, 2003.

<sup>21</sup> Toppe, Christopher, Arthur Kirsch, Jocabel Michel and Gordon Green. “Deducting Generosity: The effect of charitable tax incentives on giving.” Washington D.C. 2003.

<sup>22</sup> Congressional Budget Office. “Effects of Allowing Nonitemizers to Deduct Charitable Contributions.” December 2002.

<http://www.cbo.gov/showdoc.cfm?index=4008&sequence=0#pt3> accessed December 1, 2003.

the importance of a specific goal, in this case, increasing the funding for and production of affordable housing in order to support healthy communities where teachers and nurse's aids can afford housing and children in stable homes can focus on school, play and friends.<sup>23</sup>

## VI.) Affordable housing principles applied to the three models

### A.) Dependability

Tax credit models are generally more dependable than direct appropriations and less subject to swings in the political environment because they are written into the tax code rather than revisited during the passage of budgets. They remain in the tax code until either a sunset clause written in the original legislation is reached or a bill is introduced to amend or repeal it.

Missouri's state investment credit program is nearly three times larger than any of the other tax credit programs, with 2002 credit commitments resulting in approximately \$99 million State tax expenditures over the next ten years. A Missouri Housing Development Commissioner<sup>24</sup> noted that given the expected \$1 billion deficit Missouri is facing, the tax credit programs are in danger of being cut. No staff people in Illinois or North Carolina mentioned similar concerns. Exploratory research into the Florida Charitable Contribution Tax Credit revealed that Florida is also considering cutting its program as a result of tight budgets.<sup>25</sup>

### B.) Simplicity

Investment credits are very complex, even though they use existing application, administration and monitoring structures. Coordinating the investment structure with federal tax credits is difficult. It requires investors be owners, provisions for owner-investors to monitor operations of the development, and terms that allow investors to exit the project when credits have been used. It can work well, but it is not simple.

The tax-linked bonus is formulaic and therefore very simple for developers and administrators to understand and use.

Charitable credits, as implemented in Illinois, require some additional administrative infrastructure, but they can be very simple for developers and donors when a donor

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<sup>23</sup> Minnesota Housing Partnership: Affordable Housing Primer. <http://www.mhponline.org/Affordable%20Housing/Primer/Primer.htm> accessed December 4, 2003.

<sup>24</sup> Pete Ramsel, interview, December 2, 2003.

<sup>25</sup> Toni Randall, interview, November 20, 2003.

who has need of tax credits participates.<sup>26</sup> Two main features make charitable credits more appealing. First, it is a one-time credit that carries with it no monitoring or other responsibilities. Second, there is no threat that credits will be recaptured by the state. Transferable charitable credits offer great opportunity for leveraging municipal resources, but this introduces much greater complexity, although not as involved as state investment credits.

### C.) Flexibility

As they exist in other states, the investment tax credit and the tax-linked bonus are relatively inflexible in use, available only to LIHTC eligible projects.<sup>27</sup> The charitable tax credit is used in a wide variety of projects, ranging from LIHTC apartment buildings with hundreds of units to one single-family home. It also has an Employer Assisted Housing component with different income requirements. Charitable credits in both Missouri and Illinois allow flexibility in donations ranging from land and cash to services.

In no states are investment credits used with projects that do not have federal credits or would meet LIHTC criteria. In most cases, if a project receives federal credits, it also receives state credits.

Currently, North Carolina provides refunds only to projects that receive federal credits. Because of the simpler administration and because there are no investors whose investment requires ownership of a project, it would be possible to use it with any type of housing. Probably bonus eligibility requirements would need to be tied to some other form of MHFA funding.

### D.) Efficiency

The three tax credit models in Missouri, North Carolina and Illinois all resulted in a net increase in state resources used for affordable housing. In Missouri and North Carolina they provide the majority of state affordable housing funding and in Illinois they provide nearly 40 percent of funding. The investment credits are not an efficient use of state resources; for every dollar the state loses in revenue only 35 cents goes into projects. However, they are administratively very efficient, using the same staff already responsible for federal tax credit administration, adding 3.5 staff people. The North Carolina model improves on this. Every foregone state dollar results in one dollar in a project, and administration requires only one staff person. The Illinois and Missouri charitable credits place more dollars into projects than the state loses in revenue. In Missouri, only one person is needed to administer \$10 million in credits. In Illinois 3.5 staff people are needed for \$14.3 million in credits.

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<sup>26</sup> Developers must track donation commitments, but the administration is as simple as a donor earmarking a commitment with a letter. The only difficulty arises if a donor has conditions that are incompatible with a projects' completion.

<sup>27</sup> It is possible to use LIHTC with rental land trusts.

## E.) Effectiveness

There are no formal evaluations of state tax credit program effectiveness. However, individual projects in each of the programs are held to high standards. Investment credits and the tax-linked bonus are held accountable in the same ways as all projects seeking federal tax credits. They are held to strict levels of financial feasibility, site and project design, development team capacity, and monitoring once the development is placed in service.

Charitable credits also take advantage of strict LIHTC accountability structures for rental projects. There are different administrative structures for ownership developments, but there are in depth reviews of applications. Monitoring ownership housing income targeting is the responsibility of the developer, as the developer recaptures the credits if income requirements are not met. There is an EAH set-aside in the charitable program with higher income limits, but this program is held to identical accountability standards as other ownership housing in other respects.

## VII.) Context for housing tax credits in Minnesota

### A.) Current affordable housing funding levels

The State of Minnesota has been a national leader in its funding for affordable housing.<sup>28</sup> State appropriations rose from \$47 million in the 1996-1997 biennium to \$173 million in the 2000-2001 biennium. However, with the projected budget deficit, they fell to \$106 million in 2002-2003, with an MHFA base appropriation of \$80.4 million and are only \$69.8 million for 2004-2005.<sup>29</sup> Notably, tax expenditures did not generally experience the deep cuts appropriations did.<sup>30</sup>

### B.) Minnesota tax liability

Tax credits are useful only if there are taxpayers with enough liability to take advantage of the credits.<sup>31</sup>

The State of Minnesota collected \$13.5 billion of taxes in fiscal year 2003. The Minnesota tax liability for taxes that potentially could be offset by an affordable housing tax credit are:

- Individual Income Taxes: \$5.6 billion
- Corporate Franchise (Income) Taxes: \$542 million
- Sales and Use Taxes: \$4.5 billion
- Insurance Premium Taxes: \$199 million

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<sup>28</sup> For a comparison of housing costs in the four states discussed in this report, see Attachment 3.

<sup>29</sup> For a comparison of state housing spending in the states discussed here, see Appendix E.

<sup>30</sup> Joel Michael, interview, December 11, 2003. There was a sense that reducing tax expenditures would be perceived as increasing taxes rather than expenditure cuts.

<sup>31</sup> For additional information on Minnesota tax expenditures, see Attachment 21.

- State General Levy<sup>32</sup> (Property Taxes): \$588 million<sup>33</sup>

Further detail regarding dollar amounts of tax liability by industry and by taxable net income categories is available in Minnesota Department of Revenue reports.<sup>34</sup> It is unlikely that any affordable housing tax credit will be so large that there will be inadequate tax liability to use them, assuming a wide variety of taxes are eligible.

The majority of tax liability is borne by a minority of taxpayers. 691 corporate tax filers making up about one percent of total corporate returns paid 64 percent of state corporate income taxes in 2001.<sup>35</sup> Similarly, the 10 percent of Minnesota households with the highest incomes paid 39 percent of Minnesota state and local taxes.<sup>36</sup> Manufacturing; Finance, Insurance and Real Estate; and Trade have the highest tax liabilities, each with more than \$125 million in 2001.<sup>37</sup> This raises the question of whether to have minimum and maximum credits or donations. A high minimum donation, such as the \$10,000 minimum in Illinois, targets the few businesses and households who pay the largest portion of state taxes. A limit on maximum credits, such as in Missouri's AHAP program, prevents one business from using all the credits and allows the greatest number of individuals and businesses to contribute.

Northeastern Minnesota is struggling economically and there is concern that it might be difficult to secure charitable donations from businesses and employers. While there are limited tax liabilities in the region, the mining sector of Minnesota's economy pays the highest effective tax rate in the state, and these companies may seek opportunities to offset their taxes.<sup>38</sup>

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<sup>32</sup> The State General Levy is paid by Class 3 (commercial, industrial and public utility property exclusive of electric generating machinery), Class 4c(1) (seasonal residential recreational property, including cabins), and Class 5(1) (unmined ore property).

<sup>33</sup> Minnesota House Research, House Research: Taxes, State and Local Taxes

<http://www.house.leg.state.mn.us/hrd/issinfo/sltaxes.htm>, accessed December 6, 2003.

<sup>34</sup> Minnesota Department of Revenue Tax Research Division. "2001 Minnesota Corporate Income Tax Bulletin." November, 2002.

[http://www.taxes.state.mn.us/taxes/legal\\_policy/other\\_supporting\\_content/corpbull\\_01.pdf](http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/corpbull_01.pdf) accessed December 2, 2003.

<sup>35</sup> Ibid. P. 5.

<sup>36</sup> Minnesota Department of Revenue Tax Research Division. "2003 Minnesota Tax Incidence Study." March, 2003. P. 22.

[http://www.taxes.state.mn.us/taxes/legal\\_policy/other\\_supporting\\_content/whole\\_doc\\_feb2003.pdf](http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/whole_doc_feb2003.pdf) accessed November 29, 2003.

<sup>37</sup> Minnesota Department of Revenue Tax Research Division. "2001 Minnesota Corporate Income Tax Bulletin." P. 13.

<sup>38</sup> Minnesota Department of Revenue Tax Research Division. "2003 Minnesota Tax Incidence Study." P. 36.

### C.) Housing need

A recently released report, "The Next Decade of Housing in Minnesota"<sup>39</sup> finds that in 2000, there were 300,000 low-income Minnesota households unable to afford their housing. The study estimates there will be another 33,000 low-income households in need of affordable housing units by 2010. This estimate assumes current rates of private affordable housing development will continue and that public and philanthropic sources will subsidize an additional 26,400 new units. The report does not take into account affordable units lost through demolition or attrition, or affordable units that are converted to market rate apartments. It also notes that it was unable to count households living in crowded homes or in housing in poor condition and that homeless households are probably significantly undercounted.

Low and moderate income Minnesotans have a broad variety of housing needs. Some struggle to maintain their homes, others are homeless despite holding full-time jobs, still others are paying more than 50 percent of their income in rent or for their homes.

This range of housing needs requires an equally broad range of responses. Minnesota's small and large communities need small and large apartment buildings, single-family homes and ownership attached homes. With a growing population, there is need for new construction, but the state's housing stock is aging and there is need for rehabilitation of existing homes and apartment buildings. In addition, tens of thousands of units in Minnesota currently receiving federal housing subsidies are at risk of being converted to market rate apartments, and many will be lost as affordable homes without active work to preserve them.<sup>40</sup>

A balanced response must be flexible enough to serve all these needs.

### D.) Administrative options

Minnesota's Housing Finance Agency has strong project evaluation, program administration, and project compliance capacity for affordable multi-family and single family developments. Currently, MHFA partners with the Family Housing Fund (FHF), the Metropolitan Council, the Greater Minnesota Housing Fund (GMHF), and the Greater Twin Cities United Way to evaluate funding applications through the Consolidated Request For Proposals. Many funding sources and programs evaluate proposals through this process, and it would be useful and appropriate to have an additional source of gap funding be administered in this way.<sup>41</sup>

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<sup>39</sup> BBC Research and Consulting, prepared for the Family Housing Fund, the Minnesota Housing Finance Agency and the Greater Minnesota Housing Fund. "The Next Decade of Housing in Minnesota." November, 2003. Denver, Colorado.

<sup>40</sup> Minnesota Housing Partnership: Affordable Housing Primer.

<sup>41</sup> Currently, Habitat for Humanity has a unique set-aside and is ineligible to apply for other MHFA funding. However, if the statute and Habitat were interested, MHFA would be willing to discuss ways for Habitat to access new resources. Mike Haley, interview, December 10, 2003.

## VIII.) General recommendations

### A.) Administration

MHFA should administrate any affordable housing tax credits using current underwriting processes and funding criteria. Approval should be contingent on other MHFA funding. Existing income eligibility standards and reporting requirements used for other programs should be extended to a state tax credit program. Outside these basic parameters, MHFA should write the program rules to ensure the greatest possible compatibility between this funding source and existing programs. MHFA, possibly in partnership with other affordable housing umbrella organizations, will need to undertake significant marketing efforts to educate developers and investors or donors about the program. MHFA should not market, syndicate, or sell credits on behalf of developers.

### B.) Evaluation

MHFA has structures to evaluate development projects in place. However, information should be gathered to evaluate any new program. Collected data should include:

- Units built
- Total development costs
- Rents
- Types of residents
- What is the rural/urban split

If the program is a charitable tax credit, they should also include:

- Types of businesses making donations
- Leveraging
- How many businesses or donors are increasing their investments and by how much
- What is being donated (types of investment)

### C.) Geographic credit targeting

It may be useful to use the credit to target development. This is likely to increase the political support for the credit if targeting is done as a companion to other targeted economic development tools such as JOBZones, Empowerment Zones, transportation corridors or other areas targeted by municipalities. Also, credits in rural areas are more difficult to use than in urban areas because there are fewer businesses. Missouri responds by using a higher rate in rural areas, 70 percent as opposed to 50 percent in urban areas helps encourage investment. Drawbacks to targeting credits is the increase in complexity and a reduction of flexibility.

### D.) Taxpayer credit targeting

Tax credits function best when they are available to a wide variety of taxpayers. A tax credit policy should be designed to allow as many kinds of taxes to be offset as possible. For example, a representative of the St. Paul Companies stated that it would be very



appealing to them if insurance premium taxes were included.<sup>42</sup> Corporate finance taxes, individual income taxes, and the state general levy (state property tax) should be included. Sales and use tax refunds should also be explored. If the tax credit could be exempt from the Alternative Minimum Tax (AMT) for individual taxpayers it would be more appealing to investors as they would be less limited in the amount they could contribute.<sup>43</sup> Enabling individuals to participate is particularly important in regions with limited numbers of employers and businesses.

## E.) Program design considerations

Neighbors Building Community includes a discussion of characteristics of successful programs and considerations for designing a program.<sup>44</sup> Some of the more important considerations include:

- The amount of the credit; currently credit allowances vary between 40 percent and 70 percent<sup>45</sup>
- Whether to have minimum and maximum donations and/or minimum and maximum credits for projects or investors/donors
- Whether there should be a credit carryover allowance
- Eligible taxes for crediting and whether they should target the taxpayers with the largest liabilities or allow the greatest number of individuals and corporations to participate
- Eligible recipients
- State credit cap amount and provisions to keep pace with inflation

If the program is a charitable tax credit, they should also include:

- Eligible donors
- Eligible project sponsors
- Eligible services and donations<sup>46</sup>
- Communication between non-profit, business and state interests
- Encouraging use of all credits by avoiding setting a maximum allowable credit for investors or donors, or involving as many businesses and individuals as possible by avoiding a minimum donation

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<sup>42</sup> Mary Pickard, interview, December 4, 2003.

<sup>43</sup> John Ries, interview, November 17, 2003.

<sup>44</sup> View and Wayman. Pp. 71-72, 173-174.

<sup>45</sup> The credit rate should be higher than the state tax rate to create an incentive to participate. Administrators and sponsors in Florida, Missouri and Illinois all stated that higher credit percentages were better because it is easier to get businesses to donate.

<sup>46</sup> View and Wayman. In Connecticut, legislation specifies that business contributions must equal or exceed the previous year's contribution. P. 73.

## IX.) Tax credit model recommendations

Research suggests consideration of either the tax-linked bonus model or the charitable credit model. There seem to be widespread concerns about state investment tax credits, while the tax-linked bonus model retains the appealing factors of the investment credit.

The decision whether to pursue the tax-linked bonus or charitable tax credits should be based on the goals of the program. To increase production of and somewhat lower rents for federal tax credit developments, the tax-linked bonus is better. To create a flexible tool that provides additional gap funding to meet many different housing needs, a charitable credit is better.

### A.) Investment credit problems

State investment credits have some important benefits. They are simple to administer and monitor because they use federal tax credit structures that are already in place. They are a familiar model, nearly identical to federal tax credits and they are used in many states. However, they have some serious drawbacks.

They are legally very complicated to use, introducing a variety of challenges for developers and up to two sets of investors. They lack flexibility of use, being limited to the fairly sizable multi-family rental developments that work with federal tax credits. They are fiscally inefficient, commanding relatively low sales prices for the amount of state revenue lost and incur significant legal fees increasing project soft costs significantly.<sup>47</sup> Additionally, their use results in a tax liability for the limited partners which lowers the price the federal credits command. They may also be difficult to sell if there is an insufficient local market. For these reasons, there is a lack of support among stakeholders in Minnesota, given the other options available.

### B.) Recommendations for promoting the tax-linked bonus

#### 1.) Expert opinions

In interviews with experts who have worked with investment credits and North Carolina's tax-linked bonus, there is consensus that the tax-linked bonus is a better tool than state allocated investment credits. Attorney Ron Matamoros of Blanco, Tackaberry, Combs & Matamoros, P.A. said of the credit, "From an industry perspective, it's a perfect model." The National Council of State Housing Agencies' honored North Carolina with the Exemplary Legislative Initiative award. Amy Faber is an attorney with Ward and Smith, P.A. who has written articles on state investment credits and worked with credits in both Missouri and North Carolina. She feels that the tax-linked

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<sup>47</sup> Mary Pickard of the St. Paul Companies stated that the St. Paul Companies have significantly larger investment budgets than charitable budgets, and that as investment credits have an internal rate of return, they are purchased with investment budgets. They could purchase many more investment credits than charitable credits.

bonus model provides the state with the most funding for housing, has the greatest ease of use and also encourages higher pricing on federal credits because it doesn't carry with it the same tax liabilities as the investment credit.

## 2.) Eligible projects

Currently in North Carolina, only projects that receive federal LIHTCs are eligible to receive state tax credits. This makes for tremendous ease in administering and monitoring projects. There is a strong preference for a funding source that can respond to a broad set of affordable housing needs in Minnesota, and as implemented in North Carolina this approach does not respond to that range. However, this model could be implemented to apply a similar bonus to single-family and ownership housing and smaller rental projects that are found in smaller Minnesota communities.

## C.) Recommendations for promoting a charitable credit

### 1.) Benefits

Charitable credit program administrators and non-profit developers are wholeheartedly enthusiastic about their programs. They are a very cost-effective use of state tax expenditures, involve local businesses and individuals in supporting their communities, and are very flexible. Additionally, charitable credits can be used for very-low income housing, a cost range that federal tax credits do not serve and for which there are relatively few resources.<sup>48</sup> When designed well, they are easy to use.

### 2.) Eligible taxes

In order to make the credit available to the greatest number of taxpayers, as many different taxes should be eligible for the tax credit as is possible. Individual income taxes should be included because individuals are likely to be key donors in rural areas. Other taxes that should be considered are corporate franchise (or income) taxes, sales and use taxes and insurance premium taxes. If it is possible to make donors exempt from the state Alternative Minimum Tax it will be especially appealing; otherwise individuals' ability to donate is limited. As the number of households paying the AMT has increased significantly in recent years,<sup>49</sup> such an exemption may have growing importance.<sup>50</sup>

### 3.) Eligible donations

Allowable donations should minimally include cash and personal property or real estate. Other states allow stocks and bonds, materials, supplies, equipment, professional services devoted to the construction or rehabilitation of affordable housing units, technical assistance and labor. These should be considered, recognizing that a process for placing a dollar value on non-cash items will be needed.

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<sup>48</sup> David Stanley, interview, December 10, 2003.

<sup>49</sup> House Research. <http://www.house.leg.state.mn.us/hrd/issinfo/amttax.htm#A6>, accessed January 7, 2004.

<sup>50</sup> Most tax credits are not exempt from the Alternative Minimum Tax, but there are some both at the state and federal level that are. This is determined by the legislation that creates the tax credit; the credit is simply defined as usable against the AMT in the legislation.

#### 4.) Minimum and maximum donations

Minimum donations can ensure that the benefit of the credit is greater than the cost of processing donations. It should be possible to bundle small donations into a larger donation that meets the minimum donation in order to enable more individuals to contribute to projects.<sup>51</sup> Maximum donations are useful if it is important that no one company uses all of the credits and if a program goal is to involve as many businesses as possible.<sup>52</sup> However, if it is more important that every available credit be used, it should be avoided so large corporations are permitted to fill any possible gaps in the market.

#### 5.) Marketing credits

With charitable credits, the developer is responsible for locating charitable donations. This raises some marketing concerns. If demand for the credits is high, marketing them is not an issue. It is likely, especially early in the program, that significant effort will have to be put into informing potential donors of the credit. It is also important that credits be easy to access, with minimal paperwork and a short turn-around time. In Florida, credit users described non-profit staffers showing up at the door of a business with all the paperwork in hand and businesses receiving credit verification the following day via e-mail or fax.<sup>53</sup> This was reiterated by non-profit sponsor staff in Missouri.<sup>54</sup>

Some Minnesota developers have expressed concern that this may place a large burden on them, first in terms of locating donors and second if large donors institute a time-consuming application process. It was suggested that the Greater Minnesota Housing Fund and the Family Housing Fund might play an intermediary role in cooperatively seeking donations or linking donors and developers. Other suggestions were using the United Way or state-wide affiliates to funnel small donations. Ideally, both an intermediary approach and allowing a developer to secure contributions should be allowed.

	Pro	Con
Developer marketing	<ul style="list-style-type: none"> <li>• Donors can select projects that interest them most</li> <li>• Ability to target donations geographically</li> <li>• Competition is likely to result in the best projects utilizing credits</li> </ul>	<ul style="list-style-type: none"> <li>• Increase in soft costs because of time and effort recruiting donors</li> <li>• Some credits are likely to go unused</li> </ul>
Intermediary marketing (i.e. FHF, GMHF)	<ul style="list-style-type: none"> <li>• More efficient location of large donors</li> <li>• Takes advantage of existing relationships with large donors</li> <li>• More likely all credits will be used</li> </ul>	<ul style="list-style-type: none"> <li>• Donors may lose the ability to donate locally</li> <li>• Additional administration</li> </ul>

<sup>51</sup> See Illinois' IAHTC in Appendix D.

<sup>52</sup> Also, in rural areas with few corporations, individuals often provide the main source of contributions.

<sup>53</sup> Randy Evans, interview, November 24, 2003.

<sup>54</sup> Joyce Pace, interview, December 6, 2003.

## 6.) Recapture of unused credits

Still in its first year, Illinois is struggling to make use of all of its credits. Because credits are reserved for projects quite early in the development process, some projects that are approved for credits go uncompleted, some find other sources and some are unable to find donors before the two-year period to use the credits ends. In these situations, unused credits are permanently lost. In Missouri, the AHAP program administrator commented that last year they did not use \$2 million of their credits because there were last minute problems with loan closings. The credits were permanently lost, but she did not feel that this problem was common or that there was need for a change in the program to allow the state to recapture the credits. A Minnesota program should consider a mechanism for the state to reclaim unused credits in order to enable their use in another project.

## Appendix A

### Missouri: State Low Income Housing Tax Credit

The Missouri state LIHTC program is administered along side the federal tax credit. The state may allocate a project an amount equal to 100 percent of the federal credit. All administration is identical to the federal program.

The state credit commands a price much lower than the federal credit, currently about 35 cents for a dollar credit. State and federal credits are bifurcated. (Also see Attachments 4-5.)

#### Credit calculation

The credit is equal to 100 percent of the federal tax credit allocation.

#### Program details

First year of program	1991
Funding level, 2002	\$9,790,000 (This is the annual level, the credit lasts for 10 years. Therefore, the cumulative lost revenue for 2002 from allocations over the past decade is approximately \$76,000,000.)
Units funded, 2002	1256 low income units
Cost per unit	\$77,950 (\$7,795 per year for 10 years)
Administrative costs	3.5 FTE
Administrative funding	General MHDC operating dollars, which are interest earnings from their general lending business
Type of tax credited	Any individual, corporation or pass-through entity subject to certain taxes <sup>55</sup> and who owns interest in a qualified Missouri project
Administrative agency	Missouri Housing Development Commission <a href="http://www.mhdc.com/rental_production/low_inc_tax_pgrm.htm">http://www.mhdc.com/rental_production/low_inc_tax_pgrm.htm</a>

#### Unique features or drawbacks

The Missouri state LIHTC is very straightforward and simple. It is administered identically to the federal LIHTC, using the same processes. It is calculated using the same financial analysis as the federal credit. Major drawbacks are the complexity and soft costs of using the credit and the low market value of state tax credits. Federal tax credit investors incur increased tax liabilities if state credits are involved, which somewhat lowers the value of the federal credits.

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<sup>55</sup> Tax on gross premium receipts of insurance companies, tax on banks, tax on other financial institutions, corporation franchise tax, state income tax, and annual tax on gross receipts of express companies

## Appendix B

### North Carolina: State Tax Credit<sup>56</sup>

The North Carolina program is a tax-linked bonus rather than a tax credit. Only projects eligible for the federal Low Income Housing Tax Credit are eligible to claim the State Tax Credit (STC). However, an award of federal tax credits by the North Carolina Housing Finance Agency (NCHFA) does not entitle a project to claim the STC as the state income targeting is more restrictive than the federal income targeting. Eligible projects receive a bonus check from the State that is either claimed directly by the project (direct refund or grant option) or is transferred to the Agency who then lends it to the project (Agency loan option.) The closest analogy is the federal earned-income tax credit, in that both are cash subsidies issued under a tax code.

The STC is 10 percent, 20 percent or 30 percent of the development's eligible basis, which is the total cost to construct the buildings less items not subject to depreciation (such as land and reserves.) The percentage is dependent on the project's location. The state has designated each county as High, Moderate or Low Income and which corresponds to the 10 percent, 20 percent or 30 percent multiplier.

Once buildings are placed in service, projects are monitored using LIHTC processes. (Also see Attachments 6-7.)

### Credit calculation<sup>57</sup>

This project is located in a Moderate Income county.

#### Uses

Buildings (eligible basis, including construction and related soft costs)	3,600,000
Land	300,000
Other (reserves and other non-basis items)	100,000
<b>Total</b>	<b>4,000,000</b>

#### Sources

Federal Tax Credit equity raised	2,160,000
State Tax Credit (basis *.2)	720,000
Bank Loan	1,120,000
<b>Total</b>	<b>4,000,000</b>

<sup>56</sup> Information for this section is taken from Appendix H of the North Carolina 2004 Qualified Action Plan ([http://www.nchfa.org/pub/rental/2004\\_QAP.htm](http://www.nchfa.org/pub/rental/2004_QAP.htm), accessed November 17, 2003) and the National Council of State Housing Agencies summary of the program ([http://www.ncsha.org/uploads/NC\\_Credit.pdf](http://www.ncsha.org/uploads/NC_Credit.pdf), accessed November 17, 2003).

<sup>57</sup> Taken from the National Council of State Housing Agencies summary of the program. Ibid.

## Program details

First year of program	2003
Funding level, 2003	\$35,451,241 <sup>58</sup> (one-year bonus)
Units funded, 2003	2,441
Cost per unit	\$14,523
Administrative costs	Between .5 and 1.0 FTE
Administrative funding	Basic federal tax credit application fees cover program costs, plus an extra \$100 per unit monitoring fee
Type of tax credited	NA
Administrative agency	North Carolina Housing Finance Agency, <a href="http://www.nchfa.org">www.nchfa.org</a>

## Unique features or drawbacks

The State Tax Credit is very straightforward and simple. It is administered identically to the LIHTC and calculated using the same financial analysis. It is logistically simple, consisting of a check from the Department of Revenue to the project that may be used as a grant or turned over to NCHFA to administer as a loan. It is legally simple as it does not involve investors.

Federal tax credits tends to sell for a higher price on projects that receive State Tax Credits than on projects that have investment or charitable credits. This is because investment or charitable credits often create an increased tax liability for LIHTC investors, thus lowering the value of the federal credits. When the STC is taken as a loan, there is no increased tax liability. Additionally, the additional equity makes the project more financially feasible. These two factors make the investment more appealing to investors, resulting in higher federal tax credit prices.

The North Carolina bonus grew out of an investment credit similar to the one in Missouri. The program was very successful for two years, but it required investors to have significant state tax liability as well as familiarity with affordable housing and tax shelter investing. This limited the number of institutions involved in the program and after two years these institutions were approaching the limit of their need to offset income taxes. This program resulted from discussions between NCHFA and the Department of Revenue, informed by an ad hoc committee of about a dozen industry professionals.

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<sup>58</sup> There is not a specific amount allocated nor is there currently a limit on the amount that can be refunded, as it is a formula in the tax code.



## Appendix C

### Missouri: Affordability Housing Assistance Program (AHAP)

A sponsor non-profit submits an application to Missouri Housing Development Commission (MHDC) for approval. Upon approval, MHDC sends a tax credit reservation letter informing the sponsor of the amount of tax credit reserved and that the donation can be accepted. The tax credit certification is issued to the donor after the donor submits evidence of the donation, the sponsor submits any other items or fees requested by the Commission, and the restrictive covenants are filed. Project administration is identical for single-family and multi-family developments of all sizes. AHAP credits can also be used for preservation of affordable housing.

There is no oversight during project construction, as all larger projects have other project financing sources that require extensive oversight. All units are subject to an affordability period of 10 years. With ownership units, subsequent owners must also be income qualified and the acquisition price follows program appreciation guidelines, enforced by restrictive covenants. For rental units, the owner of the affordable housing must submit annual compliance documentation and the Commission is authorized to audit the owner.

AHAP credits can be used by anyone who files taxes for business income, regardless of the income, and credit can be taken against any tax liability. This results in a large number of individuals who are able to use the credit. There is no minimum donation, and many \$100-\$1000 donations are received each year. There are many donations of services ranging from legal expenses and excavating to plumbing and electrical work. Donors providing services are permitted to charge their normal rates, including their mark-up. (Also see Attachments 8-12.)

#### Credit calculation

Donation		\$100,000
	x	55%
Credit		\$55,000

## Program details

First year of program	1991
Funding level, 2002	\$10,000,000 credits for housing production <sup>59</sup> , plus \$1,000,000 for operating funding (one-year credit)
Units funded, 2002	798
Cost per unit	\$10,025
Administrative costs	1 FTE
Administrative funding	General MHDC operating dollars, which are interest earnings from their general lending business
Type of tax credited	Business firms are eligible for the credit, and a wide variety of taxes can be offset <sup>60</sup>
Administrative agency	Missouri Housing Development Commission <a href="http://www.mhdc.com/rental_production/ahap/index.htm">http://www.mhdc.com/rental_production/ahap/index.htm</a>

## Unique features or drawbacks

Credits are transferable. If credits are unused at the end of the fiscal year, they are lost but this has not been problematic according to the project administrator who has worked with the program since its inception. Because donations must be funneled through a non-profit, the program provides motivation to for-profit developers to partner with non-profits in order to access AHAP credits.

The program administrator and a non-profit sponsor both feel that there is no negative effect on charitable giving, nor is there a negative effect on operations funding for small non-profit developers. This is in part because \$1 million of this program is used for operations funding for non-profits. Many non-profits use relatively small reservations of credits, \$50,000 or less, to secure the majority of their operations funding. The program administrator and staff of a sponsor organization both stated with great certainty that the credit has resulted in a net increase in donations to sponsor organizations. Sponsors and staff gave a wholehearted endorsement, and recommend replicating it as closely as possible in Minnesota.

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<sup>59</sup> Jane Anderson, interview, December 5, 2003. In fiscal year 2002, \$2,000,000 of the housing production credits were not used because approved projects had last-minute problems with closings and it was too late for credits to be transferred to another project.

<sup>60</sup> "Business firms" defined as corporations, insurance companies, express companies, banks and other financial institutions, partnerships and their individual partners, S corporations and their individual shareholders, limited liability companies and their individual members, and individuals who either 1) operate a sole proprietorship in Missouri, 2) operate a Missouri farm or 3) have rental property in Missouri. Transferees are not required to qualify as business firms. Taxes that may be offset include tax on gross premium receipts of insurance companies, tax on banks, tax on other financial institutions, corporation franchise tax, state income tax, and annual tax on gross receipts of express companies.

## Appendix D

### Illinois: Affordable Housing Tax Credit

Corporations and individuals can receive a \$.50 credit toward their state income tax for every \$1 donated towards approved affordable housing creation development projects.<sup>61</sup> Rental and for-sale multi-family housing and single-family developments are eligible uses assuming they meet income limits. A portion of the credits are set aside for Employer Assisted Housing (EAH). Donations can include cash, property or securities.

A portion of the credits are reserved for state-wide projects and the remainder are reserved for the City of Chicago. A not-for-profit housing developer applies to Illinois Housing Development Authority (IHDA)<sup>62</sup> for a reservation of credits. Once approved, the not-for-profit developer finds a donor and secures a donation. The developer notifies IHDA of the donation and uses the donation (and other funding sources) to build housing. IHDA informs the Department of Revenue and issues the credit to the developer who passes it on to the donor. The donor takes the credit on their income tax return. Project sponsors must receive donations within two years of the reservation, and credits must be claimed within five years of the reservation.

The process may end here – and for the state, it does. However, because the credit is transferable, this credit can also resemble an investment credit. If a donor does not have use for the credit (for example, if the donor is a municipality or a not-for-profit with no tax liability), the donor can sell the credit.

In a straightforward donation where the credit is not sold, small projects with the minimum donation of \$10,000 are an effective use of the credit. IHDA has reserved credits for projects as small as one single-family ownership home. If the credits will be sold, there are greater legal fees and it is not cost effective for donations lower than \$50,000.<sup>63</sup> Credits are currently selling for approximately 80 cents. When credits are sold, a nominal donation<sup>64</sup> from the credit buyer to the project on top of the sale price is required.<sup>65</sup> In some cases, the proceeds from sales have also been donated to projects, but that is not required.

Rental projects are monitored using LIHTC processes, but ensuring ownership housing meets income requirements is the responsibility of the development agency. This works

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<sup>61</sup> Chicago Rehab Network. "Illinois Affordable Housing Tax Credit Housing Facts." <http://www.chicagorehab.org/pubs/pdfs/taxcredit2.pdf> accessed November 18, 2003 and "Illinois Affordable Housing Donation Tax Credit" <http://www.chicagorehab.org/pubs/pdfs/taxcredit2.pdf> accessed November 18, 2003.

<sup>62</sup> The City of Chicago has its own application process.

<sup>63</sup> Katy Grand, consultant to Catholic Charities, interview December 2, 2003.

<sup>64</sup> 10% of the credit amount transferred or \$10,000, whichever is less

<sup>65</sup> Joyce Probst, interview, November 26, 2003. This was described as a political compromise to ensure a direct linkage between the purchaser and the project.

because the developer recaptures the credits if income restrictions are not met. (Also see Attachments 13-20.)

### Credit calculation

Donation		\$100,000
	x	50%
Credit		\$50,000

### Program details

First year of program	2003
Funding level, 2003	\$13,000,000 (one-year credit)
Units funded, 2003	1,346
Cost per unit	\$9,110
Administrative costs	Approximately 3.5 FTE for IHDA <sup>66</sup>
Administrative funding	Some fees, they do not cover the program but IHDA expects to increase fees as program demand grows
Type of tax credited	Personal and corporate income taxes
Administrative agency	Illinois Housing Development Authority (IHDA) <a href="http://www.ihda.org">http://www.ihda.org</a> City of Chicago Department of Housing (CDOH) <a href="http://www.ci.chi.il.us/housing">http://www.ci.chi.il.us/housing</a>

### Unique features or drawbacks

The bill was designed to allow credits to be used for operating support and for preservation projects. To date, no one has used them for these purposes. The preservation provision was important in building political support for the bill. The Chicago Rehab Network, the main advocacy organization behind the bill, educated legislators about preservation needs in their districts and how the bill could be used to support those needs.

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<sup>66</sup> There may be additional staff for the City of Chicago Department of Housing.

## Appendix E

## Comparison of state affordable housing tax credit programs

	<b>Missouri</b>	<b>North Carolina</b>	<b>Missouri</b>	<b>Illinois</b>	<b>Minnesota</b>
Credit type	Investment	Refund	Charitable	Charitable	N/A
Administering agency	Missouri Housing Development Commission	North Carolina Housing Finance Agency	Missouri Housing Development Commission	Illinois Housing Development Authority	Minnesota Housing Finance Agency
Population, 2002 Census estimate	5,700,000	8,300,000	5,700,000	12,600,000	5,000,000
2002 Affordable housing funding (inc. credit)	\$91,000,000	\$38,450,000	\$91,000,000	\$34,763,000	\$53,000,000
					Includes \$12m in one-time TANF funding
2002 per capita housing spending	\$15.96	\$4.63	\$15.96	\$2.76	\$10.60
2002 credit funding level	\$9,790,000	\$35,450,000	\$10,000,000	\$14,332,000	N/A
	Annually for 10 years, \$76,000,000 state revenue lost in 2003	no cap			
2002 per capita credit allocation	\$1.72	\$4.27	\$1.75	\$1.14	N/A
% HH paying over 30% for housing	16.5%	18.4%	16.5%	21.4%	17.0%
"Housing Wage" from NLIHC	\$11.12	\$11.60	\$11.12	\$15.83	\$15.16
Credit name	LIHTC	STC	AHAP	IAHTC	N/A
First year of credit	1991	2003	1991	2003	N/A
Units funded 2002 by program	1256	2441	798	1346	N/A
Credit cost per unit	\$77,945	\$14,523	\$12,531	\$9,111	N/A
Administrative costs	3.5 FTE	1 FTE	1 FTE	3.5 FTE	N/A
Administrative funding	MHDC	application fees	MHDC	IHDA	N/A

Affordable Housing Tax Credit Report

	<b>Missouri</b>	<b>North Carolina</b>	<b>Missouri</b>	<b>Illinois</b>	<b>Minnesota</b>
Affordability period	15 years	N/A	10 years	10 years	N/A
Income restrictions	40% at 60% AMI or 20% at 50% AMI	3 categories of counties	50% AMI	25% at 60%, higher in EAH projects	N/A
Type of tax credited	Tax on gross premium receipts of insurance companies, tax on banks, tax on other financial institutions, corporation franchise tax, state income tax, and annual tax on gross receipts of express companies	N/A	Tax on gross premium receipts of insurance companies, tax on banks, tax on other financial institutions, corporation franchise tax, state income tax, and annual tax on gross receipts of express companies	Income tax	N/A
Carryforward	10 years	N/A	10 years	5 years	N/A
<b>Comments</b>					
% credit	N/A	N/A	55%	50%	N/A
Eligible donors	N/A	N/A	Business firms (filing any business tax form)	Individuals and corporations	N/A
Eligible donations	N/A	N/A	Money, real or personal property, professional services	Cash, securities, personal property or real estate	N/A
Minimum donation	N/A	N/A	none	\$10,000	N/A
Maximum donation	N/A	N/A	\$1,000,000	none	N/A

## Appendix F

### State tax credit program interaction with federal tax credits

Federal tax credits are complex to use, and understanding the interactions between LIHTC and other programs in general or for any particular project requires the expertise of real estate lawyers and accountants.

There are three predictable concerns with using large amounts of equity in a LIHTC project. Any of the tax credit programs discussed in this report would introduce the same challenges. The first is creating tax liability for the limited partners. The second is the treatment of depreciation. The last is a reduction of basis and therefore fewer federal tax credits.

Regarding tax liability, using LIHTC requires a project be owned by a taxable entity; the income of a taxable entity is taxable. Somehow, the funding must be provided to the general partner and then funneled into the project.<sup>67</sup>

For depreciation to be problematic, the equity has to be a significant portion of total financing.<sup>68</sup>

Given a preliminary examination of the charitable credit, donations resulting from the credit do not appear to affect the calculation of basis for a project. It is simply another layer of gap funding.<sup>69</sup> In Illinois land is a very common donation. As land is not included in basis, there is no question whether this type of donation would have no effect on basis.

There are several tools that serve to work around these challenges. Some examples include funneling the equity through the General Partner as a loan, although in Minnesota, MHFA is not always supportive of this because of its structure for working with troubled projects.<sup>70</sup> However, MHFA is allowed to make bridge loans, which is how North Carolina solves this problem. Other options are to use a longer depreciation schedule or to structure the loan from a third-party.<sup>71</sup>

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<sup>67</sup> Angela Christy, interview, November 17, 2003.

<sup>68</sup> Bruce Schiff, interview, November 26, 2003.

<sup>69</sup> John Ries, interview, December 12, 2003.

<sup>70</sup> Jim Dinnerstein, interview, December 4, 2003. A committee of secured lenders meets if a project has a problem, and if a General Partner lends money to its own project it is at the table both as borrower and lender.

<sup>71</sup> Bruce Schiff, interview, November 26, 2003.

## Appendix G

### Investor considerations and investment credit pricing

With investment credits, there are numerous considerations which all affect the price paid for the credits. Credit buyers are usually interested in them purely as a financial investment. Typically, state credits sell for between 30 and 50 cents for one dollar of credit, some for as low as 25 cents and in California for as much as 62 cents.

1. State tax credits reduce state tax liability that in turn increases federal tax liability (typically by 35 cents for every dollar of state reduction). This means that the credit price is first discounted by that increase.
2. Investment credits are reductions in taxes paid over multiple years (typically 10, but as few as 4). Credits become less valuable further into the future because of a lack of certainty and the time value of money.
3. The market for state tax credit investors is smaller than the market for federal tax credit investors because it is necessarily limited to those with state tax liability of the types the credit is allowed to offset.
4. State tax credit investors are responsible, as are federal tax credit investors, for ensuring the credit requirements are met. If credits are bifurcated (see below) the state investor typically bears additional oversight costs. Also, the investor is in last place for the benefits of the project and is likely to have a lower rate of return.
5. There are administrative costs for lawyers and accountants throughout the period of the investment.
6. It is quite complex for an investor to separate himself from the deal once the investment benefits have been realized.

Each of these factors reduces the sale price of state investment tax credits. One response many states have taken to the third concern is *bifurcation*. This is the ability to separate state and federal tax credits and sell them to two different parties. There are differing opinions on the value of bifurcation. Federal syndicators strongly prefer bifurcated credits, but bifurcation increases soft costs and increases marketing costs for state credits that may offset the higher price of bifurcated federal credits. If there is an adequate state market for federal credits, it is best to not bifurcate them. If the state market is very small, bifurcation is practical, recognizing that it may not be possible to find an investor for (and therefore, may not be possible to use) all the state credits.



## Appendix H

### Charitable credit tax calculation

Federal Taxable Income (before Minnesota Income Tax contribution)	500,000
Less Cash Contribution	<u>(20,000)</u>

Federal Taxable Income Before Minnesota Income Tax (Minnesota Taxable Income) **480,000**

Minnesota Income Tax @ 9.8%	47,040
Less Charitable Tax Credit (at 50% of contribution)	<u>(10,000)</u>

Net Minnesota Income Tax **37,040**

Federal Taxable Income (Federal Taxable Income LESS Net Minnesota Income Tax) **442,960**

Federal Tax @ 35% **155,036**

If No Contribution were Made:

Federal Taxable Income	500,000
Less: Minnesota Tax @ 9.8%	49,000
Federal Taxable Income	<u>451,000</u>
Federal Tax @35%	<u>157,850</u>

Net Cost of \$20,000 Contribution	
Cash Contribution	(20,000)
Less: Charitable Tax Credit	10,000
Less Federal Income Tax Savings	2,814 *
Less Minnesota Income Tax Savings	<u>1,960 **</u>
Net Cost of a \$20,000 Contribution	<b>(5,226)</b>

In this example, the project receives a contribution from the donor of **\$20,000**

To the donor, this breaks down as the sum of:

State Charitable Tax Credit	\$10,000
Federal Income Tax Savings (charitable deduction)	\$2,814 *
State Income Tax Savings (charitable deduction)	\$1,960 **
Donor's Net Cost	<b>\$5,226</b>

Adapted from an example in Neighbors Building Community: A Report of the Neighborhood Assistance Act Project, p66

\*Difference between federal tax without and with contribution

\*\*Difference between state tax without and with contribution

## Appendix I

### Minnesota stakeholder comments and suggestions

Among affordable housing developers in Minnesota, there is consensus around several ideas. Nearly everyone feels it is important to increase the amount of funding available, and there is widespread interest in the charitable tax credit. Equally important is the need for flexibility in whatever funding source is sought; it should be available for multi-family and single-family housing, small and large developments, land trusts, and whatever meets the unique needs of local Minnesota housing markets.

One theme of Minnesota's non-profit developers is the need for simplicity. Several developers mentioned the high development and operating costs created by excessive paperwork and complicated building and compliance requirements. They and others felt strongly that any new policy should use procedures and structures already in place. Barb McCormick of Project for Pride in Living commented that she is constantly explaining the complexities of housing development and regulation to donors and partners who are not housing professionals and explaining new programs should not require understanding the complexities of real estate taxation. Stephen Seidel of Twin Cities Habitat for Humanity felt that eligible donations should be limited to those easily assigned a value, excluding donations like volunteer labor.

During interviews Minnesota developers were asked specifically about marketing charitable credits and securing donations. There is little agreement on this topic. Some developers, including Jerry Boardman of the Central Community Housing Trust, felt a strong need for centralized marketing of credits. Several others suggested ways of aggregating many small donations to secure larger credit amounts.<sup>72</sup> Jenny Larson of Three Rivers Community Action, Inc. is concerned that if the only way to access credits were through an intermediary, disproportionate resources might be directed to regional centers. Several other developers felt it would be best to avoid an intermediary. They stated that while it is difficult to secure donations, non-profits are already seeking business contributions. Allowing businesses to specify where donations are used and providing new incentives and processes to make donations will make it easier to secure these donations. When asked, both Tom Fulton of the Family Housing Fund and Warren Hanson of the Greater Minnesota Housing Fund said they would consider taking on an intermediary role for their organizations.

There were other questions and concerns. Stephen Seidel asked whether it is possible for the policy to target new dollars or increases in contributions. Jenny Larson is concerned that the credit might replace other, more flexible dollars. Lastly, several people requested that any work keep the political environment in mind.

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<sup>72</sup> One suggestion is for state affiliates to collect small donations (Stephen Seidel), another is to use the United Way (Michele Weigand).

Several other Minnesota stakeholders shared useful perspectives. Tonja Orr of the MHFA commented that one of the challenges of LIHTC is that the federal credit alone is not adequate to fund housing. With federal tax credits there are still large gaps and there is barely enough gap financing available to make LIHTC work. Without adequate gap financing, MHFA will not be able to use all the federal credits.

Mary Pickard of the St. Paul Companies commented that the option to use state credits against insurance premium taxes is important to them.

Jerry Thole of US Bank is familiar with the Missouri State Credit Clearinghouse. He feels that while US Bank has tax liability in Minnesota and will use whatever credits the state offers, investment credits are very inefficient. He also suggested that it might be more cost effective to approach real estate tax policy rather than create a tax credit. He provided an example from California, where projects that have a non-profit as general partner are free of real estate taxes. In Minnesota, appraisals are based on what income a development would generate if it were market rate, even if the building has restricted rents. Taxes based on these appraisal results lead to significantly higher operating costs.

Frank Altman of the Community Reinvestment Fund also suggested that property tax reform is an important policy approach. Financial feasibility for affordable housing developments is significantly reduced in Minnesota because high property taxes placed on it result in very high operating costs. He suggested that such reform would need to be at a state level, as local governments need the property tax revenue and its loss is likely to lead to another reason local communities oppose the local construction of affordable housing.

George Latimer commented that charitable credits work well with the emphasis on public-private partnerships. As with federal LIHTC, they are both a corporate investment and funding for affordable housing. In tough budget times, as we look more to the private sector, charitable credits become more appealing.

## Acknowledgements

Thank you to the many individuals who contributed information and experiences to this report.

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## Attachments

1. Tax Credit Fact Sheet
2. State Credit Impact on Investors
3. Four-state Housing Cost Comparison from the National Low Income Housing Coalition's "Out of Reach 2003: America's Housing Wage Climbs"
4. MHDC Low Income Housing Tax Credit description
5. Missouri Tax Credit Clearinghouse Reference Guide excerpts
6. NCHFA 2004 QAP Appendix H "Overview of the 2004 North Carolina State Low-Income Housing Tax Credit Program"
7. National Council of State Housing Authorities "Executive Summary" of North Carolina's Refundable State Housing Credit, Legislative Campaign, Category #12
8. MHDC AHAP description
9. MHDC Affordable Housing Tax Credit Program, Program Guidelines
10. MHDC AHAP application
11. MHDC AHAP tax credit certification
12. "Project Examples from Missouri's Donation Tax Credit"
13. IHDA "Illinois Affordable Housing Tax Credit (IAHTC)" Fact Sheet
14. Chicago Rehab Network "Housing Facts"
15. Illinois Affordable Housing Donation Tax Credit flow chart (Chicago Rehab Network)
16. Illinois Affordable Housing Tax Credit Transferring the Tax Credit (Chicago Rehab Network)
17. Spreadsheet (from IHDA) "Assumes 1,000,000 Contribution to Not-For-Profit"
18. IHDA applications
19. Illinois legislation
20. Illinois rules
21. Department of Revenue Tax Expenditure Report excerpts:
  - Measuring the Fiscal Impact of Tax Expenditures
  - Tax income charts
  - Tax expenditure list
22. Neighbors Building Community