Expanding the LIHTC Investor Market:
S Corporations and other Pass-Thru Entities

The critical need for new investors in Low Income Housing Tax Credits (Housing Credits) is well documented. The exit of Fannie Mae and Freddie Mac from the program coupled with the crisis in the financial services industry has crippled Housing Credit demand at a time when the demands for affordable housing remain. The Housing Credit community is now engaged in an effort to identify ways of preserving existing investors while also attracting new investment capital.

One way to expand the investor base is to allow S-corporations (S corps), limited liability companies (LLCs), closely-held C-corporations and other partnerships to participate in the Housing Credit program on a similar basis as C-corporations. More businesses than ever are structured as pass-thru entities; in fact, data from the Internal Revenue Service indicate that there are thousands of potential investors structured in this way that are currently excluded from investing in the Housing Credit program. For example, 2006 Statistics of Income data reveal more than 82,000 S-corporations with more than $10 million in gross receipts and $206.8 billion in aggregate net income.

Moreover, these pass-thru businesses – because they tend to be smaller – are much more geographically spread across the nation, unlike corporate investors who tend to be clustered in larger metro areas. This means these potential investors have both tax liability to offset and are located in areas in need of affordable housing. Moreover, many of these investors have an additional motivation to invest in their local communities where they can see the benefits firsthand.

Under present law, S corps, LLCs, partnerships and other similar entities pass through tax items (including revenue, expenses, and tax losses such as deductions and credits) to the individual (or corporate) owners of those business entities. This creates a problem for investment in the LIHTC program because of application of the passive loss rules contained in section 469 of the Internal Revenue Code of 1986. For individual investors and owners of these businesses, these rules effectively prohibit claiming tax losses and credits from the program, except for approximately $8,750 permitted under the $25,000 tax credit deduction equivalent amount.

To address this problem and increase Housing Credit investment, credits and tax losses allocable to LIHTC investments could be allowed to offset income at the entity levels for S corps, LLCs and closely-held C-corporations that would otherwise be passed-thru to individual taxpayers.[1] For S Corporations, this would require amending tax code section 1366 (as it relates to the pass-through of items to S-Corporation shareholders) to allow the reduction of items of income prior to their pass through to the owners of the S-corporation.

To reduce income passed through to owners of S corps, the credit amounts would need to be converted into deduction equivalent amounts using rules similar to section 469(j)(5) according to the corporate tax rate, as defined in section 11(b)(1)(D) (35%). These deduction equivalent amounts would reduce tax on items of net revenue. A similar modification would be required in

[1] Note the proposal would have tax benefits from the LIHTC program offset income – not tax liability. In general, pass-thru entities pay no tax of their own, but rather pass through items of revenue and loss to their owners.

section 702 (as it relates to partnerships) to provide an exception for LLCs electing to be taxed as partnerships, as well as for closely held C-corporations, as defined in section 465(a)(1)(B).

The following is a simplified example of how it would work for a hypothetical S-corporation, with 75 shareholders and $14 million in gross receipts on an annual basis:

Investor:	S corp with 75 equal shareholders
Annual Housing Credits:	$1,050,000
Depreciation and other tax losses from property:	$1,000,000
Gross Taxable income:	$14,000,000
Losses from property:	($1,000,000)
Housing credit deduction equivalent:	($3,000,000)[2]
Taxable income flowing to each shareholder:	$133,333

It is anticipated that investments marketed under the above proposal would either be through private placements to accredited investors – as private placements are executed now – or to the public through registered offerings.

This proposal provides parity with widely held C-corporations by allowing pass-thru entities to offset revenue with Housing Credit tax benefits that would otherwise be taxable when passed through to the owners of these businesses. To ensure the high standards of oversight associated with the program are maintained, the Housing Credit community supports limiting the proposal to such entities that satisfy the following tests: (1) have at least $10 million in annual gross receipts; (2) the principal purpose of forming the entity is not the avoidance or evasion of Federal income tax; and (3) there is an expectation of reasonable asset management.

Enhancing the Housing Credit program to bring in more pass-thru entities will broaden investor demand and prove particularly beneficial in rural areas where many community banks and other potential investors are currently prevented from participating in the program. The impacts could be considerable. According to the Joint Committee on Taxation, $4.8 billion in Housing Credits were claimed in 2006 and, using an updated methodology, 89% were associated with C-corporations.[3] This represents about 0.191% of total corporate net income for 2006. If this same level of Housing Credit activity could be generated by S corps with greater than $10 million in gross receipts, additional Housing Credit investment would increase by approximately $400 million per year. This total would be even higher for a further expanded Housing Credit investor base. Ultimately, this means job and revenue creation in local communities and a more reliable source of affordable housing investment for the future.

[2] 105,000 LIHTC claims/35 percent tax rate

[3] Estimates for Federal Tax Expenditures for Fiscal Years 2006-2010. Joint Committee on Taxation. JCS-2-06. April 25, 2006. Estimates for Federal Tax Expenditures for Fiscal Years 2008-2012. Joint Committee on Taxation. JCS-2-08. October 30, 2008.