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## Harvard University

Towards a Targeted Homeownership Tax Credit

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### **Abstract**

Although the federal government provides tax incentives for homeownership, current tax provisions provide few incentives for lower-income families to buy a home and provide limited targeting of homeownership incentives. While the overall homeownership rate in the United States is at an all-time high, the gap between the ownership rates of low-income and higher-income households remains wide. In addition, homeownership rates in low-income and minority neighborhoods remain well below those in other neighborhoods. This has prompted a series of new proposals for a targeted low-income homeownership tax credit.

This paper summarizes how the current federal tax code fosters homeownership, demonstrates that current homeownership tax incentives mostly benefit those with higher incomes, and proposes a set of criteria for reviewing homeownership tax credit proposals. Based on this review, a possible approach that meets these criteria is suggested. The primary barrier to low-income homeownership is defined as an interaction between insufficient incomes to meet the monthly obligations of homeownership and a lack of downpayment and closing costs. While several strategies are identified that may address these twin barriers to homeowning, one feasible strategy is to offer a tax credit to investors who fund low-interest, second mortgages for low-income, first-time homebuyers. Such a credit would simultaneously reduce low-income homebuyers' ongoing monthly payments and the amount of savings they need to cover downpayment and closing costs. Since federal policy also recognizes the special problems of underserved areas, this strategy also calls for spatial targeting of the credit. This proposal also recommends allowing states and local governments to combine the tax credit with other federal grants such as CDBG and HOME to reach those with the lowest incomes, stimulating the redevelopment of underserved areas.

Based on a set of assumptions about how the market might price such a tax credit, \$1 billion in tax credits offered to investors in second mortgages could assist as many as 66,000 low-income homebuyers annually.

## **Towards a Targeted Homeownership Tax Credit**

by

J. Michael Collins, Eric S. Belsky, Nicolas P. Retsinas

### **Introduction**

A number of housing advocates have proposed targeted tax incentives to help low-income homebuyers. These proposals attempt to overcome the wealth and income constraints that keep low-income households from affording modestly priced homes. Proponents of these proposals argue that the largest federal tax expenditures for homeownership—the mortgage interest and the real estate tax deductions—are of little or no value in helping low-income households overcome the barriers to homeownership. Indeed, low-income homeowners seldom itemize deductions, since the total of their itemized tax deductions rarely exceeds the value of the standard deduction. Hence, most derive no benefit from the deductibility of mortgage interest and real estate taxes. Furthermore, these deductions do nothing to help low-income households who lack enough wealth to afford downpayments and closing costs. The only significant tax expenditure targeted for low-income homebuyers is the Mortgage Revenue Bond. Although this program helps some buyers overcome income constraints by providing below-market-interest rate mortgages, it is not directed at helping borrowers overcome wealth constraints. In addition, at \$2.2 billion a year, the program is funded at less than four percent of the \$58 billion expended annually on the mortgage interest and the real estate tax deductions.

This paper explores the motivation for a targeted tax credit for low-income homeownership, presents policy makers with a framework for analyzing a homeownership tax

credit and suggest one possible approach—the Low Income Second Mortgage Tax Credit (LISMTC). The paper begins by explaining the rationale for promoting low-income homeownership. It discusses the federal tax code, showing why it fails to fully address the barriers to low-income homeownership. Next, the paper describes strategies that would help low-income people overcome these barriers. The paper then reviews the choices that policy makers must make and poses questions for evaluating a homeownership tax credit.

The paper ends with the discussion of the LISMTC. The LISMTC assigns tax credits to investors in below-market rate second mortgages that help buyers reduce the amount of cash due at sale and to avoid high mortgage interest rates and insurance. The LISMTC would be allocated by existing agencies and priced by the competitive market. The LISMTC targets low-income households purchasing homes in areas defined as “underserved” by the U.S. Department of Housing and Urban Development.

### **Owning A Home Is Important to Families and Communities**

An overwhelming majority of Americans are or want to become homeowners. A recent survey finds that 77 percent of Americans prefer to own their home rather than rent, and that owning a home in the future is a top priority for 38 percent of low- and moderate-income renters (Fannie Mae National Housing Survey 1995-1997). Homeownership is part and parcel of the American Dream.

Evidence is also accumulating that suggests that homeownership may have a positive influence on the lives of families, neighborhoods and the economy. Research increasingly indicates that people who live in owner-occupied housing create stable, nurturing home environments, as well as feel better about themselves and about the control they have over

how and where they live.<sup>1</sup> Homeowners have a vested economic interest in their homes and communities.

Beyond its social and political benefits, homeownership can create economic benefits by building wealth for individuals and generating economic activity for the broader community (Emrath, 1997). With the median wealth of low-income homeowners under age 65 about 12 times greater than the median wealth of comparable renters, the wealth building aspects of homeownership are particularly important for lower-income, working families.<sup>2</sup>

### **Homeownership Rates of Low-Income Families Are Relatively Low**

While homeownership rates are at all-time highs nationally, higher-income families are much more likely to own homes than lower-income families (Table 1).<sup>3</sup> Only 45 percent of low-income households live in owner-occupied homes, as opposed to 65 percent of all households, and 86 percent of high-income households.<sup>4</sup> The U.S. Department of Housing and Urban Development (HUD) estimates that if the gap between higher and lower-income homeownership rates were cut in half, the national homeownership rate for all households would rise from 65 percent to 74 percent (Eggers and Burke, 1996). The Census estimates

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<sup>1</sup> Green and White (1994) found that the children of home owners are less likely to become involved in the justice system, drop out of school or have children out of wedlock. Rossi and Weber (1996) found owners have slightly more positive indications of life-satisfaction and self-esteem. DiPasquale and Glaeser (1997) found homeownership is correlated with membership in community organizations and voting, as well as neighborhood enhancing activities, such as gardening. Rohe and Stewart (1996) found an association between homeowning and improved property maintenance.

<sup>2</sup> 1995 Consumer Finance Survey, tabulated by Joint Center For Housing Studies. Owners under age 65, with income 80 percent or less of median area, have \$57,060 in net wealth. Renters under 65, in the same income group, have a median net wealth of \$4,930. Also, the median ratio of total wealth to housing wealth for low-income owners under 65 in 1995 was 65.73.

<sup>3</sup> 1995 American Housing Survey, tabulated by the Joint Center for Housing Studies, households with incomes below 80 percent of median versus those with incomes greater than 120 percent of median.

<sup>4</sup> Low-income is defined as less than 80 percent of median area income; High-income as greater than 120 percent. Based on 1995 revised American Housing Survey Data, tabulated by the Joint Center For Housing Studies.

that in 1993, 88 percent of all renters, and 93 percent of renters earning less than \$20,000, could not afford a house selling for half of the regional median house price.<sup>5</sup>

**Table 1**

<b>Homeownership Rates By Income</b>					
Percent of Households Owning a Home					
<i>Income as a Percent of Area Median, Adjusted for Family Size</i>					
Income Less than 50%	Income 51% to 80%	Income 81% to 120%	Income 120% to 150%	Income Over 150%	All Households
45%	59%	67%	76%	86%	65%
<i>Source: 1995 revised American Housing Survey</i>					

Moreover, homeownership rates are higher in the suburbs than central cities across all income groups, due to the concentration of lower-income families in urban areas. Overall, there is a 23-percentage point difference between central city and suburban homeownership rates.<sup>6</sup> As a result, many programs seeking to increase the number of low-income homeowners focus on urban areas..

**Income Tax Policies Provide Little Incentive for Low-Income Homebuyers**

Federal income tax policies support homeownership through:

- The mortgage interest deduction,
- The real estate tax deduction,
- The mortgage revenue bond program,
- The exclusion of house price appreciation from capital gains taxes, and
- Penalty-free IRA withdrawals for first-time buyers.

<sup>5</sup> Savage (1997). Based on an FHA-insured mortgage at a 7.5 percent, 30-year fixed rate, with 0.5 percent mortgage insurance and a 3 percent downpayment on first \$25,000 of loan, 5 percent on loan amount over \$25,000, 2 percent of closing costs, and maximum allowable debt of 41 percent, at most 29 percent can be mortgage debt.

<sup>6</sup> Herbert (1997) described several factors that contribute to the homeownership gap between cities and suburbs, including racial discrimination and segregation, a lack of single family detached housing units, a lack of income and credit.

These policies create financial incentives that encourage people to choose homeownership over renting. The largest tax expenditures for homeownership are the mortgage interest deduction and the real estate tax deduction. Valued together at \$58 billion, these two deductions amount to twice the amount allocated to all direct federal housing assistance programs in the U.S.<sup>7</sup> These deductions, however, have little value for lower-income renters. Rarely do the value of these lower-income households' itemized deductions exceed the value of their standard deduction. As a result, most homeowners with incomes below \$40,000 bypass itemizing their tax deductions in favor of taking the standard deduction. However, almost all higher-income homebuyers, who tend to have larger tax liabilities and buy higher-priced homes, itemize their tax deductions (Figure 1).

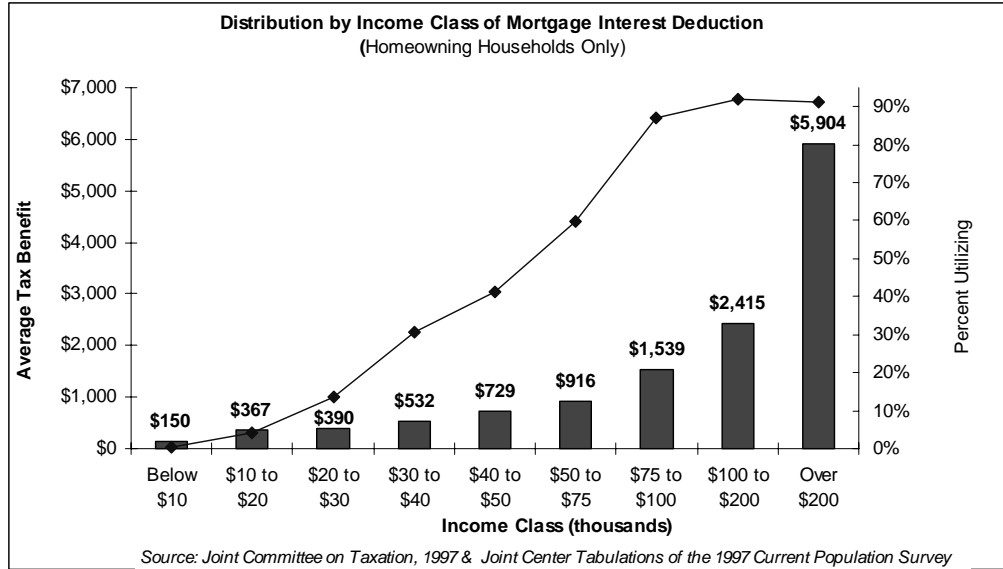
As a result of the progressive nature of federal income tax rates, even if lower income owners do itemize their deductions, they receive a smaller deduction as a percentage of income than more affluent buyers.<sup>8</sup> For example, a household with an income of \$25,000 choosing to itemize its tax deductions, would on average receive a tax benefit from the mortgage interest deduction of approximately \$390, or 1.56 percent of their income. In contrast, a taxpayer with \$87,500 in income could receive an average benefit from the mortgage interest deduction worth \$1,540, or 1.76 percent of its income—13 percent higher (Joint Committee on Taxation, 1996).

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<sup>7</sup> Some economists argue that the largest tax benefit of homeownership is the fact that imputed rent (in effect, the rent that buyers who own their home free and clear do not have to pay) is not taxed.

<sup>8</sup> Wealthier buyers tend to buy more expensive homes, which result in higher interest payments and, therefore, larger tax deductions.

**Figure 1**



Over 90 percent of the total benefits of the mortgage interest deduction accrue to homebuyers with more than \$40,000 in income (Green and Reschovsky, 1997; Follain, 1994). Because so many higher-income owners live in the suburbs, the suburbs receive a disproportionate share of the tax benefits of homeownership. While 67 percent of the average metropolitan area's houses are in the suburbs, 76 percent of the value of the mortgage interest and real estate tax deductions flows to the suburbs (Gyourko and Voith, 1997, Tables 5 and 6).

One federal income tax incentive targeted to first-time homebuyers is the exclusion of taxes and early-withdrawal penalties on up to \$10,000 of savings stored in an Individual Retirement Account (IRA) for a home purchase. This provision allows first-time buyers to accumulate and withdraw savings for a downpayment tax and penalty free. However, only 17 percent of low-income renters under 35 have retirement accounts. Moreover, the median



value of retirement accounts for those low-income renters with an IRA is only \$900.<sup>9</sup> Because saving in tax-deferred retirement accounts is only possible for those with enough earnings to save and valuable only for those with enough tax liabilities to offset, this provision is unlikely to create a significant incentive for low-income renters to save enough to buy a home.

### **Limited Tax Incentives Are Targeted to Low-Income Homebuyers**

Currently, there are three provisions in the federal tax code that create incentives for low-income homeownership: the Mortgage Revenue Bond (MRB) program, the Mortgage Credit Certificate (MCC) program, and, on a very limited basis, the Low-Income Housing Tax Credit (LIHTC). These programs provided over \$2.2 billion in tax incentives for homeownership in 1997, compared to \$58 billion for the mortgage interest and real estate tax deductions.

***Mortgage Revenue Bonds:*** The only significant tax incentive specifically targeted to lower-income, first-time homebuyers is the MRB program. MRBs are tax-exempt bonds issued by state housing agencies. The size of the program is limited by a “private-activity,” tax-exempt bond volume equal to of the greater of \$150 million per state or \$50 per capita.<sup>10</sup> The \$9 billion in capital raised from floating these bonds each year is used to issue below-market interest rate loans to borrowers with incomes below 115 percent of the area median (140 percent of median in some areas).

By lowering the monthly carrying cost of mortgages with subsidized interest rates, MRBs help first-time buyers overcome their income constraints. Approximately 66,000 of

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<sup>9</sup> 1995 Consumer Finance Survey, tabulated by Joint Center For Housing Studies. Low-income is defined as 80 percent or less of area median income, following HUD’s convention.

<sup>10</sup> In the FY 1999 appropriation, Congress increased the per capita amount beginning in 2003.

the 104,000 MRB-funded mortgages issued in 1997 went to homebuyers with incomes at or below 80 percent of the local median—HUD’s definition of low-income (NCSHA, 1998). MRBs also can help buyers overcome a lack of downpayment and closing costs. About 39 percent of MRB loans in 1997 required downpayments of 3 percent or less (NCSHA, 1998). However, when MRB-funded mortgages ease downpayment requirements, these loans require the payment of mortgage insurance, which raises the effective interest on the loan by as much as one percent. Thus, MRBs fail to simultaneously address the wealth and income constraints faced by low-income homebuyers.

The MRB program contains a limited spatial targeting component. One-fifth of the proceeds of MRBs are designated for targeted areas, defined by the Internal Revenue Service (IRS) as “qualified census tracts” (tracts with median income 70 percent or below the metropolitan area median income), or “areas of chronic economic distress,” as defined by HUD.

*Mortgage Credit Certificates:* State housing agencies that issue MRBs can also convert MRB issuing authority into mortgage credit certificates (MCCs). MCCs provide first-time homebuyers with a nonrefundable income tax credit of 10 percent to 50 percent of the borrower’s annual mortgage interest payments (up to \$2,000 annually). Like MRB’s, MCCs lower the monthly carrying costs of homeownership. An MCC worth 25 percent of a house price creates an interest subsidy equal to an average MRB-funded mortgage loan. Rather than creating a subsidy that reaches buyers through reduced interest rates, MCCs provide tax credits directly to buyers of owner-occupied housing, reducing their annual tax liability. While allocated by state housing agencies, MCCs do not require access to debt or equity markets. Typically, buyers receive credits directly from state housing agencies after

qualifying for a mortgage from a conventional lender. As a result, the administrative costs of MCCs are low.

Only 15 states participated in the MCC program in 1997, issuing only 5,600 certificates (NCSHA, 1998). MCCs are not more widely used for several reasons. First, low-income families often have a limited level of tax liability, particularly given other tax credits available, such as the earned income tax credit and child care tax credit. Since the MCC is not refundable, any amount of the credit exceeding the taxpayer's total tax bill does not result in a larger tax refund and is instead foregone. A second reason MCCs are rarely used is that a state's use of MCCs counts against the amount of bonds it is permitted to issue. By using MCCs, states forego an opportunity to earn revenue from the difference in interest rates (or "spread") between tax-exempt bonds and mortgage loans produced by MRBs. The final reason MCCs are not used more often is that lenders and buyers often do not understand how to use the program. MCCs do not address the need to fund downpayment and closing costs and are not targeted to low-income homebuyers.

***The Low-Income Housing Tax Credit (LIHTC):*** While little used for homeownership, the LIHTC has proven to be a successful way to raise private equity for investment in affordable rental housing. By providing 10 years of tax credits in exchange for equity investments in the acquisition, development or rehabilitation of affordable housing, the LIHTC has created an incentive to supply nearly one million rental units to lower-income households. Developers of affordable housing competitively sell tax credits to investors who can use credits to offset their tax liabilities. The equity raised from selling credits reduces debt required to finance a project. By reducing annual debt service payments, the LIHTC allows apartments to be rented at below-market rates. Tax credits provide competitive returns

to investors and help produce affordable housing that otherwise would not be economically viable.

The LIHTC enjoys widespread political support, as evidenced by the dozens of Congressional sponsors from both parties that sponsor LIHTC legislation. Each year, state housing agencies receive credits based on their state's population and allocate a fixed amount of LIHTCs to developers and investors through a competitive process.<sup>11</sup> A sophisticated system for delivering LIHTC-funded housing has evolved, including national and local organizations such as for-profit developers, state housing agencies, equity syndicators, corporate investors, and community-based nonprofits. Over the past decade the efficiency of the LIHTC has increased dramatically, particularly due to increased competition for credits.<sup>12</sup>

While primarily a multifamily rental program, the LIHTC has been used on a limited scale for homeownership through lease-purchase programs. Under the LIHTC, homebuyers actually lease their property for the first 15 years of the project. In the 15th year, the tenant has the option to purchase the home at a discounted price. This period provides time for tenants to accumulate downpayment and closing costs needed to purchase their home. However, Census data show that more than 60 percent of first-time homebuyers move before their 15th year of living in a home.<sup>13</sup> Under lease-purchase, homebuyers are tenants for 15 years before they become owners, and developers act as property managers. The 15-year period has proven to be too long for both the developer and lessee. Fewer than 1,000 homeownership units have been developed using the LIHTC.

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<sup>11</sup> Currently, the LIHTC is allocated at \$1.25 per capita

<sup>12</sup> While initially a \$1 LIHTC could be purchased for \$0.50, today LIHTC-related tax credits may sell for more than \$0.80.

<sup>13</sup> Joint Center for Housing Studies survivor table analysis of the 1993 and 1995 American Housing Surveys for first-time buyers.

## **Tax Programs Fail to Address Wealth and Income Constraints Simultaneously**

For the majority of low-income renters, it is a combination of wealth and income constraints that prevent them from being able to afford a home. According to estimates by the Census, in 1993, 88 percent of renter households could not afford to buy a modestly priced home—a home that is half of the regional median price (Savage, 1997).<sup>14</sup> Of those renters who could not afford to buy, 65 percent were prevented from doing so by a combination of both not having enough income to support a mortgage and not having enough savings or wealth to pay downpayment and closing costs. While 33 percent were prevented from buying a home because they lacked the wealth, but not the income to qualify for a mortgage (using FHA underwriting standards). Only 2 percent were prevented by income constraints alone (Savage, 1997).

Current federal income and other tax policies aimed at promoting homeownership fail to simultaneously attack the twin constraints of wealth and income. Moreover, most policies ignore the more common wealth constraint. The mortgage interest and real estate tax deductions, for example, reduce a homebuyer's taxes, increasing the amount of income that can be devoted to a mortgage. However, these deductions do not lower the wealth needed to cover downpayments and closing costs. Although MRB-funded mortgages can address the wealth or income constraints of low-income buyers, they do not simultaneously attack both constraints.

Lower-income renters are at a disadvantage in accumulating cash to cover downpayment and closing costs. In order to accumulate wealth, households must consume less and save more or they must receive inheritances or cash gifts from relatives or other benefactors. The

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<sup>14</sup> Based on an FHA mortgage assumptions above.

average first-time home buyer under 35 years of age, for example, takes 2.8 years to acquire enough assets to afford to buy a home, an unreachable achievement for most low-income families. Typically, 10 percent to 20 percent of the average first-time buyer's downpayment funds come from gifts (Mayer and Englehardt, 1996; Haurin, Hendershott and Wachter, 1997). Yet, low-income households generally have to spend most of all of their small incomes for basic needs such as shelter, health care and food, leaving little for savings. In addition, due to the intergenerational nature of poverty, low-income households are also less likely to receive downpayment assistance from family members than other households (Mayer and Englehardt, table 8, 1996).

Aware that many families lack enough wealth to fund a downpayment of 10 percent or more of the house price, the mortgage industry has recently begun lowering downpayment requirements to as low as 1, and even 0 percent. While the mortgage industry is reaching out to the 33 percent of renter families who are constrained from affording a modestly priced home by wealth alone, this strategy fails to reach the nearly two-thirds of renters who are unable to afford a home because of a combination of wealth and income constraints. For these renters, lowering downpayment requirements only makes income constraints worse by adding to the mortgage amount and increasing mortgage insurance premiums.

### **Strategies for Overcoming Wealth and Income Constraints**

Four ways tax policies can address the twin problems of limited wealth and income faced by the majority of low-income renters seeking to buy a home are:

- (1) *Provide a refundable income tax credit to cover closing costs and a downpayment of 20 percent—the level at which mortgage lenders no longer require mortgage insurance.*

According to the Census Bureau, a downpayment subsidy of \$10,000 would increase the share of renters who could afford a modest home from 12 percent to 36 percent (Savage, 1997). Taxpayers using this credit would need to receive a loan to bridge the period when the home is bought and the tax refund is received.

- (2) *Provide an income tax incentive for renters to save for a 20 percent downpayment and closing costs in tax-free accounts or accounts matched by tax refunds.*

In the U.S., as noted above, taxpayers may now take penalty free withdrawals from IRAs to buy a first home. Canada created a nonrefundable tax deduction for households that put assets in special homeownership savings accounts (Englehardt, 1997). Although this policy is credited with increasing the rate at which renters became homeowners in Canada, it had a very small effect on the homeownership behavior of low-income households. Low-income households have neither enough income to save, nor do they have a large enough tax liability to offset.

- (3) *Provide a tax subsidy to lenders for the difference between market and below-market interest rates for first mortgages that fully finance closing costs and require only a small downpayment.*

This approach combines low-downpayment requirements with subsidized interest rates on a first mortgage to offset larger mortgage amounts and higher insurance premiums. Lowering downpayment requirements relieves the wealth constraint and lowering the interest rate keeps income constraints in check. Relaxing downpayments only overcomes one portion of the wealth constraint. Buyers still must have enough wealth saved for closing costs and other fees, which are generally 3 to 5 percent of the house price. While, the MRB program has been used in tandem with low downpayment loan programs to achieve this result, it also requires the use of mortgage insurance, which raises the ongoing costs of mortgage payments.

- (4) *Provide a tax subsidy to lenders for the difference between market and below-market interest rates for second mortgages that capitalize downpayment and closing*

*costs into a below-market-interest-rate loan.*

A final approach is to finance downpayment and closing costs with a below-market second mortgage that reduces the loan-to-value ratio of the first mortgage below 80 percent, thus avoiding mortgage insurance. These loans (also called “piggy-back” loans) lower the wealth and income needed to buy a home. This mortgage is secured by junior lien on the property, behind the first mortgage. Because the second mortgage holder receives proceeds from a foreclosure only after the first mortgage is paid off, these loans are perceived to be a higher risk to lenders, and require higher interest rates. As a result, nonprofit lenders and state housing agencies offer these loans at below-market interest rates. These lenders are also more likely to be flexible about deferring payments in the event of temporary hardships. Lenders have learned that even a small contribution by the buyer, as small as \$1,000 or 2 percent of the mortgage, helps keep the borrower committed to their loan, thereby lowering the risk of default.<sup>15</sup>

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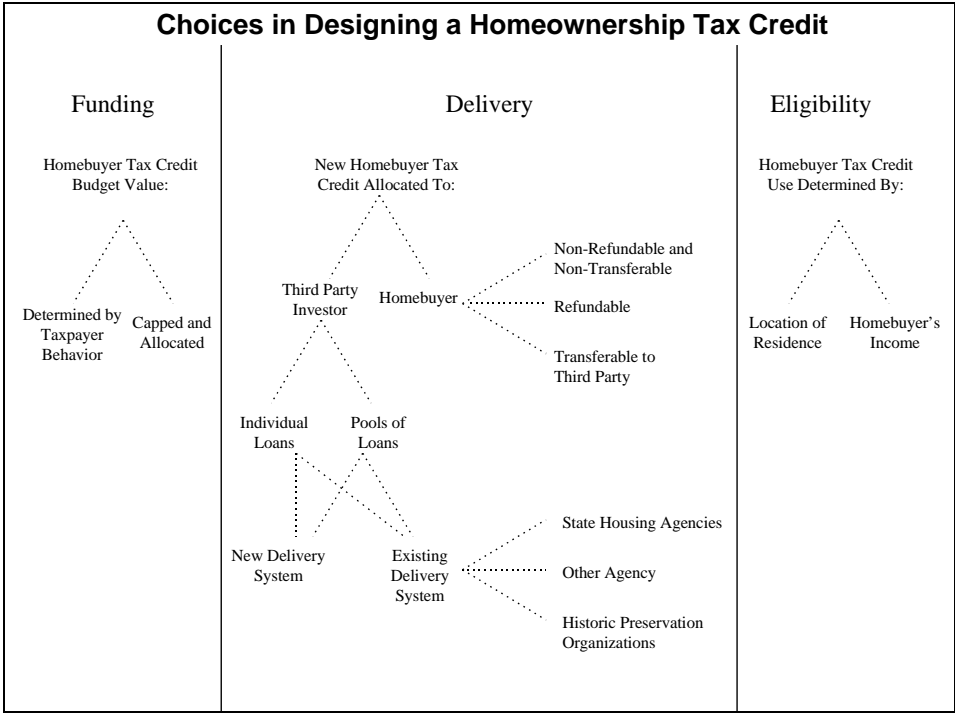
<sup>15</sup> Based on discussions with nonprofit first and second mortgage lenders.



**Policy Choices in Designing New Tax Incentives**

Over the past five years several home ownership tax credit proposals have been advanced, each drawing on the strategies outlined above to overcome wealth and income constraints (see Appendix). Most of these proposals focus on the use of a credit to help low-income families buy homes.

**Figure 2**



Policy makers are faced with several distinct choices as they consider a homeownership tax credit. Figure 2 depicts these choices as a decision tree. First, the funding mechanism for the credit must be determined. Given the political unpopularity of open-ended spending programs, capped and allocated funding strategies are suggested in almost every current proposal. Next, a system for delivering the credit must be designated. Current tax credit proposals are divided among those taken directly by the homebuyer and those taken by third-party investors or developers. Of those that are allocated to investors, the value of the credit is either attached to individual mortgaged-home purchases or to pools of mortgage loans. While some proposals allocate the credit to individual loans and others to loan pools, all of

the proposals suggest using existing tax credit delivery systems. Of those credits going directly to homebuyers, current proposals are again split among those that are refundable and those that are transferable to third parties. Recognizing that low-income households have low tax liabilities, few of the current proposals choose non-refundable and non-transferable credits. Refundable tax credits allow tax payers to receive a tax refund for any amount of tax credit that exceeds their tax liability. Non-refundable tax credits do not. Any amount of tax credit greater than the taxpayer's tax liability is foregone. Finally, almost all of the current proposals use income as an eligibility mechanism, although several combine income with spatial location.

### **Assessing Low-Income Homeowner Tax Credit Proposals**

As policymakers analyze these tax credit proposals and think through the design of new alternatives, there are several criteria they should consider. These are listed below.

#### ***Does the credit address the primary problem low-income, first-time buyers face?***

The primary barrier to homeownership for low-income families is the combined interaction of wealth and income constraints. According to a Census study of the wealth and income patterns of lower-income families, subsidizing mortgage interest rates by 3 points reduces the amount of income needed to support a mortgage, but does not have a significant effect on the number of renters who could qualify for a mortgage. Yet, a \$5,000 cash downpayment subsidy increases the number of renter households who can afford to buy by 21 percent (Savage, 1993). Clearly, a new tax credit for low-income homebuyers should help low-income renters overcome the barrier of downpayment and closing costs. It can have its

greatest impact, however, by combining downpayment and closing cost assistance with mortgage payment assistance.

***Is the credit large enough to achieve the policy’s goals?***

A tax credit should not only target the primary problems low-income homebuyers confront, it should also be large enough to have an impact on the ability of households to afford to buy a home. At a minimum, buyers need a subsidy large enough to get their first mortgage down to 80 percent of the house value to escape mortgage insurance premiums. Given resource limitations, a homebuyer tax credit would have to balance creating a benefit for a large number of households with one that is large enough to have a real impact on the pool of potential buyers. Given fixed tax expenditures, highly wealth-constrained buyers will be helped by larger-sized subsidies, but more homebuyers, with lesser constraints, will be helped by smaller-sized subsidies

On a national scale, one amount of subsidy for low-income homeowners may not be sufficient. A tax credit for homeownership would need to take regional variations in incomes and house prices into consideration. To reach down to 78 percent of half the median existing house price, second mortgages would average \$17,644 in the West to \$11,671 in the Midwest (Table 2).

**Table 2**

<b>Homebuyer Subsidy Should Account for Regional Variation in House Prices</b>					
	<b>US</b>	<b>Northeast</b>	<b>Midwest</b>	<b>South</b>	<b>West</b>
Median Existing Home Price 1997	\$124,100	\$145,100	\$106,100	\$129,000	\$160,400
Half of Median Existing Home Price	\$62,050	\$72,550	\$53,050	\$64,500	\$80,200
Subsidy Set at 22% of House Price	\$13,651	\$15,961	\$11,671	\$14,190	\$17,644

***How is the funding level of the credit determined?***

The total value of the current mortgage interest and real estate tax deductions are determined by the tax filing behavior of individual taxpayers each year. In an environment of fiscal austerity, however, a credit that is similarly open-ended, may be viewed as being too unpredictable. Uncertainties around taxpayer behavior would make analyzing the budget impact of such an approach difficult. On the other hand, the budget impact of an allocated credit is, by definition, finite. The MRB and LIHTC programs, for example, are allocated on a per capita and per state basis, which makes their budget impact easy to estimate and limit. A new homeownership tax credit should be capped and allocated in a similar per capita manner.

A new homeowner tax credit should have funding that is both predictable and indexed for inflation. The LIHTC is particularly instructive on both points. At the start of the LIHTC, the future of the program was uncertain. Investors and intermediaries were slow to use the credit until it became stable and was legislatively authorized for a longer period of time. As more entities developed proficiency in using the credit and demand for credits rose, its efficiency increased. The LIHTC legislation, however, does not index the credit for inflation. Hence, the credit has actually lost value over time as its real spending power has fallen. A new tax credit for homeownership should therefore be initially established for at least a 10-year period and be indexed for inflation.

### *How is the tax credit delivered?*

The most obvious mechanism for delivering tax credits is each homebuyer's annual tax return. Such a tax credit could be available to targeted homebuyers as they file their annual tax forms, similar to the mortgage interest and real estate tax deductions. Allowing qualified buyers to directly adjust their tax filings to receive a subsidy may be efficient, but the low tax liabilities of low-income families make a non-refundable credit provided directly to low-income homebuyers less than effective. Making such a credit refundable would produce a benefit for lower-income buyers, even if the value of their tax credits exceeded their tax liabilities. But, the impact of a such a tax credit on the total federal budget could be difficult to estimate or limit. Moreover, such a program could become difficult to administer. Even if qualified first-time buyers received a refundable tax credit for downpayment and closing costs, buyers could not access such a credit until after the next tax-filing period. In order to provide assistance at the appropriate time, lenders would have to advance the value of the credit until the buyer receives their tax refund. Given the history of refundable tax programs, this approach is unlikely to be politically favorable.

Another design for a new homeownership credit would be to allocate tax credits to targeted homebuyers. The largest administrative vehicles for delivering tax-exempt debt and tax credits are state finance housing agencies. These agencies have established relationships with lenders, investors, and for- and nonprofit developers, as well as a system for efficiently allocating a limited supply of tax incentives.<sup>16</sup>

These agencies could allow low-income homebuyers to assign or transfer their tax credits to a third party with higher-tax liabilities (such as a bank or other entity) in exchange for low-

interest loans or cash. Tracking the assignment of tax liabilities and credits could be very complicated to administer, however. Moreover, other programs allowing the transfer of tax liabilities and credits have proven unpopular with policy makers due to fraud and abuse.

State housing agencies could also offer third-party investors tax credits in return for providing mortgages that are affordable for low-income families. Tax credits could be directed to those taxpayers who have large enough tax liabilities to value tax relief. Like the politically popular LIHTC and MRB programs, the administration of this tax credit would essentially be invisible to homebuyers, but result in homes being more affordable.

***How much of the credit helps targeted families?***

One challenge of designing a new homeowner tax credit is to maximize the portion of the credit that is actually received by buyers. A credit structured like the mortgage interest deduction could be very efficient, since buyers simply adjust their annual tax filings to receive a subsidy. Little of the credit would be lost to administrative costs. Yet, without an allocation mechanism, it would be difficult to cap a direct, taxpayer subsidy at a politically acceptable level, as discussed previously.

An allocated tax credit structured to provide tax relief to lenders or investors who provide below-market rate, mortgages to low-income families could be very good at focusing on targeted buyers. Yet, individually, each homebuyer's mortgage would be fairly risky for lenders. Much of the value of the credit would go into compensating the lender's risk, rather than reducing the cost of ownership. This would result in less of the credit's value flowing to buyers. Bundling these loans into pools of mortgages, however, could diversify away much

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<sup>16</sup> Another, much smaller, existing delivery system is made up of the National Park Service and state and local historic preservation organizations. These agencies allocate Historic Rehabilitation Tax Credits for the renovation of historically significant commercial property.

of this risk, so that the credit retains more of its initial value. More of the total tax expenditure will then assist targeted buyers. A new tax credit for homeownership could be applied to pools of mortgages, rather than individual loans.

***What are the spatial impacts of the homeownership credit?***

As a result of the spatial segmentation of local housing markets by income and house price, even a low-income homeownership tax credit that is not spatially targeted would likely have strong spatial effects. Lower-priced homes, affordable to lower-income families eligible for the credit, are likely to be concentrated in urban and rural underserved areas.

Nevertheless, a tax credit that is not spatially targeted would result in home purchases outside of these areas. Given the choice, some families might want to—and be able to find—homes to buy in other places. For example, many low-income families may find the best mix of housing costs and quality does not exist in the central city, and will only chose to buy in cities or underserved areas if the tax credit restricts their choice to these areas or if they are offered financial incentives.

In some metropolitan areas there may be an insufficient supply of homes that are affordable to low-income families. As demand for units in these areas increases, the market should respond by increasing the supply of housing units suitable for ownership. If, however, housing developers fail to respond because the cost of converting apartments to owner-occupied units is too high, the supply of owner-occupied homes will be constrained and house prices will likely rise. In order to avoid supply constraints, some areas may also need to provide incentives for developers to build or renovate affordable homes. As a result, a tax credit for homeownership may require the layering of existing housing subsidies, such as the Community Development Block Grant (CDBG) and HOME programs.

## **A Possible Approach: The Low-Income Second-Mortgage Tax Credit (LISMTC)**

There are several tax strategies that could encourage lower-income families to buy homes. For the purposes of stimulating further discussion and to make the concept of a credit for low-income homeownership more tangible, we outline one such possible approach, the Low-Income Second Mortgage Tax Credit (LISMTC). The LISMTC would add liquidity to the low-income mortgage market. It would induce lenders to offer below-market interest rate mortgages that cover closing costs and the difference between a low down payment and 80 percent of the lesser of the sales price or appraised value. Where possible, this proposal builds on existing programs and regulations. For such a program to work, each of the provisions below would need to be specified but the actual details under each provision could deviate significantly from this illustration.

### ***Credit allocation and pricing mechanisms:***

State allocating agencies would receive tax credits through a per capita formula adjusted annually for inflation. The per capita formula would have the advantage of limiting the program to a pre-established size. Like the low-income housing tax credit, the allocation for one year would entitle taxpayers to take the credit in each of ten years.

Allocating agencies would sell credits through an auction to the highest eligible bidders. Eligible bidders would include regulated financial institutions, community loan funds, nonprofit community development corporations that have their own loan funds, and lenders that partner with community development corporations. Bids would be expressed as a discount per dollar of credit. Bidders would agree to originate and fund below-market-interest-rate second mortgages at that bid price to eligible borrowers in an amount of at least 18 percent and not more than 22 percent of house value. Bids would cover the difference between the below-market-interest-rate required by the program and an expected risk-adjusted market rate of return on the second mortgages. Winning bidders would receive allocations. They could then begin to use the credits after submitting evidence of having originated loans that meet program requirements. This approach would have the advantage of building on the existing institutional infrastructure that is used to price and allocate mortgage revenue bonds and the low-income housing tax credit. Like these programs, the subsidy amounts generated by the tax benefit would be determined by the market. In all cases, initial lenders would be free to sell second mortgages and transfer the tax credits to third parties in a secondary market.



Winning bidders would be required to originate and service the loans. In the case of community development corporations partnered with lenders, the community development corporations could originate and service the loans on behalf of the lender.

***Income eligibility:***

Eligible households would be those defined as low-income by HUD—households at 80 percent or less of the local area median income, adjusted for family size.

***Eligible properties:***

Property of all types, including condominiums, cooperatives and manufactured homes, would be eligible. This would encourage the flexible use of the program to meet housing demand in areas with all types of housing stock.

***Eligible areas:***

Only properties located in underserved areas as defined by HUD would be eligible. HUD defines underserved areas for the purposes of setting affordable housing goals of Fannie Mae and Freddie Mac and are thus appropriate for targeting a credit intended to stimulate mortgage demand.

***Second mortgage terms:***

The second mortgage would have a 30-year amortization schedule, or some other schedule designated by the investor and state housing agency. The interest rate would be fixed at 3 percent or some other discounted rate tied to a benchmark and fixed at the time of origination. This would lower monthly costs and lessen the chances that a household able to overcome a wealth constraint would also be constrained by too small an income.

***Maximum allowable origination fees:***

An origination fee equal to 2 percent of the house value would be the maximum that lenders could charge for the first and second mortgages combined.

***Servicing fees:***

Servicing these second mortgages would be roughly equivalent to servicing FHA loans. Therefore, the servicing fee would be 38 basis points, in keeping with Ginnie Mae's requirements. This fee would come out of the interest payments on the second mortgage. An additional servicing fee of 28 basis points would be allowed on the first mortgage. This would be an inducement to lenders to originate both the first and second mortgages to receive additional servicing income and create a conforming first mortgage that can easily be sold into the secondary market. This also allows for the costs of enhanced loan servicing and delinquency interventions, which may reduce delinquency and default.

***Pre- and Post-Purchase Counseling:***

Borrowers must attend pre-purchase training provided by approved housing counseling agencies. After origination, borrowers must receive enhanced servicing, including post-purchase counseling for delinquency and default prevention.

***Minimum downpayment:***

The minimum downpayment would be 2 percent or \$1,000, whichever is less. Imposing such a minimum downpayment requirement would restrict the pool of qualified applicants but would ensure that borrowers have a financial stake.

***Maximum debt-to-income ratios (first and second combined):***

Following FHA convention, the maximum housing debt-to-income ratio would be 33 percent and total debt-to-income ratio would be 41 percent. This would help ensure that borrowers are able to make their monthly payments. Alternatively, states could be allowed to set these ratios or allow private bidders to establish them.

***Closing costs:***

Closing costs of up to 4 percent could be included and financed by the second mortgage. Closing costs could also be paid for by the seller or by a third party as a gift. This would limit the cash to close the loan to 2 percent down or \$1,000, whichever is less.

***Maximum allowable second mortgage amount:***

The second mortgage would cover up to 4 percent in closing costs plus the difference between the downpayment and 80 percent of the lower of sales price or appraised value. This would avoid mortgage insurance premiums and give borrowers a sizable second mortgage at a low-interest rate. The second mortgage amount would be capped at \$25,000, and indexed to the Federal Housing Finance Board's house price index. This is the index used to adjust the Fannie Mae and Freddie Mac conforming loan limits.

In the case of mortgages used as part of neighborhood revitalization strategies to finance the purchase and rehabilitation of homes, the cap on the second mortgage amount would increase to \$40,000. Recognizing the difficulties of appraising the value of homes in neighborhood renewal areas, these loans can be based on either the sales price or the appraised value, rather than the lower of the two. Up to 10 percent of a state's credits may be allocated to purchase-rehab mortgages using this cap and valuation method.

***Recapture and income recertification:***

The provisions for income recertification and recapture of the tax credit would follow the rules of the Mortgage Revenue Bond program. Under these rules, if the borrower sells their home within 10 years and their income has risen more than 5 percent above the low-income cutoff at the time of sale, the borrower must pay the Treasury up to half of the

profit from house price appreciation. This procedure limits the need for income recertification to only those cases when a home is sold within 10 years.

***Minimum number of loans:***

Lenders must originate a minimum of 100 loans. This would allow enough pooling of risk to increase the price investors would be willing to pay for the tax credits.

***Conditions for Loss of Tax Credit:***

Investors would only lose the tax credit in the event that a loan is prepaid within 10 years. Investors with prepaid loans, however, would have first priority for annual tax credit allocations in order to swap in new loans to substitute for prepaid loans. Investors would not lose credits in the event of borrower default but would lose whatever principal they are unable to recover. This provides additional incentives for investors to provide enhanced loan servicing, lowering delinquencies and defaults.

***Subsidy layering:***

Layering of mortgage revenue bonds, and federal HOME and CDBG grants would be permitted for borrowers at 50 percent or less of median, but only layering of HOME and CDBG would be permitted for those with between 51 and 80 percent of the median income.

Even though borrowers would have a small financial stake in the home, this contribution would serve to lower default risk and facilitate more efficient market pricing of the LISMTC. From the borrower and second mortgage lender's perspective, the combined loan-to-value ratio of the first and second mortgage would be 98 percent. From the perspective of the first mortgage lender, the loan-to-value ratio would be 80 percent. Borrowers would therefore need less cash to purchase a home than under conventional loan terms and have lower monthly payments. Although LTVs of 98 and even 100 percent are now available from private lenders, they carry significant mortgage insurance premiums that limit their value to those with low incomes. Borrowers would therefore benefit from small downpayment requirements and below market interest rate second mortgages that spare them the mortgage insurance premiums otherwise required for LTVs over 80 percent.

For the sake of illustrating how many homebuyers a tax credit program such as this might assist under different expected internal rate of return requirements, we make the following simplifying assumptions about plausible default and prepayment rates on second mortgages:

- Conditional default rates are twice the conditional claims rates on FHA 97 percent LTV mortgages as estimated for the 1996 book of business in FHA's 1997 actuarial report.
- Prepayment rates are equal to the actuarial estimates for FHA 97 percent LTV loans originated in 1996. All prepaid loans are immediately replaced by new loans with the same conditional default probabilities each year as the original loans that they replace.
- Cash flows to investors are reduced by 38 basis points annually on the outstanding principal balance to cover servicing costs.
- Credit losses in the event of default are equal to 100 percent of the outstanding loan balance.
- Tax credits are taken in each of ten years

Under these assumptions, bidders targeting an internal rate of return (IRR) of 21 percent would bid 50 cents on the dollar for the tax credits and those targeting an IRR of 11 percent would bid 90 cents on the dollar (Table 3). Assuming further that the average second mortgage loan amount is \$13,651 (22 percent of a home priced at half the national median) and an IRR of 11 percent is acceptable, the program would assist 65,929 low-income buyers, if the program is limited to \$100 million in annual allocations. If the program is limited to \$300 million in annual allocations, 197,788 buyers would be aided.

These examples are intended to illustrate how a second mortgage credit program might work. In practice, the price of the tax credit would reflect current interest rates and expectations about loan performance and prepayments. The actual realized rate of return would in turn depend on the price of the credit and the actual, rather than expected, prepayments and credit losses on the loans. And the actual number of assisted buyers would

depend on how deeply each state targets its program and the price the market sets for the credit.

A tax credit that reduced the loan-to-value ratio on the first mortgage to 80 percent would allow households with incomes at 44 percent of the national median income afford to buy a home at half the national median price, without any additional subsidy (Table 4).

**Table 3**

**Scope of Program Assuming Second Mortgage Loans at 22% of House Price**  
 Based on House Priced Half of National Median, \$62,050  
 30-Year 3% Fixed Interest Rate on \$13,651 Mortgage

Expected IRR	Price Per \$1 of Tax Credit	Average Tax Credit Per Home	Number of Buyers Assisted		
			\$100 million annual authority*	\$200 million annual authority*	\$300 million annual authority*
21%	\$0.50	\$27,302	36,627	73,255	109,882
17%	\$0.60	\$22,752	43,953	87,906	131,858
14%	\$0.70	\$19,501	51,278	102,557	153,835
12%	\$0.80	\$17,064	58,604	117,208	175,811
11%	\$0.90	\$15,168	65,929	131,858	197,788

\* Since the tax credit is over 10 years, the total tax authority will be 10 times this amount

**Table 4**

**Possible Use of a 22% Low Income Second Mortgage Tax Credit By Region**

	<b>US</b>	<b>Northeast</b>	<b>Midwest</b>	<b>South</b>	<b>West</b>
Median Existing Home Price 1997	\$124,100	\$145,100	\$106,100	\$129,000	\$160,400
Half of Median Existing Home Price	\$62,050	\$72,550	\$53,050	\$64,500	\$80,200
2% Downpayment or \$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
4% Closing Costs	\$2,482	\$2,902	\$2,122	\$2,580	\$3,208
80% First Mortgage	\$49,640	\$58,040	\$42,440	\$51,600	\$64,160
Second Mortgage 22% of House Price	\$13,651	\$15,961	\$11,671	\$14,190	\$17,644
1st Mortgage Monthly 30 Year 7% Rate	\$330	\$386	\$282	\$343	\$427
2nd Mortgage Monthly 30 Year 3% Rate	\$58	\$67	\$49	\$60	\$74
Mortgage Insurance	-	-	-	-	-
Real Estate Taxes #	\$57	\$103	\$66	\$48	\$53
Hazard Insurance (0.6% annually)	\$31	\$36	\$27	\$32	\$40
<b>Total Monthly Payment</b>	<b>\$476</b>	<b>\$592</b>	<b>\$424</b>	<b>\$484</b>	<b>\$595</b>
Lowest Income Level Served *	\$16,310	\$20,313	\$14,550	\$16,585	\$20,393
Percent of Median 1997 Income	44%	55%	39%	45%	55%

# American Housing Survey 1995

\* Using 35% Front End Ratio

## **Conclusion**

Although the nation clearly supports homeownership through the tax code, current tax laws provide few incentives for low-income families to buy a home. While the overall homeownership rate in the U.S. is at an all-time high, the gap between the ownership rates of low-income and higher-income households continues to be significant. Current tax laws are not well targeted to address this gap. However, ideas for homeownership tax credits have recently been proposed that may be able to overcome the wealth and income constraints of low-income, first-time buyers.

This paper provides an analytical framework for reviewing current tax credit proposals for homeownership. A number of choices have been identified. A new credit should target the primary constraint to homeowning for low-income families, a lack of wealth combined with insufficient incomes. A new tax credit must balance being broadly useable by low-income families with being deep enough to have a financial impact on their decision to buy a home. A new credit must confront the reality that the tax code is an inherently difficult way to target households that pay low taxes. Credits either need to take the politically unfavorable approach of being refundable, or be allocated to a third-party. Funding for a new credit should be flexible and predictable over time. While a highly-efficient credit could be administered directly through the tax code, the use of intermediaries to allocate a credit would lead to a fixed cap on tax expenditures. Finally, while a tax credit may provide increased opportunities for low-income buyers, without a spatial targeting provision such a credit may not significantly alter homeownership in underserved areas.

Based on this analysis, and the ideas of practitioners and policy makers, Congress has the capacity to create an effective tax incentive for low-income home buyers. The gap in homeownership rates between the rich and the poor can be narrowed. Moreover, a well-

designed targeted homeownership tax credit will make the American dream of homeownership a reality for more low-income Americans.



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### ***Appendix: Brief Summary of Current Proposals for a Homeownership Tax Credit***

Because the current tax law provides little support for low-income homebuyers, a number of new tax incentives have been proposed in the last five years that seek to encourage low-income homeownership. All of these proposals hope to make homeownership more affordable for targeted households and areas. Each, however, utilizes a different mechanism and strategy. All of these strategies lower the cost of ownership for buyers. Several proposals provide a direct reduction of the buyer's monthly tax liability, thus freeing up more income for a mortgage. In other cases, a lender or investor receives a reduced tax liability in exchange for providing below-market interest rate loans. Finally, other proposals call for directly subsidizing downpayment and closing costs, or reducing the amount of downpayment required.

#### **#1 Expand the Low-Income Housing Tax Credit (LIHTC) to Lease-Purchase**

*Proposed by: Cleveland Housing Network, National Association of Home Builders*

Lease purchase is not prohibited under the LIHTC, but only a few scattered site homeownership LIHTC units have been developed. Buyers lease homes for 15 years and then have the option to buy in the 15th year. While the 15 year period is required to comply with the LIHTC law, it is too long for many potential homebuyers. The NAHB proposes that the compliance period for LIHTC projects should be reduced from 15 to 10 years for ownership projects. The Cleveland Housing Network proposes to shorten the compliance period even further, to 5 years, for lease-purchase units.

#### **#2 Expand the Low-Income Housing Tax Credit (LIHTC) to Cooperative Housing**

*Proposed by: The National Cooperative Bank*

Currently, the structure of LIHTC deals does not work well for cooperatively-owned housing. The National Cooperative Bank proposes creating two classes of stock in LIHTC-financed cooperatives, one for investors, the other for residents. While cooperatives are not the same as single-family homeownership, they do provide an alternative to rental housing with low monthly housing costs.

#### **#3 Allocate Low-Income Housing Tax Credits (LIHTC) to Pools of Affordable Mortgages**

*Proposed by: The Neighborhood Reinvestment Corporation*

The Neighborhood Reinvestment Corporation proposes that state housing agencies should have the option to allocate LIHTC-type tax credits to pools of below-market rate second mortgages. These mortgage pools would make loans to buyers whose income met LIHTC guidelines (20 percent of borrowers must be 40 percent or less of area median income, or 40 percent of borrowers must be 60 percent or less of area median income). In return, investors in these projects would receive a tax credit for 10 years equal to the present value of 70 percent of their initial investment (approximately a 9 percent tax credit per year). These second mortgages would capitalize downpayment and closing costs.

#### **#4 Create a New Tax Credit for Lenders of Second Mortgages to Low-Income Homebuyers**

*Proposed by The Center For Community Self-Help*

The Center For Community Self-Help envisions a new tax credit that will stimulate capital available for below-market rate second mortgages. In exchange for making 0 percent interest second mortgages for downpayments and closing costs (structured as non-amortizing, 15 year balloon loans), investors receive a 9 percent tax credit for 10 years. The lender for the first mortgage could be the mortgage qualifier and conduit to investors for individual loans or pools of mortgages.

#### **#5 Replace the Mortgage Interest Deduction with a Refundable Tax Credit**

*Proposed by: Richard Green, Andrew Reschovsky and Kerry Vandell, University of Wisconsin*

As part of a discussion held by the National Housing Institute, these economists undertook an analysis of converting the mortgage interest deduction into a refundable tax credit. The authors determine a refundable credit equal to 21 percent of a buyer's annual mortgage interest payments would be revenue neutral if the current mortgage interest deduction were repealed. The authors estimate mortgaged homebuying activity would shift to lower-income buyers and away from higher-income households.

#### **#6 First-Time Homebuyer Tax Credit**

*Enacted by: District of Columbia; Proposed by Bush Administration*

Proposed on a national scale by the Bush Administration (1991) and enacted into law for Washington, DC by Congress, this provides a fixed tax credit for limited time to low- and moderate-income, first-time buyers (defined as not owning a home in the last three years). Such a credit can be used to overcome buyers' wealth constraints by offsetting downpayment and closing costs.

#### **#7 Homeownership Development Accounts and IDAs (Individual Development Accounts)**

*Proposed by: No Formal National Proposals, Several State-Level Proposals*

Current laws allow buyers to access their IRAs (Individual Retirement Accounts) without penalty for home purchases. However first-time, lower-income buyers often do not have an IRA and do not accumulate enough savings to purchase a home. While both IDAs and IRAs encourage savings, IDAs provide a match for each dollar saved, from 50 cents to \$9, depending on the specific program. The dollar match can also be used as an incentive to encourage attendance in homeownership training sessions or financial counseling, as in the Home Loan Bank of New York's homeownership development account program. Several states have proposed IDA programs that provide tax credits to match the savings of qualified buyers or that provide tax credits for employers who match their employee's savings toward downpayments.

#### **# 8 Expand the Mortgage Credit Certificate (MCC) Program**

*Proposed by: Department of Housing and Urban Development*

A proposal drafted by HUD's Policy Development and Research department suggested raising the maximum MCC from \$2,000 to \$4,000 in targeted urban areas (Enterprise Zones). Currently, the \$2,000 maximum applies when the MCC is equal to 25 percent or more of annual interest payments. By increasing the limit, buyers could take a larger annual credit. This proposal does not seek to create incentives for lenders or housing agencies to promote MCCs, however, nor does it remove MCCs from the private activity bond cap.

## # 9 Expand the Historic Preservation Tax Credit to Home Owners

*Proposed by: The National Trust for Historic Preservation*

The National Trust for Historic Preservation has proposed the “Homeownership Assistance Act,” allowing owner-occupants to take a one-time tax credit equal to 20 percent of the cost of substantially rehabilitating a home in a historic area. Since these are generally ‘gut’ rehabilitation projects, these homes are typically bought and renovated at the same time. Lower-income homebuyers can transfer unused portions of the credit to lenders in exchange for reductions in mortgage interest rates. Lenders can then use the credit to offset their own corporate tax liabilities. Although not targeted to urban areas, because historic buildings are often located in urban areas, this credit may help increase urban homeownership.

### *Comparison of Proposals to Expand Tax Incentives for Homeownership*

Policy Proposal	Proponents	Mechanics	Eligibility/Beneficiaries	Comments
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1	Revise the LIHTC to Better Facilitate Various Forms of Ownership	Cleveland Housing Network	Reduce LIHTC compliance period for the acquisition, development, or rehabilitation of lease purchase housing from 15 to 5 years. Resulting sale prices are below market values.	Same income restrictions as LIHTC. Investors who make 15 year commitments to projects receive tax credits equal to the present value of 70 percent of the qualified basis (net land) of the unit over 10 years (approximately 9 percent annually).	Allows borrowers to accumulate downpayment  Allows production of very low cost ownership units  A clause officially expanding the use of LIHTCs to lease purchase projects is contained in Sec. 3(2).xiii of HR 3290.
1		National Association of Home Builders	Reduce LIHTC compliance period for lease purchase projects from 15 to 10 years		The NAHB supports other approaches that use the LIHTC to stimulate affordable home building.
2		National Cooperative Bank	Extend LIHTC to Build/Rehab Cooperatively Owned Buildings	Create two classes of LIHTC stock, one for investors and one for residents. Most cooperative buildings are in cities in the Northeast.	Proposed in Senate Bill 2125.  Estimated that 1,600 cooperative units would be produced in five years.
3	Revise the LIHTC for Investors in Pools of Affordable Mortgages	Neighborhood Reinvestment Corporation	State housing agencies allocate tax credits to pools of below-market rate mortgages. Investors in pool receive the credits to boost their return.	Income restrictions similar to the LIHTC, but based on the value of the underlying mortgages in the loan pool being loaned to households meeting income requirements. Units must remain low-income for 30 years.	Raises needed equity for affordable mortgage markets.
4	Credit for Lenders of Zero Interest Second Mortgages to Low-income Buyers	North Carolina Center for Community Self-Help	Lenders qualify low-income buyers for a first mortgage. Individuals or corporations make 0 percent 15-year second mortgages in exchange for 10 year, 9 percent tax credit (similar to the LIHTC).	Value of the second mortgage is limited to 20 percent of the home sales price for households 60 percent to 80 percent of median area income, or 30 percent of price if income is less than 60 percent of area median. Credits could be allocated by state housing agencies.	Lowers required down payment, as well as carrying costs. Stimulates investors in below market rate mortgages.

***Proposals to Expand Tax Incentives for Homeownership, Continued***

	<b>Policy Proposal</b>	<b>Proponents</b>	<b>Mechanics</b>	<b>Eligibility/Beneficiaries</b>	<b>Comments</b>
5	Refundable Credit for Buyers that Replaces Mortgage Interest Deduction	Richard Green, Andrew Rescovsky and Kerry Vandell	A tax credit replacing the mortgage interest deduction valued at 21 percent of previous year's mortgage interest payment. Second option is \$850 fixed credit for all buyers.	The benefits of borrowing to buy a home would be transferred from higher-income households to lower-income households. Households earning less than \$40,000 would receive 30 percent of the benefits of a credit, versus only 8 percent of the mortgage interest deduction.	This proposal was part of several explored in 1997 working paper for the National Housing Institute. These ideas were primarily intended to encourage discussion.  The 21 percent credit is designed to be revenue neutral.
6	One Time First Time Buyer Credit	National Association of Home Builders (1991) and Enacted by Congress	As enacted: an income-based tax credit worth up to \$5,000 for first-time buyers in the District	Phases out if income more than \$70,000 for individuals or \$110,000 for couples. Available for homes purchased before January 1, 2001. These credits would not be refundable.	Similar to ownership proposal made by the Bush Administration in 1991 and a policy used in 1975 to stimulate the single family housing market.
7	Home Ownership Individual Development Account (IDA)	Corporation for Enterprise Development	Tax credits to match amount potential buyers save in special savings account co-held by an agent and potential homebuyer	Match is based on household's income, wealth and attendance in homebuyer training sessions. Various tax credits and deductions have been proposed. Canada had a tax policy in the 1970s and 1980s that allowed tax deductions for contributions to qualified first-time homebuyer savings accounts.	Several demonstration projects have been proposed at the state level.
8	Expand Use of Mortgage Credit Certificates (MCC)	US Dept. Housing and Urban Development - Office of Policy Development and Research discussion paper	Proposed maximum MCC value would be raised from \$2,000 to \$4,000.	The MCC limit would be raised only in designated areas, such as Empowerment Zones and Enterprise Communities. Buyers receive a reduction in monthly PITI only if they adjust their W-2 tax withholdings. Although many lenders use the MCC in mortgage calculations, some do not.	MCCs less used now than they were in the 1980s. Some states find the MCC too complex, others prefer the flexibility and revenue generation of mortgage revenue bonds.
9	Tax Credit for Owners That Renovate Historic Homes	National Trust for Historic Preservation	Owners receive one-time tax credit equal to 20 percent of the value of a substantial rehabilitation. Lower-income homebuyers can transfer the credit to lenders, who use it to offset corporate tax liabilities.	The credit is not targeted to lower-income households, but historic properties tend to be in urban, lower-income areas. Also, the credit phases out for higher-income households.	Current historic preservation tax credits cannot be used by owner-occupants and can only be used to offset passive income.  HR 1134 and S. 496 contain these provisions.
10	Low-Income Second Mortgage Tax Credit	Collins, Belsky, Retsinas	Investors in a pool of second mortgages receive a 10 year tax credit in return providing capital for a zero interest loans capitalizing downpayment and closing costs.	The credit is targeted to low-income households and are designated for targeted areas, such as the GSE underserved areas.	Proposed as a model in Working Paper.