

# THE LOW INCOME HOUSING TAX CREDIT AND INNER-CITY REVITALIZATION

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## Abstract

*Inner-city revitalization is a complex challenge requiring multiple strategies for success. Successful revitalization efforts must include quality housing opportunities for lower-income households. The federal Low Income Housing Tax Credit (LIHTC) program, established as part of the Tax Reform Act of 1986, is a policy tool that has the potential to contribute to inner-city revitalization. Program implementation is very complex, however, and many community-based organizations may be unable to participate due to lack of capacity. This article examined the structure of the LIHTC program and the extent to which it has been a part of inner-city revitalization efforts since the program's inception. It also explored the implications of the LIHTC's structure for continuing to contribute to inner-city revitalization through the participation of community-based housing organizations. Finally, recommendations were made for enhancing the effectiveness of the LIHTC in promoting quality housing opportunities in inner-city neighborhoods through the participation of community-based organizations.*

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## Introduction

Inner-city revitalization is a complex challenge requiring the application of multiple strategies in order to effect positive, long-term change. Creating quality housing opportunities for individuals and families is typically an important part of neighborhood revitalization efforts. Introducing quality housing opportunities for low-income households in revitalization areas can be particularly challenging, however, and may require public subsidies in order to be financially feasible. One public policy tool with the potential to contribute to inner-city revitalization is the Low Income Housing Tax Credit (LIHTC) program. The LIHTC was originally created by Congress as a part of the Tax Reform Act of 1986 and provides a tax incentive for the construction or substantial rehabilitation of rental housing for

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lower-income households. While the program has the potential to play a significant role in inner-city neighborhood change by providing new or substantially improved housing opportunities for low-income households, the complexity of delivering housing using the program and the incentives inherent in the program may diminish its impact.

Although the LIHTC has become the primary vehicle for delivering subsidized multifamily housing in the U.S. and is currently responsible for more than 25% of the multifamily housing produced in the nation (Malpezzi & Vandell, 2002), the literature contains relatively little empirical evidence regarding its operation. This may arise in part from the program's design. As a feature of the federal tax code rather than a direct appropriation of Congress, there is less information available to researchers about the operation of the LIHTC and its outcomes than with programs administered, for instance, by the U.S. Department of Housing and Urban Development (HUD). The relative lack of empirical evidence to be found in the literature prompted Varady (2006) to highlight the need for more detailed research on the LIHTC program.

This article explores the structure of the LIHTC program and the extent to which it has been used to provide housing opportunities in inner-city neighborhoods since implementation began in 1987. It also explores the implications of the program's structure for contributing to continued expansion of inner-city housing opportunities through the participation of community-based housing organizations. This article closes by making recommendations for enhancing the effectiveness of the LIHTC in promoting quality housing opportunities in inner-city neighborhoods that contribute to revitalization efforts.

### **LIHTC Program Structure**

The LIHTC program is meant to bring the efficiency and discipline of the private market to affordable rental housing development (Cummings & DiPasquale, 1999). Housing units are built by the private sector (for-profit or nonprofit entities) using credits that are allocated by a state agency. Decisions about project size and location, as well as administration of the project, are left to the developer rather than a public agency. Nationally, the total number of housing units produced using the LIHTC exceeds one million (O'Regan & Quigley, 2000). LIHTC units comprise about 5% of the national rental housing stock, and in some years have comprised almost one half of the multifamily units built in the U.S. The impact of the LIHTC program has been even more significant in certain Census tracts, particularly those in inner-city neighborhoods.

The mechanics of the LIHTC program have been discussed extensively elsewhere (for instance, Guggenheim, 2003); key points are briefly summarized here. The LIHTC program provides a tax credit to projects that is tied to units set aside for income-qualified tenants. The credits can be granted to projects with at

least 40% of the units set aside for households with incomes at 60% of area median income or below, or 20% of the units set aside for households with incomes at 50% of area median income or below. Thus, the program provides the potential for mixed-income projects which may improve housing opportunities available in low-income neighborhoods, including improvements gained by deconcentrating poverty. While the LIHTC is a federal program with the Internal Revenue Service as the source of ultimate oversight, policy implementation is devolved upon the states. Developers obtain credits through a competitive process administered by state housing agencies, and the dollar amount of credits available for distribution each year is limited.

For new construction and substantial rehabilitation projects, the credit is approximately 9% of the “qualified” basis *per year* for 10 years and may provide a subsidy totaling up to 70% of the qualified basis. The qualified basis is determined by deducting land costs and costs associated with units not occupied by income-eligible households from total development costs. For example, if the total development costs for a tax credit project are \$5 million and \$1 million of these costs is for the purchase of land and \$500,000 is for construction of market-rate units (e.g., units for which there will be no income restrictions), then the qualified basis of the development is \$3.5 million.

The 9% tax credit cannot be used for the acquisition of existing properties, except where substantial rehabilitation is intended, nor can it be used for projects financed with tax-exempt bonds or for those receiving certain below-market-rate loans from a federal source. Developments receiving federal HOME dollars are exempt from this restriction and may include the 9% credit. In addition, the use of Housing Choice/Section 8 vouchers by individual tenants is permitted at all tax credit properties. For projects ineligible for the 9% credit, the credit is equal to 4% of the qualified basis per year. Under the 4% credit, a tax-credit subsidy may be provided that ranges up to 30% of the qualified basis of the property. Below-market-rate financing that is provided for new construction projects through state-funded agencies and programs does not disallow the use of the larger 9% credit.

Maximum allowable rents on the units against which the tax credits are claimed are constrained by the median income in a metropolitan area or non-metropolitan county. More specifically, allowable rents are capped at what a household with the maximum qualifying income in the metro area could afford if it paid 30% of its gross income for rental housing, including tenant-paid utility expenses. For example, if the developer has chosen to meet the 40%/60% units/income standard, the maximum allowable rent is equal to the amount a household with income equal to 60% of the area median would spend on rent if 30% of gross household income is devoted to rent and utilities. The project must continuously

satisfy these restricted-income criteria for at least 15 years and, in some cases, for as long as 50 years.

### **The Role of Nonprofit Developers**

The LIHTC program can be particularly important to nonprofit housing sponsors. From the outset, states have been required to allocate at least 10% of their LIHTC resources to nonprofit development each year. Nonprofit sponsors in inner-city areas commonly take the form of community development corporations (CDCs). These organizations have a long history of being located in low- to moderate-income neighborhoods (Rohe & Bratt, 2003). For these communities, there is often no other organization that provides a housing product or housing service other than a CDC (see also Bratt et al., 1998). While CDCs primarily concentrate their activities on housing production, expanded programmatic efforts also include economic development, workforce training for community residents, and some social services (Glickman & Servon, 1998; Nye & Glickman, 2000).

Despite the support that CDCs receive from organizations such as the Local Initiatives Support Corporation (LISC), the Enterprise Foundation and NeighborWorks America, as well as regional and local entities, many CDCs have limited capacity to deliver housing (Rohe & Bratt, 2003). In broad terms, Glickman and Servon (1998) and Nye and Glickman (2000) suggested that capacity issues fall into five different categories: resource, organizational, networking, programmatic, and political. Participation in LIHTC development generates fees, and allows CDCs to build experience and create partnerships and networking opportunities.

An analysis of LIHTC data for the period 1987 through 2001 provided by HUD indicated that slightly less than 17% of all LIHTC developments had nonprofit sponsors. It is important to understand that HUD is dependent on state housing finance agencies to provide data on each year's LIHTC allocations, and that the quality of this reporting may vary from year to year and state to state. While even at 17% the number of projects sponsored by nonprofits is large, there is unrealized potential for further participation by nonprofits—particularly smaller nonprofits—in the program.

### **Location of LIHTC Developments**

Cummings and DiPasquale (1999) examined the first 10 years' experience with the LIHTC program. Some 27% of the projects in their sample were in Census tracts in which no new rental housing had been built in the preceding five years. In 13% of the tracts in which LIHTC projects had been built, they represented over 20% of all rental housing in the tract. The authors found that "LIHTC projects provide affordable housing for low and moderate households in higher-

income neighborhoods or better quality housing in low-income neighborhoods” (Cummings & DiPasquale, 1999, pp. 267-268).

Several studies have examined the types of neighborhoods in which LIHTC projects have been sited. These studies suggest that a significant portion of LIHTC projects have been built in inner-city locations. For example, Rohe and Freeman (2001) found that predictors of the location of LIHTC developments include the percentage of African-American residents in a neighborhood, value of owner-occupied housing (a negative coefficient), neighborhood income, percentage in poverty, vacancies, and other variables indicative of a poverty neighborhood. Newman and Schnare (1997) also found that LIHTC projects are concentrated in low-income neighborhoods. In contrast, McClure (2006) described the LIHTC as a vehicle for the deconcentration of poverty and cited evidence that developers increasingly choose suburban locations in which to develop LIHTC properties. While deconcentration of poverty is an important goal within U.S. housing policy, Freeman (2006) noted the importance of continued recognition of the spatial isolation of minorities. Thus, continued development of quality housing opportunities in inner-city neighborhoods that may be home to highly concentrated minority populations is also a significant policy issue.

The design of the LIHTC program results in the determination of LIHTC project location by developers who successfully apply for program resources. Allocating the credits through state agencies is intended to provide greater flexibility in meeting local needs. Goals of private-sector development firms, however, may conflict with public policy goals in that profit-oriented developers may be reluctant to take on developments completely congruent with the desires of the public sector or housing advocates to meet lower-income housing needs. State housing finance agencies responsible for administering the LIHTC face the challenge of fostering a competitive arena in which developers submit applications for developments most in keeping with state housing policy priorities.

### ***State Allocation Plans***

In addition to requiring states to designate an agency that will allocate the tax credit, Section 42 of the Internal Revenue Code requires these agencies to create an annual Qualified Allocation Plan (QAP) outlining the process by which the agency will choose among competing developments. These plans establish the minimum requirements all applications must meet, such as financial feasibility standards, site requirements, developer experience, and other measures of project quality; establish set-asides of tax credit resources for projects located in high-need areas or serving priority populations; and establish scoring systems by which competing projects will be ranked on measures of project quality and their accordence with state policy objectives.

Since 1990 the LIHTC has provided an added financial incentive for development in concentrated low-income areas known as Qualified Census Tracts (QCTs). Developments in these areas have been eligible to receive 30% more tax credits than they would if located outside a QCT (U.S. Public Law 101-239). Developments located in Difficult to Develop Areas (DDAs) are also eligible for this additional financial incentive. These areas are characterized by high development costs vis-à-vis local wage levels and are outside the scope of this article. State QAPs also play an important role in establishing incentives for project locations and characteristics.

While states may establish priorities that suggest inner-city housing opportunities contributing to neighborhood revitalization as a primary goal, establishing these priorities cannot make a project feasible absent other conditions. Successful projects often require additional subsidies or incentives. Successful developers are those with experience and the capital to be able to withstand lengthy application review periods and compliance monitoring requirements.

### **Inner-City Housing, Multiple Subsidies, and CDCs**

Despite its importance within U.S. housing policy, the LIHTC typically does not create a sufficient subsidy without being combined with other public programs to reach low-income households. Thus, the U.S. General Accounting Office found that some 40% of LIHTC households in 1996 were also receiving direct rent subsidies such as Section 8 vouchers or certificates (GAO, 1997), now known as Housing Choice Vouchers. Using the LIHTC program to reach lower-income households is consistent with the objectives of a CDC, but can be difficult to achieve. Although the LIHTC has provided significant resources for nonprofit housing development since its inception, O'Regan and Quigley (2000) have noted that nonprofit housing finance is complex, costly, and requires expertise and capacity not possessed by many nonprofits.

Cummings and DiPasquale (1999) examined the financial viability of tax credit projects and the multiple subsidies involved in these projects. They found that units built using the LIHTC program vary widely in total development cost, ranging from under \$40,000 to over \$100,000 per unit. The range in development costs reflects the range of housing types and costs across areas, which result from the flexibility that state agencies have in implementing the program. Operating revenues exceeded operating expenses for 78% of projects in their sample, including 83% for-profit projects but only 60% for nonprofit projects. The authors noted that LIHTC developments are often dependent on other sources of subsidy to be viable, and that even with additional subsidy they do not reach lower-income households. These additional subsidies come from a variety of federal, state, and local sources (Stegman, 1991). Suburban properties use almost no special financing, while central-city developments use extensive

special financing. Central-city developments frequently need extensive special financing to overcome financial feasibility hurdles typically associated with inner-city development, including land costs and a need to provide units affordable to households with extremely low or very low incomes in higher proportions than is likely to be necessary with suburban development. Smaller projects are also more likely to use special financing such as below-market interest rates or zero-interest loans and grants.

Cummings and DiPasquale (1999) also found that over time more of the tax credits have been used for housing rather than fees and administrative expenses. The authors also found that the highest returns for investors were from projects developed by nonprofits, possibly because such projects are considered more risky and, therefore, demand a higher investor return. LIHTC projects are frequently heavily subsidized beyond the subsidy provided by the LIHTC. The authors concluded that the LIHTC program is expensive because of its reliance on multiple sources of financing.

Quercia, Rohe, and Levy (2000) examined the role of creative finance in LIHTC projects. They found that on average, a rental development had 4.3 different funding sources. As a result, reporting requirements were burdensome, as was the process of making amendments to property management plans. On the positive side, the projects that resulted were affordable and there were strong relationships that resulted from the partnerships created by the financing structure.

### **The LIHTC Development Process and Inner-City Housing**

The literature discussed above suggests that LIHTC projects can be in suburban, rural or urban locations, and that urban projects provide quality housing in low-income neighborhoods. Federal criteria for QAPs were changed in 2000 to give selection preference to projects serving the lowest income tenants, those that will serve qualified tenants for the longest period, or projects located in QCTs where the development will contribute to a concerted community redevelopment plan (U.S. Public Law 106-554). LIHTC projects often employ multiple subsidies to create a financially feasible project. Finally, nonprofit developers can play a major role in the LIHTC program, particularly in serving inner-city neighborhoods.

In encouraging inner-city development, the LIHTC might address not only the goal of providing better housing for low-income households, but also the goal of preserving existing affordable housing and fostering new housing development capacity in inner-city neighborhoods. Nationally, empirical evidence suggests that the goal of providing better housing is being met (Cummings & DiPasquale, 1999).

Affordable housing preservation is a national concern and relates to the expiration of affordability periods among both LIHTC properties and properties funded under older, HUD-administered programs. Without concerted preservation

efforts, there is a strong potential for the loss of affordable units as the commitment periods for assistance expire and fail to be renewed. The type of ownership and an organization's mission can drive the decision about terminating affordability. The mandate of a nonprofit owner is generally to serve low-income households in the neighborhood. A study prepared for HUD found that nonprofits are less likely to opt out of rental assistance contracts when compared with for-profits because "nonprofit owners are often mission-driven to provide affordable housing" (Finkel et al., 2006, p. ix). This national study of properties funded under HUD programs established prior to the LIHTC prepared by Abt Associates (Finker et al., 2006) used a multivariate regression model to analyze close to 9,000 properties with project-based rental assistance, of which 763 opted out of the program. A key variable was type of ownership; nonprofit owners were significantly less likely to opt out when compared with other owners. For-profit owners have a strong focus on the financial bottom line and aim for maximization of investment returns (Pedone, 1991; Wallace, 1995). Therefore, a for-profit organization is more likely to exit the funding program and sell the property or convert to market-rate housing if it makes financial sense to do so.

The goal of fostering new housing development capacity in inner cities—a goal not specifically articulated by federal policymakers responsible for the LIHTC—may not yet be realized in many states. This goal is the focus of the remainder of this article. Following a brief discussion of the development process, an analysis of inner-city LIHTC development will be presented.

The complexity and risk of the LIHTC development process, combined with the predevelopment expenditures beyond those required in conventional development, limit the number of developers able to participate. These developers are large, with substantial financial resources, and are experienced in the LIHTC program. Some nonprofit developers have been able to position themselves as successful LIHTC developers, but they are generally large, experienced entities or they work in partnership with large for-profit entities. The LIHTC program is not one that encourages the development of new entrepreneurial companies because of the pre-development costs involved and the weight assigned to experience in states' competitive selection processes. While the program may result in new units in inner-city markets, it may not lead to locally based development and property management services.

Much of the activity associated with the LIHTC development process is similar to that found with conventional multifamily properties. Three primary features differentiate LIHTC development: (a) the timing of development activities, including the receipt of the developer's fee, typically takes place over a longer time frame (two to three years) than in conventional multifamily development; (b) additional costs for LIHTC application preparation, including legal and accounting fees; and (c) the expenses associated with tax credit compliance

throughout the period of affordability. Further, there is significant additional risk in that a project which appears viable may not be approved for an allocation of tax credits due to the highly competitive selection process found in nearly every state.

### **The LIHTC in Inner-City Neighborhoods: Data and Analysis**

In this study, nonprofits and inner-city development was analyzed with the Low Income Housing Tax Credit using HUD's LIHTC database for the period 1987 through 2001. These data are available through HUD User at [www.huduser.org/datasets/lihtc.html](http://www.huduser.org/datasets/lihtc.html). This database contains details related to development location, including information on whether a property is located in a central city and QCT. Further, nonprofit sponsor status is provided. Thus, this dataset allows the exploration of nonprofit housing development efforts in inner cities using the LIHTC.

The database contains information on 21,084 developments. Geographic location details were available for 18,777 of these observations and nonprofit versus for-profit status for 14,719 developments; the analysis is based on the latter observations. Table 1 contains an overview of the LIHTC program results by sponsorship category.

**Table 1. LIHTC Development Sponsors by Status, 1987-2001**

|                    | <b>Number of Developments</b> | <b>Percentage of Developments</b> |
|--------------------|-------------------------------|-----------------------------------|
| Total              | 14,719                        | 100                               |
| For-profit sponsor | 11,485                        | 78                                |
| Nonprofit sponsor  | 3,234                         | 22                                |

For-profit organizations sponsored 78% of LIHTC developments funded from 1987 through 2001, while 22% were sponsored by nonprofits. Nonprofit participation varied widely among the states and across regions. Table 2 shows reported sponsorship status by Census region. While the Northeast and West each have over 30% of the developments sponsored by nonprofit developers, only 20.3% in the Midwest and 14.1% in the South had such sponsorship. These variations may reflect the existing nonprofit capacity in each of the high-sponsorship areas. This may indicate a lack of capacity, particularly in the South, and reflects the potential to use the program to boost such capacity.

Qualified Census Tracts in central cities have attracted a significant amount of LIHTC development activity; 22% of LIHTC developments are in such locations. Thus, the LIHTC has proved to be a significant tool for stimulating affordable inner-city housing development.

**Table 2. LIHTC Developments by Census Region**

|             | Number of For-Profit Developments | For-Profit as % of All Tax Credit Development | Number of Nonprofit Developments | Nonprofit as % of All Tax Credit Developments | Total Number of Developments |
|-------------|-----------------------------------|---|----------------------------------|---|------------------------------|
| Northeast   | 1,847                             | 69.25   | 820                              | 30.75   | 2,667                        |
| Midwest     | 3,426                             | 79.69   | 873                              | 20.31   | 4,299                        |
| South       | 4,744                             | 85.85   | 782                              | 14.15   | 5,526                        |
| West        | 1,441                             | 65.59   | 756                              | 34.41   | 2,197                        |
| Puerto Rico | 27                                | 90.00   | 3                                | 10.00   | 30                           |
| Total       | 11,485                            | 78.03   | 3,234                            | 21.97   | 14,719                       |

What role have nonprofit developers played in developing LIHTC housing in inner cities? As shown in Table 3, nonprofits sponsored more than 32% of inner-city LIHTC development between 1987 and 2001. Therefore, nonprofits sponsored a higher percentage of inner-city LIHTC development than they did for the tax credit program as a whole. Nonprofits sponsored a lower share of smaller projects (30.7% of those with less than 50 units) than larger projects as compared to for-profit developers. The expectation was that the nonprofits would sponsor a larger share of smaller projects, as for-profits have greater resources to complete large projects. This finding may further illustrate the capacity of some nonprofits to undertake larger-scale development.

The second part of Table 3 shows that about two thirds of all nonprofit projects are not undertaken in QCTs, while 80% of for-profit projects are undertaken outside those areas. While nonprofits are more likely to be represented in QCTs, they clearly view their role as larger than developing in inner-city areas, possibly due to goals of dispersion of the target population to higher-income areas or barriers to development in QCTs.

**Table 3. LIHTC by Location and Development Size**

|                    | Number of For-Profit Developments | For-Profit as % | Number of Nonprofit Developments | Nonprofit as % | Total Number of Developments |
|--------------------|-----------------------------------|-----------------|----------------------------------|----------------|------------------------------|
| Central city, QCT  | 2,278                             | 67.88           | 1,078                            | 32.12          | 3,356                        |
| 50 or less units   | 1,649                             | 69.31           | 730                              | 30.69          | 2,379                        |
| More than 50 units | 629                               | 64.38           | 348                              | 35.62          | 977                          |
| Other locations    | 9,207                             | 81.03           | 2,156                            | 18.97          | 11,363                       |
| Total              | 11,485                            | 78.03           | 3,234                            | 21.97          | 14,719                       |

The level of nonprofit participation in QCT projects and the total number of QCT projects varied among Census regions (Table 4). In the West, over one half of QCT developments were nonprofit developments, but only about 11% of all national QCT projects were in the West. Over 30% of QCT developments were developed by nonprofits in both the Northeast and Midwest and only 18% in the South. The largest share of QCT projects were in the Midwest and Northeast. The uneven capacity across the country for LIHTC development may also be illustrated by these findings.

**Table 4. Nonprofit Sponsors and Inner-City LIHTC Development by Census Region**

|           | Number of For-Profit Developments | For-Profit as % | Number of Nonprofit Developments | Nonprofit as % | Total Number of Developments |
|-----------|-----------------------------------|-----------------|----------------------------------|----------------|------------------------------|
| Northeast | 707                               | 69.11           | 316                              | 30.89          | 1,023                        |
| Midwest   | 670                               | 63.57           | 384                              | 36.43          | 1,054                        |
| South     | 742                               | 81.99           | 163                              | 18.01          | 905                          |
| West      | 159                               | 42.51           | 215                              | 57.49          | 374                          |
| Total     | 2,278                             | 67.88           | 1,078                            | 32.12          | 3,356                        |

While the data indicate that nonprofit housing sponsors have made a strong contribution to inner-city revitalization efforts through production of affordable rental housing with the LIHTC, they also indicate that more than 67% of the LIHTC housing developed in inner-cities was sponsored by for-profit organizations. Given that nonprofits are more likely to have missions allied with the social context of inner-city revitalization, it is somewhat surprising that a large majority of LIHTC development in revitalization areas has been produced by for-profits. Further, there are differences across regions that indicate that nonprofits are not looked to for development of LIHTC housing or do not have the capacity to undertake such projects in some areas. The LIHTC program may present the opportunity to build such capacity and bring developers to inner-city development with a continuing stake in the area.

### Conclusion and Recommendations

The LIHTC program has played an important role in the construction of new multifamily housing in inner-city neighborhoods since its creation in 1986. However, the complexity of the program, compliance monitoring requirements, risk of an unsuccessful application, the costs entailed in completing an application, and the time involved in working through the process serve to limit the number of developers with the capacity to participate. Developers require substantial

resources and staying power, as well as experience with the program, to be successful in the highly competitive statewide arenas for LIHTC resources. As such, the potential for smaller local developers—especially nonprofits, which may be more engaged and sensitive to the needs of inner-city communities—are limited in their ability to participate.

Capacity building, additional points in the application process, expedited reviews, long-term affordability commitments, and other vehicles might expand participation and further the ability to use the LIHTC program to reach community revitalization goals. State Qualified Allocation Plans that provide a project selection incentive for nonprofit organizations or small, community-based for-profit groups working in partnership with experienced for-profit LIHTC developers is one means through which locally based inner-city development may be fostered. Under such an arrangement, the application for LIHTC resources may receive priority under a nonprofit or other set aside, as well as score additional competitive points for ownership make up.

Some pitfalls may exist in such an arrangement, however. Grassroots organizations—whether nonprofit or for-profit—have the potential to be exploited by larger firms that understand how to work the LIHTC system to their advantage. States seeking to foster capacity building through partnerships between nonprofit or small for-profit groups and larger, experienced developers can increase the potential for successful partnership outcomes by providing clearly written guidelines on how such partnerships are to be managed and how the experienced developer will help the smaller, less-experienced partner build capacity for future endeavors. Finally, state and local governments can expand the pool of potential inner-city nonprofit developers through pre-development loans that provide financial assistance with costs associated with the lengthy LIHTC application process.

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