Policy Briefs

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Low-Income Housing Tax Credit **Qualified Census Tracts**

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Abstract

The Qualified Census Tract (QCT) provision of the Low-Income Housing Tax Credit statute encourages private developers to build low-income housing in low-income and high-poverty areas. This article discusses the legislative history of the QCT provision, explains the current designation methodology, and introduces several research issues concerning QCTs.

Introduction

The U.S. Department of Housing and Urban Development (HUD) designates Qualified Census Tracts (QCTs) for the Low-Income Housing Tax Credit (LIHTC) Program, which was created by the Tax Relief Act of 1986 as an incentive to increase the availability of low-income housing. LIHTC projects located in QCTs are eligible for up to 30 percent more tax credits than identical projects not in QCTs, which provides a strong incentive to locate projects funded with tax credits in the lowest income areas. As defined in Section 42 of the Internal Revenue Code, QCTs are areas where 50 percent or more of the households have incomes below 60 percent of the area median income

(AMI), or where the poverty rate is 25 percent or higher. Further, the statute restricts the total population of designated QCTs to 20 percent of area population.[1, 2]

The success of the LIHTC Program and the intuitive nature of the designation criteria have limited discussion on how QCTs are designated and their general effect within the LIHTC Program; however, the tax credit program and the households it aims to serve could greatly benefit from introspective research. This policy brief discusses the legislative history of the QCT provision and the current designation methodology before discussing research issues concerning QCTs.

Legislative History of the QCT

The Tax Relief Act of 1986, which created the LIHTC Program, did not include the bonus for projects in QCTs. QCTs and the similar concept of difficult development areas (DDAs) were added by amendments to the tax code in the Omnibus Budget Reconciliation Act of 1989. QCTs likely were intended to provide additional incentives for the rehabilitation or replacement of substandard rental housing in low-income areas. QCTs originally were defined using only the income criterion described above (that is, in areas where 50 percent or more of the households have incomes below 60 percent of AMI subject to the 20-percent population cap). In 2000, Congress passed the Community Renewal Tax Relief Act, which added the poverty-rate criterion. Any tract with a poverty rate of at least 25 percent became eligible for QCT status. The new poverty-rate criterion, which was first applied to the QCTs effective January 1, 2002 (*Federal Register,* 2001), increased the number of designated tracts from approximately 7,700 in 2001 to more than 9,900 in 2002. In practical terms, this change substantially expanded the number of sites eligible for higher levels of subsidy.

QCT Designation Methodology

Qualified Census Tracts are designated periodically as new decennial census data become available or as metropolitan area definitions change. The most recent update of QCTs, effective January 1, 2007 (*Federal Register,* 2006), reflects the recent change to 2000 Census-based metropolitan area definitions (OMB Bulletin, 2003) and the availability of new, more detailed 2000 Census income distribution tables. HUD obtained a special tabulation of 2000 Census household income data at the census-tract level that was more highly detailed than that published by the Census Bureau for general public use. HUD used these new data to more accurately determine the eligibility of census tracts for QCT designation. The current designation of QCTs also uses the new Office of Management and Budget (OMB) metropolitan area definitions without modification to evaluate how many census tracts can be designated under the population cap, but it uses the HUD-modified definitions and their associated AMIs for determining QCT eligibility.

[1] The reference area is the entire metropolitan area, as defined by the Office of Management and Budget, for urban tracts or the sum of nonmetropolitan counties in a state for rural tracts.

[2] In addition to playing an integral role in the Low-Income Housing Tax Credit (LIHTC) Program, the Small Business Reauthorization Act of 1997 created the Historically Underutilized Business Zone (HUBZone) Empowerment Contracting program to encourage development in economically distressed areas by providing more access to federal contracting opportunities. A business that is located in a HUBZone and that has at least 35 percent of its employees residing in the HUBZone is eligible for federal contracting preferences. By statute, a tract with Qualified Census Tract (QCT) status also receives HUBZone designation. Although only currently designated tracts are eligible for the boost in tax credits in the LIHTC Program, Congress engineered, for the HUBZone program, a series of grandfathering amendments so that the loss of QCT status does not affect a tract's continuing eligibility for HUBZone status.

HUD uses the HUD metro fair market rent area (HMFA)[3]-level area median gross incomes (AMGIs) to determine QCT eligibility because the QCT statute refers to the same section of the Internal Revenue Code that defines income for purposes of tenant eligibility and unit maximum rent.[4] According to Section 42, QCTs are determined as follows:

1. To be eligible for designation as a QCT, a census tract must have at least 50 percent of its households with incomes below 60 percent of the AMGI or have a poverty rate of 25 percent or more. In metropolitan areas, HUD calculates 60 percent of AMGI by multiplying by a factor of 0.6 the HMFA median family income for 1999, as estimated by HUD from 2000 Census data. Outside metropolitan areas, HUD calculates 60 percent of AMGI by multiplying by a factor of 0.6 the state-specific, nonmetropolitan balance median family income for 1999, as estimated by HUD.

2. For each census tract, the percentage of households below the 60-percent income standard (income criterion) was determined by (a) calculating the average household size of the census tract, (b) applying the income standard after adjusting it to match the average household size,[5] and (c) calculating the number of households with incomes below the income standard using a special tabulation of household income data from the 2000 Census that provides more detail than the data on household income distribution publicly released by the Census Bureau.

3. For each census tract, the poverty rate was determined by dividing the population with incomes below the poverty line by the population for whom poverty status has been determined.

4. QCTs are those census tracts in which 50 percent or more of the households meet the income criterion or in which 25 percent or more of the population is in poverty, such that the population of all census tracts that satisfy either one or both of these criteria does not exceed 20 percent of the total population of the respective area.

5. In areas where more than 20 percent of the population resides in eligible census tracts, census tracts are designated as QCTs in accordance with the following procedure:

    a. Eligible tracts are placed in one of two groups. The first group includes tracts that satisfy both the income and poverty criteria for QCTs. The second group includes tracts that satisfy either the income criterion or the poverty rate criterion, but not both.

[3] HUD metro fair market rent areas are entire Core Based Statistical Area (CBSA) metropolitan areas or subareas of CBSAs established to set fair market rents (FMRs) and income limits. See "Final Fair Market Rents for the Housing Choice Voucher Program and Moderate Rehabilitation Single Room Occupancy Program for Fiscal Year 2007": http://www.huduser.org/datasets/fmr/fmr2007f/FY2007F_FR_Preamble.pdf.

[4] By rule, the Internal Revenue Service sets these income limits according to HUD's very low-income limits, which in fiscal year 2006 and thereafter are established at the HUD metro fair market rent areas level. HUD uses the entire metropolitan statistical area (MSA), however, to determine how many eligible tracts can be designated under the 20-percent population cap because the statute states that MSAs should be treated as singular areas for this purpose.

[5] The tract average-household-size-adjusted income limit (TAHSAIL) is calculated by multiplying 60 percent of the area median gross income (AMGI60PC) by an adjustment of -10 percent for every person less than 4, and +8 percent for every person more than 4, with a minimum of 1 person per household and a maximum of 8. Thus, if tract average household size is 1, then TAHSAIL = 0.70 * AMGI60PC; if tract average household size is 2.5, then TAHSAIL = 0.85 * AMGI60PC; if tract average household size is 4, then TAHSAIL = 1.00 * AMGI60PC; and if tract average household size is 8, then TAHSAIL = 1.32 * AMGI60PC.

b. Tracts in the first group are ranked from lowest to highest on the income criterion. Then, tracts in the first group are ranked from lowest to highest on the poverty rate criterion. The two ranks are averaged to yield a combined rank. The tracts are then sorted on the combined rank, with the census tract with the highest combined rank placed at the top of the sorted list. If two or more tracts tie, more populous tracts are ranked above less populous ones.

c. Tracts in the second group are ranked from lowest to highest on the income criterion. Then, tracts in the second group are ranked from lowest to highest on the poverty rate criterion. The two ranks are then averaged to yield a combined rank. The tracts are then sorted on the combined rank, with the census tract with the highest combined rank placed at the top of the sorted list. If two or more tracts tie, more populous tracts are ranked above less populous ones.

d. The ranked first group is stacked on top of the ranked second group to yield a single, concatenated, ranked list of eligible census tracts.

e. Working down the single, concatenated, ranked list of eligible tracts, census tracts are designated until the designation of an additional tract would cause the 20-percent limit to be exceeded. If a census tract is not designated because doing so would raise the percentage above 20 percent, subsequent census tracts are then considered to determine if one or more census tracts with smaller populations could be designated without exceeding the 20-percent limit.

Practical Issues in QCT Designation

As mentioned earlier, Congress has acted to increase QCT eligibility only once, adding the poverty rate criterion in 1989. Changes that increase tract eligibility have no effect on the overall allocation of tax credits that each state receives,[6] but the changes do provide more choices of locations where the additional incentives are available for locating housing within low-income or high-poverty areas, or both. Under the current designation rules, developers continue to face two impediments to using the higher subsidy level to build low-income housing within low-income or high-poverty communities: (1) neighborhoods that straddle two census tracts and (2) the 20-percent population cap.

The Census Bureau defines tract boundaries using major natural and manmade geographic features such as roads, rail lines, rivers, and shorelines. Frequently, the neighborhoods centered on major thoroughfares are split by census tract boundaries, with one side of the street being in a QCT and the other side not. Current law allows the increase in basis to apply only to LIHTC-financed buildings located entirely within the boundaries of the census tracts designated by HUD as QCTs, even though the neighborhoods immediately adjacent to the boundaries of the QCTs may be indistinguishable from those within the QCT. In addition, properties where LIHTC projects are to be developed occasionally straddle QCT boundaries. This straddling can limit the size or location of LIHTC

[6] Increases in the number of designated Qualified Census Tracts (QCTs) may not be entirely revenue neutral. Some tax credits are issued automatically to affordable rental housing projects financed with tax-exempt private activity bonds under Section 142 of the Internal Revenue Code. Because private activity bond issuances are subject to annual volume caps, the low-income housing tax credit (LIHTC) associated with bond-financed rental housing is not subject to the annual state allocation caps on LIHTC. Therefore, if, as a result of an increase in QCTs, more bond-financed projects are done in QCTs with an associated increase in LIHTC issued, revenue collected by the U.S. Treasury will be reduced.

projects because developers must choose between either accepting a lower eligible basis by locating part of a project outside of a QCT or relocating to a different site, if one exists, in the eligible tract. Although a site straddling tract boundaries may be more desirable, and sometimes is the only option available, the loss in basis and tax credits may render the project financially infeasible.[7]

The population cap imposed in the LIHTC statute poses a larger restriction and a fundamental fairness issue. The QCT eligibility requirements limit the portion of each metropolitan area or nonmetropolitan balance within a state that may be designated as a QCT. Specifically, no more than 20 percent of the total population in each metropolitan area and nonmetropolitan part of each state may be designated QCTs; thus, only 88 percent of eligible tracts are currently designated QCTs. This limitation has a disproportionate effect across areas. In some metropolitan areas, all eligible tracts can be designated, even those that minimally satisfy the eligibility criteria; in other areas, eligible tracts with higher poverty rates or higher percentages of households with incomes below 60 percent of AMI, or both, cannot be designated. In census tracts affected by the cap, this restriction may reduce the capacity to finance affordable housing.

Research Issues

Despite the use of the QCT designation in the LIHTC Program for almost 20 years, research on the effect of designated census tracts in the program is lacking. The following three research questions regarding Qualified Census Tracts and the market for low-income housing warrant attention. The first two questions address whether QCTs reach the households and communities intended; the third question examines the effect on the households served.

1. *Are eligible tracts not designated because of the population cap underserved by the LIHTC?* In 2007, more than 1,500 tracts that qualified under the income or poverty rate criterion, or both, were not designated QCTs because of the 20-percent population cap. Many of these tracts far exceeded the eligibility thresholds. For example, almost 300 eligible but undesignated tracts exceeded the minimum thresholds for both the income and poverty rate criteria. Further, more than 500 eligible but undesignated tracts had a poverty rate greater than 35 percent, and more than 100 eligible but undesignated tracts had at least 65 percent of households with incomes below 60 percent of AMI; both of these levels far exceed the minimum thresholds. Thus, these tracts often have a higher poverty rate or a higher percentage of low-income households than designated tracts in other metropolitan or nonmetropolitan areas, but they do not qualify simply because their metropolitan area or nonmetropolitan region has a relatively high percentage of its population residing in tracts characterized by low incomes or high poverty rates, or both. When considering projects located in low-income, high-poverty rate tracts, do developers respond to the QCT incentive and primarily locate LIHTC projects in designated tracts, or do these undesignated, yet eligible tracts receive a similar level of LIHTC investment?

[7] This loss could be cured legislatively by allowing low-income housing tax credit-financed buildings on properties adjacent to a Qualified Census Tract (QCT) to be eligible for the increase in basis, which currently is afforded buildings located entirely within QCTs.

2. *Are QCTs the areas of greatest need for affordable housing?* Qualified Census Tracts have been a key component of the LIHTC Program since 1990. Their purpose is to provide additional incentive in directing private investment to areas with the greatest need for affordable rental housing. Congress defined these areas, as discussed earlier, by the income and poverty rate criteria. An area with a large percentage of low-income households relative to its metropolitan area or its nonmetropolitan region, or with a poverty rate exceeding 25 percent, is deemed as needing additional subsidy for rehabilitation or new construction of low-income housing. Research is lacking to support this presumed need or examine alternative measures. These criteria have the important characteristics of (a) being intuitive; that is, low-income residents need affordable housing, and these areas have the highest percentage of low-income residents; and (b) relying on readily available, uniform data covering the entire country at the census tract level. These criteria are strictly indicators of demand, however, and they do not incorporate supply-side measures. Because neither existing housing supply nor affordability are taken into consideration in the designation process, it is unclear if other, undesignated areas, which may have slightly higher income levels but a lower stock of affordable rental housing, might not have a greater need for low-income housing subsidy.
3. *What is the effect of directing additional low-income housing to the poorest areas, particularly within metropolitan areas?* The additional incentive to locate low-income housing into already low-income areas may have the perverse and self-reinforcing effect of concentrating low-income households in the lowest income and highest poverty neighborhoods, rather than providing low-income housing throughout a larger area. This effect is particularly important in urban areas, where metropolitan economies are continuing to experience a geographic expansion into the suburbs. Existing research has documented so-called "flight from blight," where businesses follow high-income households to the suburbs, leaving a pocket of poverty in inner cities without access to the newly relocated jobs. Quite often, low-income households depend on public transportation, which does not provide convenient access to suburban employers, if at all. Does providing additional subsidy for locating low-income housing to already low-income and high-poverty areas limit the ability of these households to obtain new employment or, more generally, to pull themselves out of poverty? Do QCTs help revitalize neighborhoods or accelerate their decline by artificially encouraging the concentration of poverty?

Conclusion

The 30-percent boost in LIHTCs associated with QCTs has helped finance more than one-fourth of all LIHTC projects and approximately one-third of projects in recent years. In 2004, the latest year for which data are available, 34.2 percent of LIHTC projects and 40.5 percent of LIHTC units were located in a QCT.

Researchers can help improve our understanding of the effects of the LIHTC, the largest affordable housing production subsidy in the United States, by more closely examining this facet of the program.

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Additional Reading

To further investigate Qualified Census Tracts (QCTs), researchers can access useful information at the following three websites:

- HUD's QCT website: http://www.huduser.org/datasets/qct.html.
- QCT designation data (including detailed income distribution tables at the tract level) website: http://qct.huduser.org/tables/data_request.odb.
- HUD's low-income housing tax credit database: http://lihtc.huduser.org.