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Using Tax Exempt Bonds For RAD Transactions

Opportunities and Challenges

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4% LIHTC Bonds

- If at least 50% of the eligible basis of a multifamily housing project (new construction or rehab) is financed with exempt facility bonds meeting the requirements we will discuss hereafter, and which receive an allocation of volume cap pursuant to Section 146 of the Code, then the project qualifies for 4% tax credits.
- The availability of 4% credits is limited to the extent of the availability of volume cap.
- This is considered an "of-right" type of credit.

4% LIHTC Bonds Cont'd

- There is no ceiling or limited pool of 4% tax credits for partnerships using tax-exempt bonds to finance their projects. However, even though there is no specific limit for the amount of 4% credits a state can allocate, the 4% tax credits are ***not*** "unlimited." The total amount of 4% tax credits available is limited by the amount of volume cap allocated to LIHTC projects;
- Private activity bond volume cap is allocated to each state via a federal formula based on population;
- States are free to formulate their own rules about how to allocate that volume cap to projects within the state.

4% LIHTC Bonds Cont'd

- In order for a non-governmental entity to finance an eligible project using volume cap tax-exempt bonds, the entity needs a governmental unit to issue the bonds on its behalf. So, the partnership approaches a potential **Issuer** (often a state housing finance agency) to petition the **state** authority to issue a portion of the state's volume cap of Private Activity Bonds.

4% LIHTC Bonds Cont'd

- Section 142(d)(1) of the Code provides that the term "qualified residential rental project" means any project for residential rental property if, at all times during the "qualified project period," such project meets the requirements under Section 142(d)(1)(A) or (B), which are commonly known as the "set-aside requirements."

4% LIHTC Bonds Cont'd

- "Set aside requirements" are commonly known as the 20/50 test or the 40/60 test.
- Sections 142(d)(1)(A) requires that 20 percent or more of the residential units in a project be occupied by individuals or families whose income is 50 percent or less of area median gross income*.
- Section 142(d)(1)(B) requires that 40 percent (25 percent for New York City projects) or more of the residential units in a project be occupied by individuals or families whose income is 60 percent or less of area median gross income*.

*Area median gross income is determined by HUD on an annual basis

4% LIHTC Bonds Cont'd

- "Qualified Project Period" means the period beginning on the first day on which 10 percent of the residential units in a project are occupied and ending on the latest of:
  - the date that is 15 years after the date on which 50 percent of the residential units in the project are occupied;
  - the first day on which no tax-exempt private activity bond issued with respect to the project is outstanding; or
  - the date on which any assistance provided with respect to the project under Section 8 of the United States Housing Act of 1937 terminates.
- If the issue date of any 4% LIHTC Bonds issued to finance a qualified residential rental project occurs after the first day on which at least 10 percent of the residential units in the project are occupied, then the qualified project period begins on the issue date of the bonds.

4% LIHTC Bonds Cont'd

- 4% LIHTC Bonds will be exempt from federal income taxation if 95% or more of the "net proceeds" of the bonds is used to provide exempt facilities and facilities to be used by an exempt person, including property functionally related and subordinate thereto.
- This is the so-called "95/5" or "good costs/bad costs" test.

4% LIHTC Bonds Cont'd

- "Net proceeds" means the proceeds of the issue (net of any discount but including premium) minus any proceeds deposited into a reasonably required reserve or replacement fund, plus earnings.
- Good costs are generally capital costs of the project. These include land (with some restrictions) and building acquisition, hard costs of construction/rehabilitation and various soft costs that are considered capitalizable to the project. A knowledgeable accounting firm with experience in multifamily housing transactions can be very helpful in determining which project costs are good costs for tax-exempt bond purposes.
- Costs of issuance for the 4% LIHTC Bonds are not capitalizable costs of the project and will be included in the 5% bad costs component of the 95/5 test. Costs of issuance paid with bond proceeds cannot exceed 2% of the bond proceeds.

4% LIHTC Bonds Cont'd

- RAD deals often have seller notes or other features that can complicate the good cost/bad cost analysis. Work with your team early on these issues.

4% LIHTC Bonds Cont'd

- In the case of an acquisition/rehab project, if the property has been used previously, an amount equal to at least 15% of the total costs of the acquisition of any building (and equipment therefor) financed with 4% bond proceeds must be spent on rehabilitation of the project.
- These rehabilitation expenditures must be chargeable to the capital account of the building.
- For projects containing more than one building, this 15% rehabilitation requirement applies to each building.

Qualified 501(c)(3) Bonds

There are many legitimate reasons for a public housing authority ("Authority") to form a separate nonprofit corporation ("Nonprofit"). One of the most significant reasons is to help shield the Authority's assets from potential liability when the Authority engages in a special project. For example, an Authority developing a new low income housing project may form a Nonprofit to provide an additional layer of protection for the Authority's assets in case the new project fails or triggers substantial liabilities.

An Authority that forms a Nonprofit must carefully comply with the applicable tax rules. The Authority should organize its Nonprofit as a Nonprofit entity under state law, but this will not automatically exempt the Nonprofit from federal or state income taxation. The Nonprofit must also apply to the Internal Revenue Service ("IRS") to request a determination that it is exempt from federal income taxes. Additionally, the Nonprofit may also be able to apply for state tax exemption.

Qualified 501(c)(3) Bonds Cont'd

- Section 501(c)(3) of the Code provides that certain types of organizations shall enjoy tax-exempt status so long as they are organized and operated exclusively for, religious, charitable, scientific, literary or educational purposes.
- Providing rental housing may be deemed "charitable" under certain conditions, including when such housing is designed to meet the needs of the elderly or the poor and distressed.
- In order to provide housing for the distressed and poor, the charitable organization typically must comply with Revenue Procedure 93-32 which requires:

Qualified 501(c)(3) Bonds Cont'd

- In order to provide housing for the distressed and poor, the charitable organization typically must comply with Revenue Procedure 93-32 which requires:
  - at least 75% of the units must be occupied by residents with incomes below 80% of median income (with adjustments for family size);
  - at least 20% of the units must be occupied by residents with incomes below 50% of median or at least 40% of the units must be occupied by residents with incomes below 60% of median income (with these limitations adjusted for family size);
  - the housing must be "affordable" to the tenants described in (a) and (b) as evidenced by rents set at levels not in excess of government imposed restrictions and other policies providing relief for the poor and distressed; and
  - the remaining 25% of the units can be rented without regard to tenant income.

Process (Inducement)

- The first step in any multifamily bond transaction is typically the adoption of an inducement resolution.
- In a 4% LIHTC Bond transaction, this step must be undertaken by the Issuer. In a 501(c)(3) transaction, the adoption may be done by the Issuer or the Borrower.
- Inducement relates to the ability of the Borrower to use the proceeds of tax-exempt bonds to reimburse itself for expenditures made prior to the date of issuance of the bonds.

Process (Inducement), Cont'd

- In order to be eligible for reimbursement, among other things an expenditure must have been incurred (paid) no earlier than 60 days prior to the date on which the bond issuer (or Borrower in the case of a qualified 501(c)(3) bonds) declares its intent to reimburse the expenditure with the proceeds of tax-exempt bonds.
- Inducement resolutions can take many forms but each must contain (i) a general description of the project (for example, "a 100-unit residential rental facility in Atlanta, Georgia,"), and (ii) the maximum principal amount of the bonds expected to be issued for the project.

Process (Inducement), Cont'd

- In addition, the expression of official intent must be reasonable, that is, it should not grossly overstate the amount reasonably expected to be needed to finance the project and should not be made for extremely speculative projects that are unlikely to be undertaken at all.
- There are exceptions to the reimbursement rules. For example costs of issuance and certain "preliminary expenditures" (architectural, engineering, surveying, soil testing, etc.) not in excess of 20% of the issue price of the bonds may be reimbursed absent a valid declaration of official intent.

Process (TEFRA Approval)

- A further administrative step that must be undertaken with respect to all private activity bonds issued to finance multifamily housing (all types except governmental bonds) is the TEFRA Hearing.

- The Tax Equity and Fiscal Responsibility Act of 1982 added requirements to the tax code requiring that all private activity bonds be approved by the applicable elected representative of both the governmental unit that issues the bond and each governmental unit having jurisdiction over the area in which the facility to be financed with the proceeds of the bonds is located.

Process (TEFRA Approval), Cont'd

- Approval must be granted after a public hearing following reasonable public notice describing the bonds to be issued and the project to be financed.
- Highest elected official must approve:
  - Mayor/City Council/County Commissioners
  - Governor
  - State Attorney General

Process (TEFRA Approval), Cont'd

- Reasonable public notice is generally described as published notice that is reasonably designed to inform residents of the affected governmental units of the proposed issue. Notice is presumed reasonable if:
  - it is published no fewer than seven (7) days before the hearing;
  - given in the same manner and locations required by the governmental unit under state law for notice of public meetings;
  - published in one or more newspapers of general circulation;
  - New rules allow website posting but many issuers have not yet adopted rules for complying with this notification method.

Process
(TEFRA Approval), Cont'd

- To be valid, a TEFRA notice must contain:
  - a general, functional description of the type and use of the facility to be financed;
  - the maximum aggregate amount of the obligations to be issued for each "project;"
  - the initial owner, operator or manager of the facility
  - the location (or prospective location) of the facility by a general description designed to inform readers of the project's location.

Process
(TEFRA Approval), Cont'd

- In general, the bonds must be issued within one-year of the receipt of the "public approval."

Publicly Offered vs. Privately Placed Bonds

- Public offering
  - Requires bond underwriter
  - Subject to Rule 15c2-12 (disclosure)
  - Often greater upfront cost
  - May be less flexibility in timing of closing
  - Often lower rates than direct purchase

Publicly Offered vs. Privately Placed Bonds

- Private Placement
  - Fewer parties (negotiating directly with bond purchaser)
  - May more flexibility in terms of timing
  - May be more (OR less!) flexibility in terms
  - May be lower upfront cost
  - May be higher rates

Thank You

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