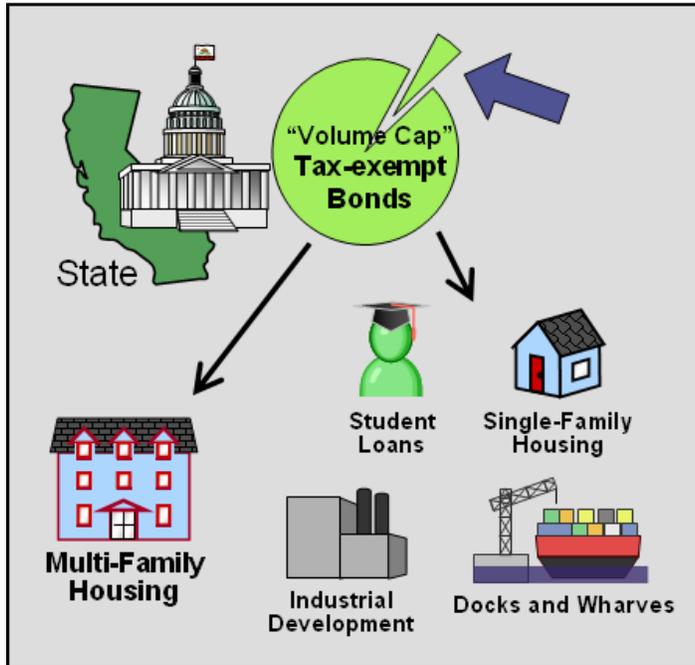


Tax-Exempt Housing Bond Basics

This handout contains excerpts from the LIHTC Basics workshop presented by Novogradac & Company LLP. Contact **Wayne Michael** at wayne.michael@novoco.com, or 415.356.8073 for details on conducting an on-site workshop at your office.

Some background on tax-exempt bonds



States and local governments often finance public projects (like roads, prisons, schools, etc.) through the issuance of tax-exempt bonds—"tax exempt" because the bond purchasers do not have to pay taxes on interest payments received. Interest payments from bonds issued by private organizations for private activities, however, are generally taxable to bond purchasers. Bond purchasers are generally willing to accept lower interest payments for tax-exempt bonds because of the tax savings.

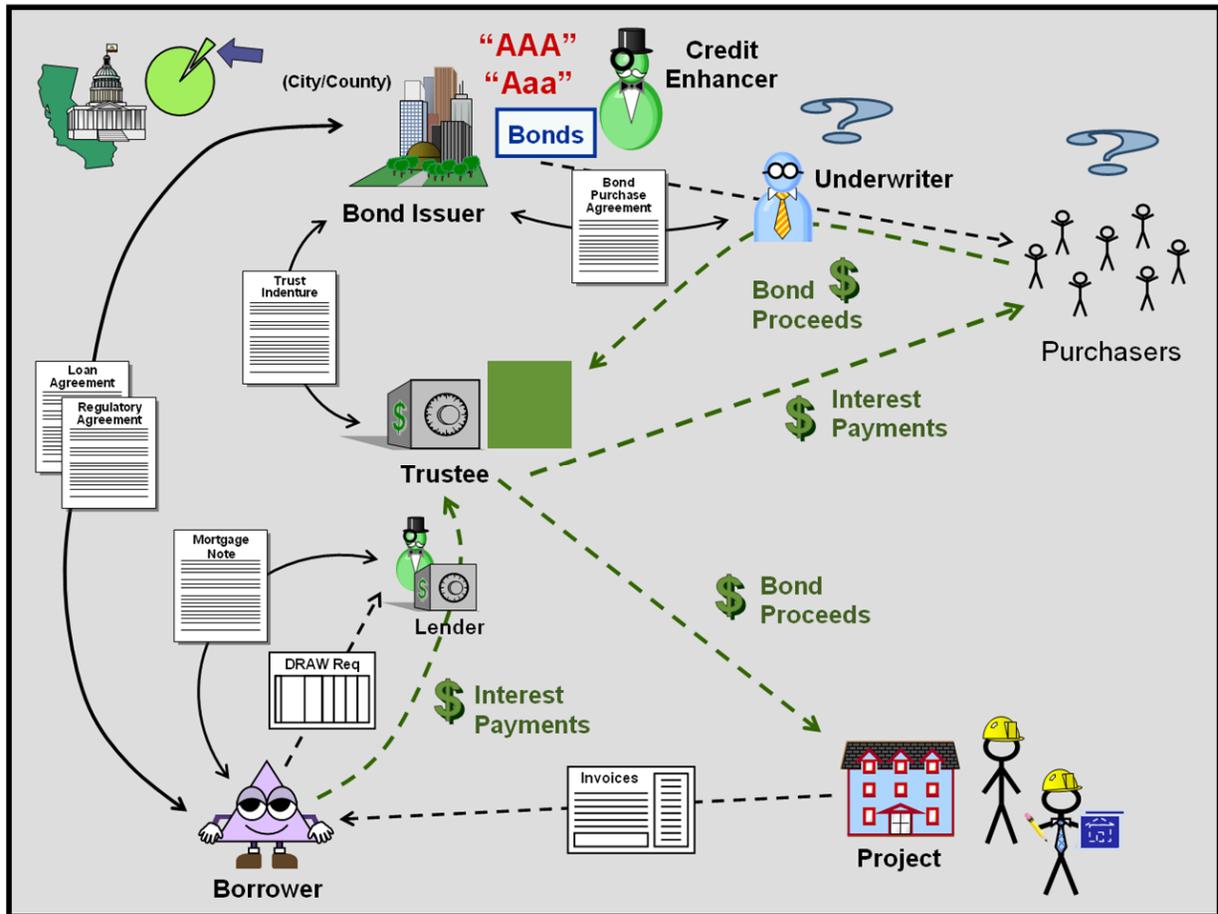
To promote *certain private activities* (which are deemed to benefit the public), each state is also authorized to allow the issuance of a set amount of **private activity "volume cap" tax-exempt bonds**

(under IRC §142(d)). The tax-exempt nature of the bonds makes them potentially as attractive to bond purchasers as bonds issued for public projects. Volume cap bonds can be allocated to finance multifamily housing projects, single-family housing, student loans, industrial development and other areas. In 2009, the amount of volume cap for each state is the greater of **\$90 per capita or \$273,270,000**.

Projects that are financed (whether new construction or acquisition/rehab) in part by federal subsidies (i.e. volume cap bonds) **are eligible for 4% tax credits only**. Since the interest earned by the bondholders is tax exempt, the interest rate *paid* by the partnership is lower than non-tax-exempt bonds or conventional construction loans. Lower interest rates result in a higher loan amount as well. Projects financed by these tax-exempt bonds cannot be rewarded with lower interest payments AND 9% credits (which would be the best of both worlds), so they are simply ineligible for 9% credits.

There is no "limited pool" for the 4% tax credit as there is for the 9% credits. To obtain 4% tax credits, a partnership must first apply for an allocation of private activity bonds, which if received, leads to a non-competitive application process for the 4% tax credits.

Bonds: The big picture



When an operating partnership (the **Borrower**) needs to finance a LIHTC project using volume cap tax-exempt bonds, the partnership needs another entity to issue the bonds on its behalf. So, the partnership approaches a potential **Issuer** (typically a city, or a county, or a housing authority) to petition the **state** authority to issue a portion of the state's volume cap of Private Activity Bonds. A **Regulatory Agreement** between the Borrower and the Issuer establishes the Borrower's responsibilities regarding the **rent and income** restrictions and other aspects of leasing the apartment units.

The **Purchasers** of the bonds are typically individuals or entities who simply want to make a good return on their investment. They know nothing about the financial stability of the Borrower (or even who the Borrower is, for that matter).

Executing a **bond purchase agreement** with the Issuer, the **Underwriter** markets the bonds to potential Purchasers and acts as a "middleman" between Purchasers and the other parties. The Underwriter will typically even advise the Borrower on selecting the appropriate Issuer and on the process for obtaining the volume cap bonds in the first place.

Since no one is going to purchase the bonds based on the financial security of the Borrower, a financial institution with a superior credit rating ("AAA" or "Aaa") steps in as a **Credit Enhancer** to guarantee that the Purchasers will receive a return of their capital as well as **timely interest payments**.

Confident in the AAA or Aaa rating attached to the bonds, the Purchasers buy the bonds through the Underwriter. The **bond proceeds** do NOT go directly to the Borrower, Issuer, or Underwriter but instead to a **Trustee**, where they are “held in trust” according to the provisions of a **trust indenture**, an agreement between the Trustee and the Issuer which outlines the terms for repayment of proceeds.

The Borrower enters into a **mortgage note** with a lender affiliated with the Credit Enhancer. If the Borrower defaults on the loan, the Credit Enhancer has claim to the project since the Credit Enhancer is still obligated to pay the Purchasers.

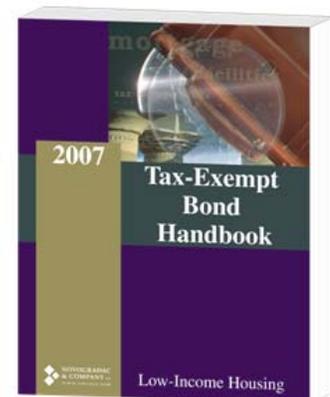
Contractors and other service providers periodically submit **invoices** to the Borrower. Typically monthly, the Borrower aggregates the invoices, attaching them to a **draw requisition** for funds to be released to the service providers. As months pass, the proceeds are slowly depleted and eventually the Project is completed. During this time, the Borrower continues to pay interest on the full value of the loan and will, at some point, be required to pay back the principal.

The Underwriter, Credit Enhancer, and Trustee—and each entity’s respective **legal counsel**—all work for a fee. The participation of so many fee-earning parties makes financing costs of tax-exempt bond deals incredibly high.

The **2008 Housing and Economic Recovery Act** (the “2008 Housing Act”) contains a provision that should help stretch the bond cap: recycling previously issued bonds. Before the **2008 Housing Act**, if volume cap bonds were paid off quickly and subsequently reissued, the reissuing of the bonds “counted” as new bonds against the state’s bond cap. Under the new law, however, a **reissued bond will NOT count against the state’s volume cap** as long as 1) it is reissued within six months after the original bond was refunded, 2) the reissuance is within four years of the original issuance, and 3) the reissued bond matures within 34 years of the original issuance.

Bond interest and AMT

Although the interest on volume cap bonds is *tax-exempt* to the bond purchasers receiving those interest payments, up until July 30, 2008, that interest was still subject to the Alternative Minimum Tax (AMT). For any taxpayer subject to AMT, volume cap bonds would have been less attractive than other income sources not subject to AMT. ***As part of the 2008 Housing Act, tax-exempt housing bond interest income received from tax-exempt bonds issued after July 30, 2008 is no longer subject to AMT.***



How 4% credits differ from 9% credits

Each LIHTC project will fall into either the 9% category or the 4% category depending upon how the project is financed (9% = conventional construction loan, which converts to a permanent loan after construction is finalized; 4% = tax-exempt bonds).

The 9% and 4% categories are further divided by the *construction method* of the project—constructing the project from the ground up **OR** acquiring an existing project and rehabilitating it (rehabilitation must be completed within 24 months to be eligible for tax credits).

NOTE: The IRS treats the acquisition costs and rehabilitation costs as separate “buildings” for tax credit purposes. Details of this treatment will be explained for fully in the LIHTC Calculation portion of this handout.

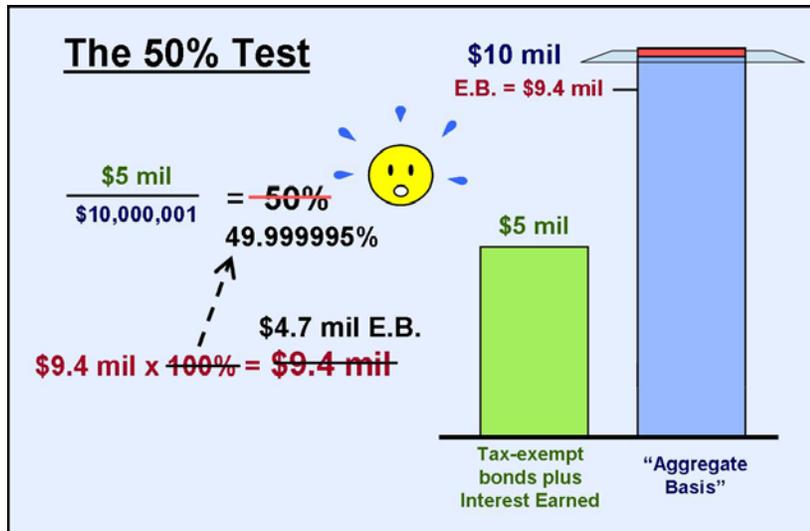
		Construction Method	
		New Construction	Acquisition/ Rehabilitation
Financing Method	Non-Federally Subsidized (Perm Loan)	9% credits	Acq – 4% Rehab – 9%
	Federally Subsidized (TE bonds)	4% credits	Acq – 4% Rehab – 4%

Projects financed with a conventional construction loan (normal interest rate; from a conventional lender; not “*federally subsidized*”) are eligible for 9% credits. However, acquisition costs of an existing project are eligible only for 4% credits. *The higher credit percentage for rehabilitating the project rewards the partnership for improving a project and not merely acquiring it.*

There are a limited amount of 9% tax credits made available to the state housing agencies each year as defined in the Internal Revenue Code. Since the total annual 9% credits are limited, they are called “competitive” credits. Each partnership wanting an allocation of 9% credits submits an application to the state housing agency. The state housing agency “reserves” a **piece of the total credit pie** (or “pool”) for partnerships with the best applications.

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 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 volume cap tax-exempt bonds allocated to LIHTC projects. The amount of 4% credits is effectively limited through what is called the **50% test**.

Bonds and the 50% test



At least 50% of the project's **aggregate basis** (basically land plus depreciable assets) must be financed by volume cap tax-exempt bonds plus interest earned on the bonds for the entire eligible basis of the project to be exempt from the state housing agency's competitive 9% tax credit allocation process (and, thereby be fully eligible to claim the 4% credits). *If, for example, only 49.999999% of the aggregate basis of a project is financed with volume cap tax-exempt bonds,*

then the project has failed the 50% test and only 49.999999% of the project's eligible basis is shielded from the strict competition of 9% credits (and only 49.999999% of the eligible basis can be used for calculation of 4% credits). This means, therefore, that 50.0000001% of the eligible basis is NOT shielded from the competitive allocation process. Ineligibility of 50.0000001% of otherwise eligible basis translates into a 50.0000001% forfeiture of 4% tax credits! (see IRC § 42(h)(4)(B).)

Additional bond rules

15% Rehab Requirement – Rehab must be 15% or more of that portion of the cost of buildings and fixtures financed with bonds.

Inducement Resolution – It is the first “official action” passed by the Issuer communicating intent to issue bonds for a specific activity. Any expenditures occurring earlier than 60 days prior to the Inducement Resolution cannot be reimbursed with the bond proceeds.

Cost of Issuance Limitation – No more than 2% of bond proceeds may be used to pay costs associated with issuing the bonds. Costs of issuance beyond 2% of the bond proceeds can be part of a bond-financed project, but those costs must be paid from other sources of funds.

Public Hearing or “TEFRA” Requirement – According to the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), the issuer of the bonds must communicate its intent to issue the bonds (and the purpose for issuing them) in a public hearing within two weeks after issuing the Inducement Resolution. The TEFRA hearing is typically part of a city/county council meeting or board meeting of the issuer. The public hearing requirement can open up “Not-in-my-back-yard” (NIMBY) issues from those in the community who may oppose construction of affordable housing.

Good Costs vs. Bad Costs - At least 95% of bond proceeds must be used to pay or reimburse “**Good Costs**”. Good Costs include land & depreciable costs for income tax purposes that are paid or incurred after the date of Inducement Resolution. “**Bad Costs**” include costs incurred prior to Inducement Resolution, intangible assets, bond issuance costs and underwriting, as well as loan origination fees amortized over the permanent loan period.

Attracting equity for 9% deals vs. 4% deals

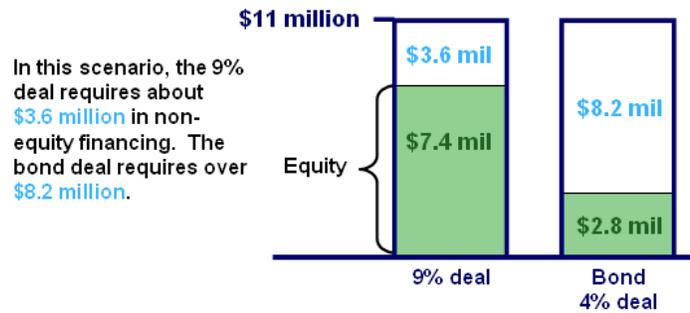
A major difference between a 9% deal and 4% deal is the 9% deal’s ability to generate more tax credits and, therefore, more equity.

Look at the following graphic to the right. In this example, we show two single-building projects each with a Qualified Basis of \$10 million. However, one is financed in-part with conventional debt (a 9% deal) and the other is financed in-part with tax-exempt bonds (a 4% deal).

Simply due to the differing tax credit percentages in our example (9.00% vs. 3.40%), the 9% deal will generate over 2.5 times the tax credits and will then attract over 2.5 times more equity.

Even though bonds will cover at least half of the project’s aggregate basis, there will still be a *financing gap* needing to be filled by other sources of funds.

Qualified Basis	10,000,000	10,000,000
x Applicable percentage	x 9.00%	x 3.40%
Annual tax credits	900,000	340,000
x Ten years	x 10	x 10
Total tax credits	9,000,000	3,400,000
x Limited Partner %	x 99.99%	x 99.99%
Limited Partner share	8,999,100	3,399,660
x Price per credit	x 0.82	x 0.82
Purchase price	7,379,262	2,787,721



(This chart shows some notable differences between 9% deals and 4% (bond) deals. Note the difference, for example, in *Financing Fees*.)

	“9%” Tax Credits	Bonds with “4%” Credits
Financing Fees	Low	High to very high
Interest Rates	Higher	Lower to very low
Rents	Lower (< 50% AMGI)	Higher (60% AMGI)
Financing Leverage	Low to very low	High
Amenity Costs	Higher (due to competitive application requirements)	Lower
Competition for Allocation/Reservation	Very high	Low

15 Steps to Putting a Bond Deal together

- 1) Find a potential property and run initial numbers for feasibility of the project
- 2) Put the team together:
 - Accountant
 - Equity Partner
 - Underwriter
 - Local Developer's Bond Counsel
 - Credit Enhancer
- 3) Issuer passes inducement resolution
- 4) Credit enhancement commitment
- 5) Private activity bond application submitted to Issuing Authority
- 6) Public notice of the project (2 weeks)
- 7) TEFRA hearing held
 - The Tax Equity and Fiscal Responsibility Act
- 8) Private activity bond application approved
 - Bond allocation awarded
- 9) Tax credit application submitted
- 10) Bond counsel drafts documents required for closing Bond Indenture
 - Loan agreement
 - Regulatory agreement
 - Underwriter-due diligence
 - POS preliminary official statement
 - Credit enhancer documents
 - Tax credit investor documents
 - Partnership agreement
- 11) Issuer passes bond resolution including the following:
 - Issuer's approval of TEFRA hearing
 - Private activity bond allocation
 - Credit enhancement commitment
 - Bond rating from agency
 - Preliminary official statement
- 12) Underwriter prices and contracts for selling the bonds
- 13) Bond purchase agreement
- 14) Bond Closing
- 15) Final Official Statement

Glossary

Arbitrage Yield Restriction – Arbitrage occurs when tax-exempt bond proceeds are invested in securities that yield a greater return than the interest charged on the bonds. Restrictions exist on the amount of arbitrage bonds can earn without putting the tax-exempt status of the bonds in peril. In instances where the restriction is violated, exceptions exist that allow for the tax-exempt status of the bonds to remain intact.

Bond Counsel – Attorney representing the bond issuer and bondholders. The attorney provides an opinion that the interest on the bonds is exempt from federal taxation. Responsible for the bond inducement resolution, bonds, the bond indenture, the financing agreement, the regulatory agreement and the tax opinion.

Bond Issuer – Governmental or Non-Profit entity responsible for issuing the bonds.

Credit Enhancer – For fee, guarantees that the bondholders will receive scheduled bond payments.

Indenture – An agreement between the bond issuer and the trustee containing the terms and procedures for payment of the bonds.

Inducement Resolution – A resolution passed by the bond issuer communicating the intent to issue bonds for a specific activity.

Official Statement – The marketing prospectus used by underwriters to sell the bonds. The official statement summarizes the terms of the bonds and other information relevant to the investment decision.

Rating Agency – Agencies that determine or “rate” the investment risk of the bonds. Examples include Standard & Poor’s and Moody’s Investor Services.

Regulatory Agreement – An agreement entered into between the borrower, the bond issuer and the trustee specifying the income rent and income restrictions a project owner must comply with for the bonds to retain their tax exempt status.

TEFRA Hearing – The bond issuer’s public notice, public hearing and approval by elected officials of a bond issuance.

Underwriter – An investment bank that underwrites and markets the bonds to investors.



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