USING TAX EXEMPT BONDS WITH HOUSING TAX CREDITS

IPED’s Learn the Basics: Housing Tax Credits 101
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OVERVIEW

WHY ARE WE TALKING ABOUT BONDS?

Construction Method

Financing Method

	New Construction	Acquisition/ Rehabilitation
Non-Federally Subsidized (Competitive Credits)	9% credits	Acq – 4% Rehab – 9%
Federally Subsidized (Tax Exempt bonds)	4% credits	Acq – 4% Rehab – 4%

WHAT ARE TAX-EXEMPT BONDS?

Section 103 of the Internal Revenue Code

- Interest Income is exempt from Federal tax
- Interest Income is generally exempt from state tax

What Kinds of Bonds are Eligible?

- Private Activity Bonds — finance projects of for-profits
  - Only private activity bonds work with housing credits — Section 142 of the Code
- Governmental Bonds and §501(c)(3) Tax-Exempt Bonds generate tax-exempt interest, but they don't work with housing credits

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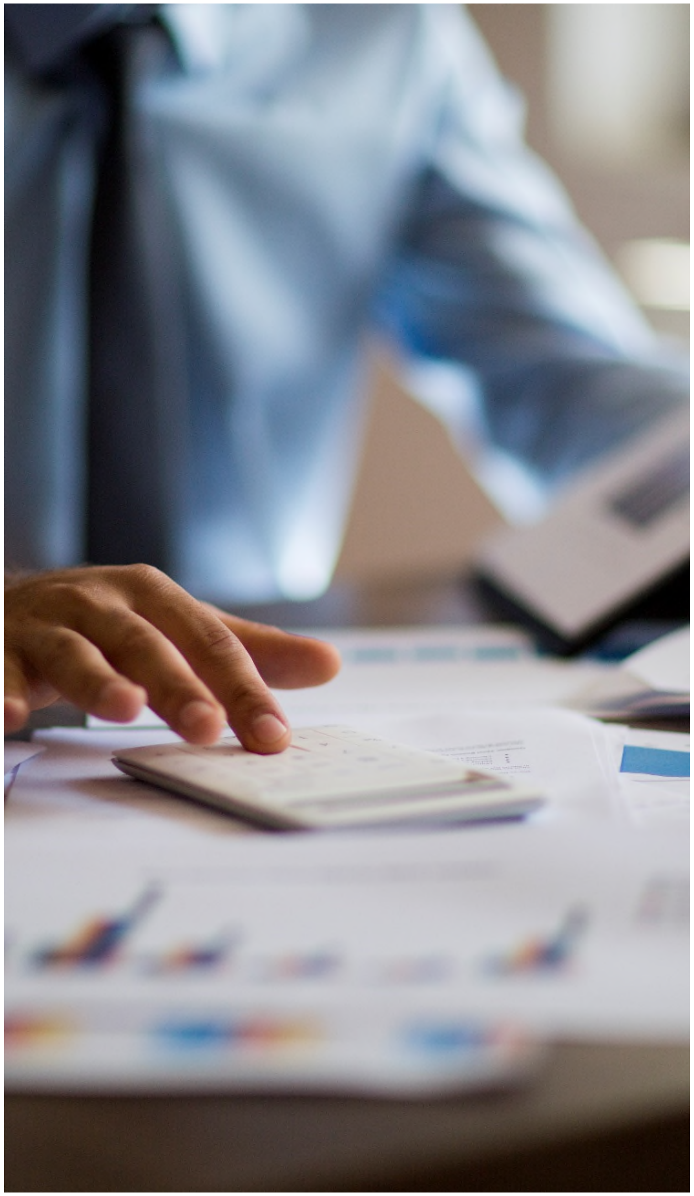
BASICS OF HOUSING BONDS

- Housing Bonds are revenue bonds
- Issuer is not lending its own money
- Issuer has no liability for debt service on the bonds
- Issuer is a “conduit” — acts as pass-through agent
- Note that these bonds must be sold – just because the state will issue bonds doesn’t mean that there is a buyer who will put up the money

TAX EXEMPT LOANS

- More recently Issuers have been utilizing Tax Exempt Loan (TEL) Structures
- Instead of issuing bonds a funding lender will loan funds to the Issuer who will then utilize volume cap to have the loan treated as tax-exempt
- Because two loans are being made this is often referred to as a back-to-back structure
- Functionally it is the same as a bond issuance, but technically there is no bond but a tax-exempt obligation.



WHAT ARE THE BENEFITS OF BONDS?

- Interest Rate Benefit
  - Bond Rating
  - Credit Enhancement
- Reduced Interest Rate (Allows for more debt!)
- Possible To Reduce Debt Coverage Ratios
- “Automatic” 4% Tax Credit Allocation – good solution in states where 9% allocations are very competitive
- More flexibility in project development

SOME BOND OBSERVATIONS

- Not like credit competition, but there is still competition and hurdles to get bond approval
- Projects must apply for volume cap which is limited; some states are more competitive than others
- Credit Enhancements available (but sometimes expensive)
- Bonds have lower interest rates than conventional debt (but currently, both are low)

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SOME BOND OBSERVATIONS (CONT'D)

- Total for all private activity bonds (which includes Housing): $120 Per Capita in 2023; Minimum of $358,845,000 per state
- Housing Competes With Other Uses
  - Typically, housing bonds are about 55-60% of the total, but this varies by state and demand
  - Some states dedicate bonds to particular uses
  - Volume cap is more competitive in some states; varies by market
- Must pass 50% test, described later
- Also need “42(m) letters” that project complies with the QAP and does “not exceed the amount… necessary” for “financial feasibility”.

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WHAT’S THE DIFFERENCE BETWEEN 9% AND 4% CREDITS?

(Eligible Basis) x (Low Income Percentage) x (Credit Percentage) x 10 = Credits

Although the Credit Percentage for Bond transactions is now fixed at 4% this is still significantly lower than in 9% transactions.

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COMPARISON OF 30% AND 70% RATES

	Project X	**Project Y**
Eligible Basis	10,000,000	10,000,000
x Applicable Fraction	100%	100%
Qualified Basis	10,000,000	10,000,000
x Applicable Percentage	4%	9%
Annual LIHTC	400,000	900,000

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WHY IS THERE SO MUCH LESS EQUITY IN A BOND DEAL?

- Reduced credit percentage (currently 4% vs. 9%)
- Tax Losses are spread across a smaller amount of Tax Credit dollars (Result may be an increased credit price)
- Sometimes, this results in minimum gain problems –
  - e.g., a $10M project with 9% credits at 90¢ might raise $8.1M from the investor, while 4% credits only raise $3.6M.
  - With 30 year depreciation, it takes longer than the 15 year compliance period to use up a $8.1M capital account, but just under 10 years to use up $2.88M.
  - Increased subordinate debt on bond projects can also lead to greater losses on bond deals causing capital accounts to go negative sooner.

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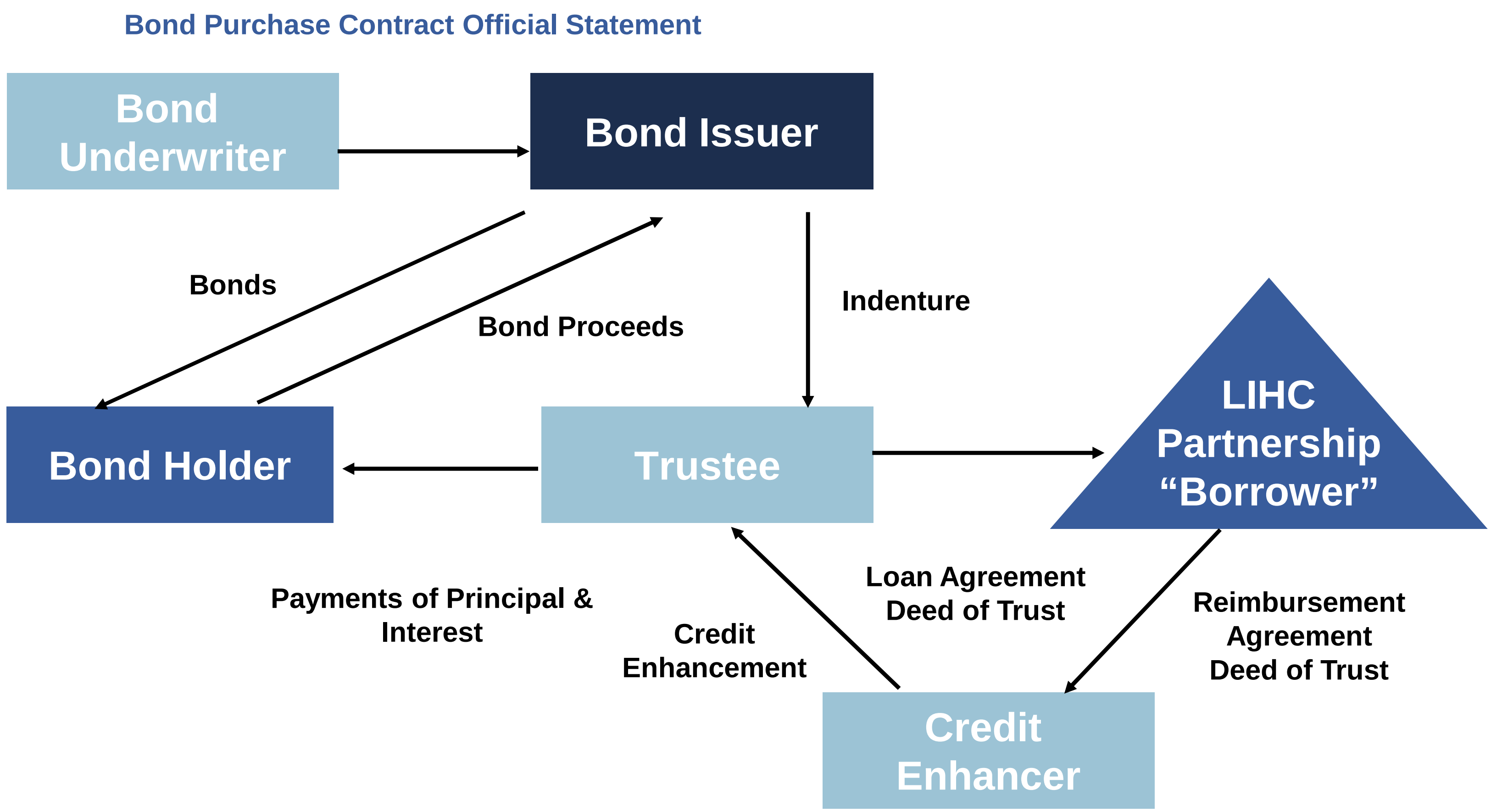
STRUCTURING BOND TRANSACTIONS

TYPICAL TAX-EXEMPT BOND STRUCTURE



BOND DEAL STEPS

1. Issuer passes inducement resolution
2. Credit enhancement commitment
3. Private activity bond application submitted to Issuing Authority
4. Public notice of the project (2 weeks)
5. TEFRA (The Tax Equity and Fiscal Responsibility Act) hearing held
6. Private activity bond application approved and Bond allocation awarded

BOND DEAL STEPS

7 — Tax credit application submitted to state agency (need “42(m) letters”)

8 — 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

9 — Issuer passes bond resolution**

- Issuer’s approval of TEFRA hearing
- Private activity bond allocation
- Credit enhancement commitment
- Bond rating from agency
- Preliminary official statement

10 — Underwriter prices and contracts for selling the bonds

11 — Bond purchase agreement

12 — Bond Closing

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CREDIT ENHANCEMENT

- Credit Enhancement for Bond Loans are usually necessary to allow Bonds to have higher credit ratings and reduces the risk to the holder of the Bonds
- Credit Enhancement can be used to ensure that the Bond Loan will have a fixed interest rate for its term

- Letter of Credit from Bank (typically construction only)
- HUD Insured Mortgage—FHA 221(d)4
- Fannie Mae or Freddie Mac enhancement (often seen in TEL structure)
- Interest Rate Swaps (used to fix rate in variable rate bond)

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DUE DILIGENCE ISSUES FOR TAX-EXEMPT BOND TRANSACTIONS

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DUE DILIGENCE ISSUES: 95/5 TEST

Sometimes referred to as the Good Cost Bad Cost Test — a tax-exempt bond test.

- Purpose of 95/5 test is to show that a bond issue qualifies as a tax-exempt bond issue – the interest income earned by the holders of the bonds will be excluded from income for federal income tax purposes.
- The Test is that Qualified Costs of a project must equal or exceed 95% of the Net Bond Proceeds.

SPECIAL RULES: 95/5 TEST

Definition of Net Bond Proceeds:

Face amount of the bonds (tax-exempt)

Plus:
- Any bond premium
- Interest earned on undrawn bond proceeds
- Accrued Interest at sale

Less:
- Any bond discount
- Any reasonably required reserve or replacement fund

Equals: Net Bond Proceeds or Project Loan Amount

SPECIAL RULES: 95/5 TEST

What may be included in Qualified Costs is determined by two factors:

1. **What costs were incurred**
2. **When the costs were incurred**

SPECIAL RULES: 95/5 TEST

What costs are included in Qualified Costs?

Qualified Costs are costs capitalized into land and the depreciable basis of the project with certain exceptions

Exceptions include:

- Related party profits (Development Fee, Contractor Profit, Architect Profit, etc.)
- Costs related to commercial space (see 1.103-8(a)(3))
- Related party acquisitions
- Seller take back loans and assumed debt may be excluded from acquisition costs

- Examples of "bad" costs found in most development budgets
  - Reserves
  - Intangible Assets
  - Bond issuance costs and underwriting
  - Permanent loan fees and costs
  - Lease-up costs

SPECIAL RULES: 95/5 TEST

Other rules related to Qualified Costs:

- Qualified Costs for land acquisition cannot exceed 25% of net bond proceeds of the issue (IRC 147(c)).
- Qualified Costs exclude costs incurred to provide swimming pools, recreation facilities, or health club facilities for which an independent charge is accessed (commercial costs) or which are made available to the general public. (Treasury Regulation 1.103-8(b)(4)

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SPECIAL RULES: 95/5 TEST

When must costs be incurred to be included in Qualified Costs?

Qualified Costs are costs incurred no earlier than 60 days prior to the date of inducement resolution – again, with certain exceptions.

It is important to note the date of the inducement resolution to make sure this test is met

Exceptions include:

- Preliminary Expenditure Exception – includes cost for architecture, engineering, survey, soil testing and similar costs incurred prior to commencement of acquisition, construction, or rehabilitation of a project. Does not include land acquisition, or similar costs incidental to commencement of construction.
- Preliminary Expenditure Exception is limited to an amount not in excess of 20% of the aggregate issue price of an issue (Treasury Regulation 1.150-2(f)(2)).
- Deminimus Exception – applies only to costs of issuance or to an amount not in excess of the lesser of $100,000 or 5% of the proceeds of an issue (Treasury Regulation 1.150-2(f)(1)).

SPECIAL RULES: 95/5 TEST

Other rules with respect to timing to be aware of:

Reimbursement Allocation (Treasury Regulation 1.150-2(d))—occurs if an expenditure with respect to a project is paid before the issue date of the bonds for the project. Reimbursement allocations are only allowed if:

- Payment of original expenditure occurred no more than 60 days prior to date of inducement resolution.
- Reimbursement is made not more than 18 months after the later of:
  - The date the original expenditure was paid, or
  - The date the project is placed in service
- But in no event more than three years after the original expenditure was paid.

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ADDITIONAL REQUIREMENTS OF PRIVATE ACTIVITY BONDS

Rehabilitation expenditures with respect to an existing project together with equity to be expended for rehabilitation on an existing project must equal or exceed 15% of the portion of the project's acquisition cost financed with tax-exempt bond proceeds (IRC 147(d)).

With respect to the above described minimum rehabilitation expenditure requirement:

/ Rehabilitation Expenditures shall not include any amount which is incurred after the date 2 years after the later of:

- The date on which the project was acquired, or
- The date on which the bond was issued.

Issue costs paid with proceeds limited to 2% of proceeds of the issue (IRC 147(g))

50% FINANCING REQUIREMENT

- IRC Section 42—LIHTC rule for projects financed with tax-exempt bond proceeds.
- Generally, in order to claim LIHTCs under IRC section 42, a project must have received an allocation of LIHTCs from the applicable state housing finance agency.
- An exception to the allocation requirement exists with respect to certain tax-exempt bond financing under IRC Section 42(h)(4). This section provides that no housing credit allocation is required in order to claim LIHTCs under Section 42 with respect to that portion of the eligible basis of a qualified low income building that is financed with tax-exempt bond proceeds.

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50% FINANCING REQUIREMENT

A special rule allows tax credits to be obtained for an entire building if 50% or more of the aggregate basis of the building and the land on which the building is located is financed by tax-exempt obligations.

This threshold is commonly referred to as the "50% Test."

More specifically, the 50% test is a fraction:

- The numerator of which is the tax-exempt net bond proceeds received by the project (plus any interest income earned on unexpended bond proceeds during the construction period) and used to finance aggregate basis, and
  - Timing Issues (before or after the building is placed in service)
  - How long must the tax-exempt bonds be outstanding?
  - Tax-exempt bonds can be construction only, permanent only, construction to permanent, or some combination thereof
- The denominator is the aggregate basis in land and building.

50% TEST | THE NUMERATOR

Note that the 50% test does not involve direct tracing of where the tax-exempt bond proceeds were actually spent. Specific guidance related to determining the use of bond proceeds for the 50% test is provided under Treasury Regulation section 1.42-1T(f)(ii), which states the following:

For purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in section 1.103-13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95% or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

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50% TEST | THE NUMERATOR

- Simply stated, this regulation says you respect the allocation of the tax-exempt bond proceeds included in the bond documents for purposes of the 50% Test.

  If the bond documents say X amount of the proceeds get used to finance aggregate basis items, you would include X amount of the tax-exempt bond proceeds in your numerator.

  If the bond documents are inconsistent or silent with respect to the allocation, then you use a pro rata allocation for purposes of determining the portion of the tax-exempt bond proceeds in the numerator of the fraction.
- Be sure to review the Form 8038 and the Borrower’s tax certificate given to Bond Counsel

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50% TEST THE NUMERATOR

Tax Credit 50% Test Examples		No funding of nonqualified costs	Funding of nonqualified costs	Pro rata allocation
Facts				
Bond amount		200,000	200,000	200,000
Issue premium (discount)		-	-	-
Earning on unexpended proceeds during construction		6,000	6,000	6,000
Aggregate basis of buildings		275,000	275,000	275,000
Land cost		10,000	10,000	10,000
Total development costs		340,000	340,000	340,000
Net proceeds from issuance				
Bond amount	i	200,000	200,000	200,000
Issue premium (discount)	ii	-	-	-
Earning on unexpended proceeds during construction	iii	6,000	6,000	6,000
Net proceeds from issuance	iv = i + ii + iii	206,000	206,000	206,000
Calculation of net proceeds for 50% test				
a Calculation based on method in bond documents				
Net proceeds from issuance per above	I	206,000	206,000	
Less amount per bond documents used to fund nonqualified costs	II	-	(4,000) *	
Less amount per bond documents used to fund reserves	III	-	(10,000) *	
Net proceeds for 50% test	IV = I + II + III	206,000	192,000	(See pro rata below)

* Bond Indenture specifically states these amounts were to be paid from the tax-exempt bond proceeds.

b Pro rata calculation				
Aggregate basis of buildings				275,000
Land cost				10,000
Total	(a)			285,000
Total development costs	(b)			340,000
Ratio	(c) = (a) / (b)			83.82%
Net proceeds from issuance	(d) = iv above			206,000
Net proceeds for 50% test	(e) = (c) x (d)			172,676
Percentage of aggregate basis of buildings and land financed with tax-exempt bonds				
Net proceeds for 50% test	x = IV or (e)	206,000	192,000	172,676
Total depreciable Cost	y1	275,000	275,000	275,000
Land Cost	y2	10,000	10,000	10,000
Aggregate Basis in Building and Land	y = y1 + y2	285,000	285,000	285,000
Percentage	z = x / y	72.3%	67.4%	60.6% Note

Note Use of the pro rata method of allocation will usually have an adverse impact on the calculation of net proceeds available for use in the 50% test which may result in a lower ratio. If you believe that use of the pro rata method is required, please consult with the appropriate low-income housing tax credit specialists in the tax department.

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50% TEST | DENOMINATOR

- With respect to the denominator, aggregate basis plus land may not equal eligible basis plus land. Aggregate basis includes all depreciable costs including any commercial costs which were excluded from eligible basis.

- Land includes the original purchase price plus any amounts subsequently capitalized to land such as demolition costs or non-depreciable site work.

DUE DILIGENCE

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OVERVIEW

As already discussed, Housing Tax Credits received in Tax Exempt Bond Financed Transactions are not awarded competitively like 9% Tax Credits.

Tax Credit Due Diligence is very different from a transaction with 9% Tax Credits – Project will not need a reservation letter, a carryover agreement or have to meet the 10% Expenditure Test.

Housing Tax Credits received through Tax-Exempt Bond financing are not considered “allocated” until the project is complete and 8609s are received.

50% TEST ISSUES

As also discussed above, bond financed projects must meet the 50% test in order to receive the full amount of Housing Tax Credits. Ensuring that this test is met is an important part of due diligence review.

Remember that Bond Counsel cares about different issues than tax credit counsel. In particular, bond counsel doesn't care if the 50% test (discussed below) is passed.

Construction overruns and/or delays may adversely affect the 50% calculation long after closing.

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FAILING THE 50% TEST

Suppose building and land costs $9.9M and eligible basis is $8M, 100% low income, and credit rate is 4.0%. If you have $5M of bond proceeds, the credits are 4.0% times $8M times 10 years, or $3.2M

Same assumptions, except the cost of the land and building rose to $10.1M. Because 5/10.1 is 49.5%, you can't meet the 50% test. So, the credit is 5/10.1 times 4.0% times $8M times 10 years, or $1.58M. Half the credits have been lost due to a $200K cost overrun.

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FIXING THE 50% TEST

- Can't simply say that bonds only finance eligible basis items
- Might lease some of the project to keep down capital cost, but the lease must be "respected" for tax purposes (i.e. long term leasing a separate clubhouse to remove it from basis)
- Reduce capital expenditures to insiders, e.g., development fee
- Don't forget that (A) earnings on invested bond money can be a big help, while (B) proceeds used to pay bad costs can add to the problem –
  Be sure to check the Form 8038
- Go back to the issuer and see if it will issue more bonds

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TAX CREDIT DOCUMENTS

In a Tax Exempt Bond Financed Transaction we usually review the following Housing Tax Credit documents:

- Tax Credit Application
- 42(m) Letters
- Form 8038
- Extended Use Agreements
- 8609s

APPLICATIONS

Tax Credit Application:

- Generally tax credit applications are submitted to award points to projects and determine which deals will receive competitively award Housing Tax Credits
- Some State Credit Agencies still require applications to be submitted for Tax Exempt Bond financed transactions even though the Housing Tax Credits are not competitively awarded
- The representations made by the developer in the tax credit application are still binding on the project

130% TEST

If project is claiming a 130% basis boost, must confirm that it is located in a QCT or DDA at the time of the tax credit application.

NOTE: Tax Exempt Bond financed transactions are not eligible for discretionary basis boosts under the Housing and Economic Recovery Act

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42(M) LETTER

42(m) Letters must meet the requirements of subsections (m)(1)(D) and (m)(2)(D).

- 42(m)(1)(D) requires a letter ***from the housing agency*** that project complies with the qualified allocation plan applicable to the area where the project is located
- 42(m)(2)(D) requires a letter ***from bond issuer*** that the bond amount does "not exceed the amount… necessary" for "financial feasibility"

Some states issue two separate 42(m) letters, while other states combine this requirement into a single letter.

42(m) letters do not finally fix the amount of the allocation, which is done by the 8609s

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CREDIT RATE ELECTION

- Commencing for Project’s placed in service after December 31, 2020 with bonds issued after December 31, 2020 the credit percentage cannot be less than 4%
- For projects that have closed and do not qualify for the fixed rate, the Project will either have elected to fix the rate in the month the bonds were issued or will have to have the floating rate apply in the month they are placed in service.
- This means that even deals which place in service in 2021 may have a floating rate if the bonds were issued in 2020.
- It is also possible to have an acq/rehab transaction where the Project was acquired at the end of 2020 but bonds issued in 2021 resulting in the acquisition rate being below 4% and the rehab rate at 4%

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8609s

- Evidence that property has an allocation of LIHTC. Attached to the partnership K-1 tax return
- Issued by state agency after cost certification
- Check that owner name is correct and credit amount is the same as expected. If it is not the same, an adjuster may be due.
- This is usually received post-closing.

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EXTENDED USE AGREEMENT

- Projects receiving Housing Tax Credits are required to enter into an Extended Use Agreement with State credit agency pursuant to Section 42(h)(6) of the Code
- The Extended Use Agreement is usually separate from the Tax Exempt Bond Regulatory Agreement but not always.
- NOTE: The rules are slightly different, so what is needed for one can be different from what is needed for the other.
- Extended Use Agreement is sometimes recorded post-closing but at a minimum must be executed and recorded prior to the end of the first year in which the project receives Housing Tax Credits.

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EXTENDED USE AGREEMENT

- The Extended Use Agreement must:
- Require that the project maintain the applicable fraction listed in the Extended Use Agreement
- Allow individuals who meet applicable income requirements to enforce their rights in state court
- Prohibit the partial disposition of the project
- Prohibit discrimination against holders of Section 8 vouchers
- Be binding on all successors of the project owner
- Be recorded as a restrictive covenant against the property

QUESTIONS?

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