OVERVIEW OF TAX-EXEMPT “AFFORDABLE HOUSING” BONDS

The following is a high level overview of tax-exempt multifamily housing bonds, which are available to developers to purchase, construct or rehabilitate qualified multi-family housing projects, i.e., “affordable housing.”

Tax-Exempt Bond Financing

Multifamily housing revenue bonds are issued by a governmental authority, which may be a city or county housing authority created under the Housing Authorities Law [O.C.G.A. § 8-3-1, et seq.], an urban residential finance authority created under the Urban Residential Finance Authorities Act for Large Municipalities [O.C.G.A. § 36-41-1, et seq.] for cities with a population of at least 350,000 in 1980 (i.e., Atlanta), a statutory development authority created under the Development Authorities Law [O.C.G.A. § 36-62-1, et seq.], a development authority created by local constitutional amendment, or a downtown development authority under the Downtown Development Authorities Law [O.C.G.A § 36-42-1, et seq.]. While a state authority, the Georgia Housing and Finance Authority created by the Georgia Housing and Finance Authority Act [O.C.G.A. § 50-26-2, et seq.], is also authorized to issue multifamily housing bonds, a local authority would be the more likely choice for use as the issuer.

The issuing authority serves as a mere conduit, and its own funds are not pledged to the repayment of the bonds, nor are the bonds backed or secured by the general credit of taxing power of the local government or any other public revenue sources. Rather, the bonds are payable from funds provided by the developer of the project, and any credit enhancement the developer may provide, such as personal/corporate guarantees, bond insurance or a letter of credit. The project itself would also secure the bonds (either directly through a deed to secure debt for the benefit of the bondholders, or indirectly as security for the credit provider).

Multifamily housing revenue bonds can be sold in a private placement, such as to a bank or group of participating banks, or can be sold in a public sale through an underwriter. If properly structured, these bonds are exempt from registration under the Securities Act of 1933, as amended; therefore, avoiding the costs and time applicable to registration.
Bond proceeds can be used for the acquisition, construction or rehabilitation of a multifamily housing project (including land and buildings), and to fund most related fees, including bond underwriting and issuance costs, construction financing, legal, audit, FHA mortgage processing, replacement reserves and settlement costs. However, in the case of tax-exempt bonds, federal tax law imposes a 2% limit on the use of bond proceeds for most costs of issuance, including underwriter’s discount.

Multifamily housing bonds are a type of “private activity bonds” that may be issued as tax-exempt bonds for certain “qualified residential rental projects” under Section 142 of the Internal Revenue Code of 1986, as amended (the “Code”), provided the bonds are issued in full compliance with the applicable federal tax rules.

As a general matter, tax-exempt bonds are attractive to developers of affordable housing because the interest rates on tax-exempt housing revenue bonds are lower than the rate on taxable borrowings. The Housing and Economic Recovery Act of 2008 (“HERA”) repealed the alternative minimum tax on multifamily housing bonds, which could result in an additional reduction in the applicable interest rate by approximately 20 to 30 basis points. In addition, as discussed below, use of tax-exempt bonds to finance at least 50% of the project’s “eligible basis” (as defined in Section 42 of the Code) could make the project eligible for low income housing tax credits (“LIHTC”) without the need to obtain a separate volume cap for the LIHTC.

Sections 103 and 141 through 150 of the Code and related federal tax law impose a number of general requirements that qualify the interest paid under private activity bonds as tax-exempt. The following is a pertinent, but not exhaustive, list of the requirements generally applicable to all private activity bonds: (i) TEFRA approval: following a public hearing, the issuer must obtain the official approval of the highest elected public official (if the project is in a city, this could be in the form of the written approval of the mayor or of a resolution of the mayor and city council or, if the project is in the unincorporated area of a county, the approval by resolution of the County Board of Commissions or the written approval of its chairman if elected by popular vote), (ii) volume cap as allocated by the Georgia Department of Community Affairs, (iii) for acquisition/rehabilitation projects, the buildings within the project must receive rehabilitation expenditures equal to at least fifteen percent (15%) of the acquisition cost of the buildings, (iv) investment earnings on the bonds and other proceeds would be subject to the arbitrage and rebate rules under Section 148 of the Code and (v) a 2% limit financing costs of issuance with bond proceeds. In addition, if bond proceeds are to be used to reimburse costs incurred by the developer prior to the issuance of the bonds, the issuer would need to adopt an inducement resolution (“official intent” declaration) so as to permit the reimbursement of most pre-issuance capital expenditures that are incurred after a date that is 60 days prior to the date of such declaration.

In addition to the general qualifications above, there are also tax rules that are specific to multifamily housing bonds which require that at least 95% of the net proceeds must be used to finance a qualified residential rental project. The project financed by the proceeds of such bonds

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1 Several of these rules are modified, or may be not applicable, when the conduit borrower is a nonprofit corporation, which qualifies under Section 501(c)(3) of the Code.
must be a “residential rental project” consisting of one or more buildings or structures (each having an independent foundation, outer walls and roof) together with any facilities functionally related and subordinate thereto, and containing one or more similarly constructed “units” that are not used on a transient basis. For such purposes, a “unit” is any accommodation containing separate and complete facilities for living, sleeping, eating, cooking and sanitation. However, such units may be served by centrally located equipment, such as heating and air conditioning. As a result of HERA, single-room occupancy units without full kitchens are now considered to be “units.” Multiple buildings are part of the same project only if such buildings (i) have “similarly constructed units,” (ii) are proximate (located on the same parcel, on contiguous parcels or on parcels that would be contiguous except for the interposition of a road, street, stream or similar property), (iii) are owned by the same person and (iv) are financed pursuant to a common plan (e.g., financed by the same bond issue or bond issues issued under the same indenture). Property that is “functionally related and subordinate” include facilities to be used by tenants, such as swimming pools and other recreational facilities, parking areas, heating and cooling equipment, trash disposal equipment, and units to be occupied by a resident manager or maintenance personnel.

Another requirement of multifamily housing bonds, is that “at all times” during the “qualified project period” the project must meet the requirements of the unit “set aside” test elected by the issuer at the time of issuance of the bonds. The “qualified project period” begins on the first day on which 10% of the units in the project are occupied and ends on the latest of: (i) the date that is 15 years after that date 50% of the units are occupied, (ii) the first day on which no tax-exempt private activity bond issued with respect to the project is outstanding, or (iii) the date on which any assistance provided with respect to the project under Section 8 of the United States Housing Act of 1937 terminates. Under the “at all times” requirement, if there is a failure to comply with the set aside requirement, there is a period of 60 days within which it may be corrected. Such 60 days commences on the date non-compliance is discovered or would have been discovered by the exercise of reasonable diligence. If the non-compliance is not corrected within the 60-day cure period, interest on the bonds will become taxable retroactively to the date of issuance and subsequent conformity will not revive the tax-exempt status of the bonds.

At the time the bonds are issued, the issuer (as directed by the developer) must elect to use one of the following two “set aside” tests: (1) at least 20% of the units must be occupied by individuals earning 50% or less of area median gross income (the “20/50 test”), or (2) at least 40% of the units must be occupied by individuals earning 60% or less of area median gross income (the “40/60 test”). Once the election is made, the “set aside” test cannot be changed. The earnings levels are subject to a family size adjustment that parallels the family size adjustments under Section 8 of the United States Housing Act. For example, if the 20/50 test is elected, a family of 4 would meet the test if its income does not exceed 50% of area median gross income, a family of 3 would meet the test if its income does not exceed 45% of area median gross income, a family of 2 would meet the test if its income does not exceed 40% of area median gross income, and a single individual would meet the test if his/her income does not exceed 35% of area median gross income. If the income of a new tenant meets the required “set aside” income test, a subsequent increase in the tenant’s income will not cause the unit to cease to comply as a “set aside” unit until the tenant’s income exceeds 140% of the applicable income.
limit. When that happens, and if any unit (whether or not such unit is comparable or smaller in size) in the particular building is or becomes vacant and available for rent, such unit must, when next rented, be rented to a new tenant whose income does not exceed the applicable limit.

**Low Income Housing Tax Credits**

Section 42 of the Internal Revenue Code provides a tax credit to developers of qualifying properties. Tax-exempt multifamily housing bonds, for which volume cap has been obtained, can be combined with low income housing tax credits (the “LIHTC”) if 50% or more of the project’s “eligible basis”, as defined in Section 42 of the Code, is financed with the proceeds of such bonds.

In order to qualify for the LIHTC, properties must meet certain tests that restrict both the amount of rent charged to tenants (the “Gross Rents Test”) and the income of eligible tenants (the “Income Test”). To satisfy the Gross Rents Test, the rents charged by a low-income housing project must not exceed 30% of the area’s median gross income, adjusted for family size. The Income Test for a qualified low-income housing project requires that the project owner irrevocably elect one of two income level tests: either a 20-50 test or a 40-60 test. In order to satisfy the first test, at least 20% of the units must be occupied by individuals with income of 50% or less of the area’s median gross income, adjusted for family size. To satisfy the second test, at least 40% of the units must be occupied by individuals with income of 60% or less of the area’s median gross income, adjusted for family size.

The types of projects eligible for the LIHTC are apartment buildings, single family dwellings, duplexes, or townhouses. Projects may include more than one building. Tax credit project types also vary by the type of tenants served. Housing can be for families and/or special needs populations including the elderly. Enhanced LIHTCs are available for difficult development areas (DDAs) and qualified census tracts (QCTs) as an incentive to developers to invest in more distressed areas: areas where the need is greatest for affordable housing, but which can be the most difficult to develop. In these distressed areas, the LIHTC can be claimed for 130% (instead of the normal 100%) of the project’s total cost excluding land costs. This also means that available credits can be increased by up to 30%. The LIHTC finances part of the total cost of many projects rather than the full cost and, as a result, must be combined with other resources. The financial resources that may be used in conjunction with the LIHTC include conventional mortgage loans provided by private lenders and alternative financing and grants from public or private sources. Specifically, sources of financing can include Community Development Block Grant (CDBG) loans and grants, Federal HOME loans, the Affordable Housing Program of the Federal Home Loan Banks, and loans from utilities and banks. Individual states provide financing as well, some of which may be in the form of tax credits modeled after the federal provision. Additionally, some LIHTC projects may have tenants who receive other government subsidies such as housing vouchers.

The value of the credit is approximately (i) 9% of qualified basis per year for new construction (“9% credits”) or (ii) 4% of qualified basis per year for rehabilitation or federally subsidized buildings (tax-exempt bond financing is considered such a subsidy) (“4% credits”). The 9% credit projects typically receive 60% to 75% of their development budget from tax
credits, whereas approximately 30% to 40% of the development costs in a 4% credit project come from the tax credits.

While the 9% credits provide a greater incentive to the developer, they are also subject to a highly competitive process for allocation (similar to, but separate from, the volume cap allocation for tax-exempt multifamily housing bonds). However, if at least 50% of the eligible basis of the project is financed by tax-exempt bonds for which volume cap has been allocated to the bonds, the project may qualify for the 4% credit without having to apply for a separate allocation of LIHTC.

Although commonly referred to as 9% and 4% credits, the actual tax credit rates employed are not exactly 9% and 4%, and vary on a monthly basis. This is because the 9% and 4% credits are intended to yield a total amount over the 10-year credit period that is worth 70% and 30%, respectively, of the net present value of the credits. The actual rates, which are indexed to 10-year U.S. Treasury bond yields, are calculated and released monthly by the U.S. Treasury Department. Over the past five years (2008-2013), the actual 9% rate had ranged from 7.35% to 7.94%, and the rate for May 2013 was calculated as 7.41%\(^2\). During that same period, the 4% credit has ranged from 3.15% to 3.14%, and the rate for May 2013 was calculated as 3.18%.

Additional Information

This paper is a quick-reference guide. The information in this paper is general in nature. Various points, which could be important in a particular case, have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

Additional information concerning this topic, as well as White Papers and references on other topics, can be found at http://danmcrae.info/.

\(^2\) Under HERA, the applicable percentage for non-federally subsidized new buildings (i.e., projects eligible for the 9% credit) placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%.
If you have any questions or comments, we would be pleased to provide more information. Please contact:

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