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Financing Multi-Family Housing: Structuring the Low-Income Housing Tax Credit and Tax-Exempt Bonds

Documenting Transactions for Investors and Developers

TUESDAY, APRIL 19, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Financing Multi-Family Housing: Structuring the Low Income Housing Tax Credit and Tax-Exempt Bonds

Multifamily Housing Bonds

Types of Multifamily Housing Bonds

- Governmental tax-exempt bonds
- Section 501(c)(3) bonds
- Private Activity Section 142(d) bonds
  - These bonds are the subject of today's presentation

Multifamily Housing Bond Basics

General

- Bonds are generally issued through state and local housing finance agencies to finance the construction or rehabilitation of multifamily developments.

Nature of Obligations

- Generally, the obligations are special, limited obligations payable only from sources of funds specifically pledged for repayment (*i.e.* project revenues, payments from credit enhancement, *etc.*).

Benefits

- Tax-exempt financing permits a state or local housing finance agency to assist developers in obtaining a lower cost of financing.

Multifamily Housing Bond Basics

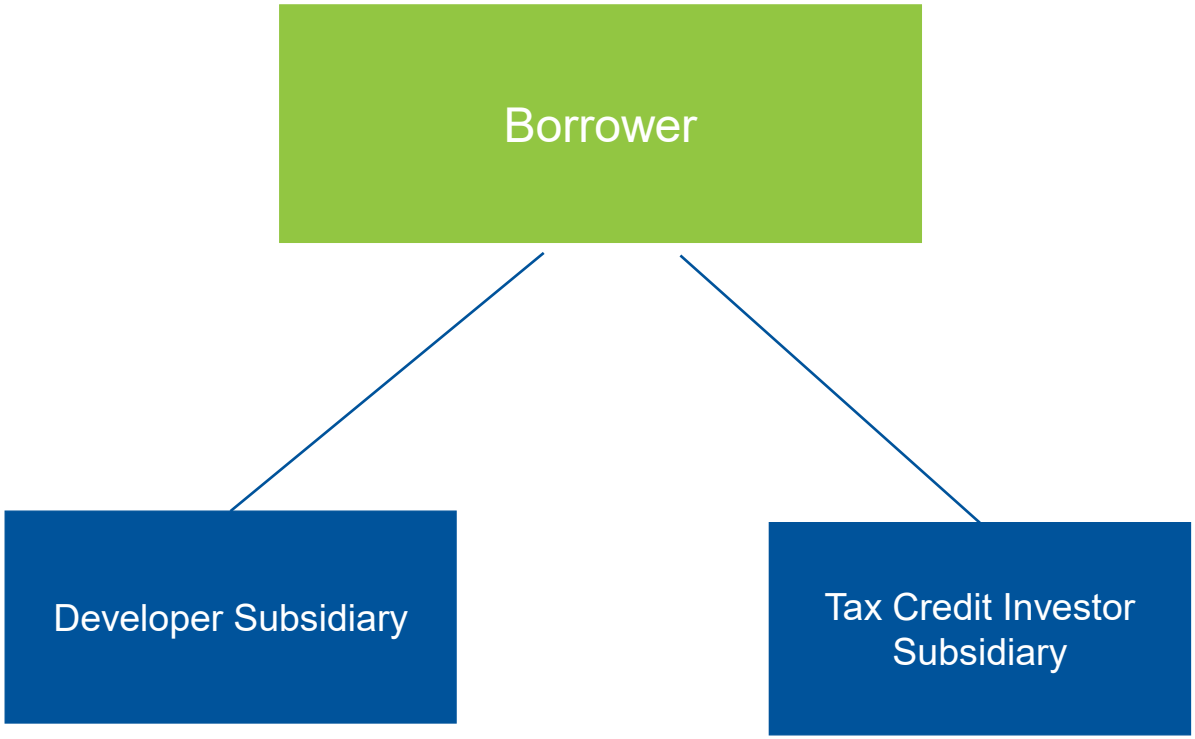
Benefits (cont.)

- Interest on tax-exempt bonds is exempt from federal income taxation and, in certain states, from state income taxation; therefore, the interest rate paid on tax-exempt bonds is typically lower than the interest rate on taxable obligations of equal creditworthiness.
- On certain multifamily housing bond deals (*i.e.* bonds issued under Section 142(d)), the financing structure permits a developer to receive an allocation of 4% low-income housing tax credits.
  - Projects must be financed at least 50% with tax-exempt bonds to receive tax credits.

Qualified Private Activity Bonds

- Private activity bonds are bonds for which, subject to certain exceptions:
  1. More than 10% of the proceeds are used for any private business use and more than 10% of the proceeds are, directly or indirectly, secured by property used in a private business use or from payments in respect of property used in a private business use, or
  2. The amount of proceeds used to make loans to non-governmental borrowers exceeds the lesser of 5% of the proceeds of the issuance or $5,000,000
- Private activity bonds are taxable unless the bonds meet certain requirements and are “qualified private activity” bonds under the Internal Revenue Code.
- Residential rental facilities (*i.e.* multifamily housing developments) are a classification of qualified private activity bond.

Typical Composition of Borrower Entity



Basic Parties to Multifamily Housing Bond Transaction

Issuer

- Issues the bonds and loans the proceeds to the Borrower.
- May earn an issuance fee and ongoing administrative fee.

Developer

- Typically acts as general partner of the Borrower.
- Achieves lower costs of financing and may earn a developer fee.

Equity Investor

- Contributes capital to the Borrower in exchange for low-income housing tax credits and certain other benefits.
- May share in excess cash flow of the project.

Common Bond Structures in Today's Market

- HUD Cash-Collateralized
- Freddie Mac Tax-Exempt Loan (TEL)
- FNMA MBS as Tax-Exempt Bond Collateral (M.TEB)
- Private Placements

HUD Cash-Collateralized

- Short-term bonds in principal amount sufficient to meet 50% test.
  - Typically, a mandatory tender date is established approximately one year prior to maturity.
- Bond proceeds deposited in Project Fund.
- As Bond proceeds are drawn to pay project costs, FHA loan proceeds are deposited into Collateral Fund.
- Funds on deposit under the Indenture are always sufficient to pay debt service on the Bonds (*i.e.* cash collateralized).
- Bonds sold via public offering.
- Low interest rates and reduced ongoing Bond-related fees (issuer administrative fee).
- Lengthy underwriting process.

Freddie Mac TEL

- Typically 16 to 18-year term.
- Funding Lender makes a loan to Governmental Lender (*i.e.* a housing agency) that then loans the proceeds to the Borrower.
- Freddie Mac buys the "TEL" (*i.e.* the bond) from the Funding Lender:

  - Immediate delivery: Moderate or minimal rehab projects

  - Forward delivery: Substantial rehab or new construction

- Closing timeframe significantly shorter than HUD Cash-Collateralized structure.

FNMA M.TEB

- Typically 10 to 30 year term.
- Similarly to the Freddie TEL, M.TEBs can be structured as immediate or forward delivery.
- MBS payments passed through to Bondholders.
- Forward deliveries resemble HUD Cash Collateralized structure initially.
  - After project completion, collateral funds used to purchase FNMA mortgage-backed security.

► Closing timeline significantly shorter than HUD Cash-Collateralized structure.

Trends in Multifamily Housing Revenue Bonds

- Private activity bond volume cap usage continues to outpace previous years.
  - Increase is largely attributable to multifamily housing
  - Impact of fixed 4% low-income housing tax credit
- Emergence of “ESG” or environmental, social and governance designations
- Rising construction costs

Federal Tax Law Considerations

Federal Tax Law Requirements

Volume Cap

- Tax-exempt single family and multifamily housing bonds require an allocation of private activity volume cap, except where the proceeds of the bonds are loaned to a Section 501(c)(3) organization.

TEFRA Notice and Hearing Requirement

- A notice, public hearing and approval by the issuer and the governmental host is required under the Tax Equity and Fiscal Responsibility Act. Generally called a TEFRA notice and TEFRA hearing and TEFRA approval.

Federal Tax Law Requirements

- Must be a residential rental housing facility (*i.e.* no condos, hotels, dormitories, *etc.*).
- Low income set aside:
  - 20% of units set aside for tenants whose income does not exceed 50% of area median
  - 40% of units set aside for tenants whose income does not exceed 60% of area median
- Low income set asides must be met at the time 10% of the units are occupied and continue until the later of (i) 15 years after 50% occupancy, (ii) the first day in which no tax-exempt private activity bonds issued with respect to the project are outstanding and (iii) the date on which any project-based Section 8 subsidy ends.

Federal Tax Law Requirements

- At least 95% of bond proceeds must be spent on “good costs,” which generally include all capital costs with limited exceptions.
- If bond proceeds are used to reimburse for previous expenditures, such expenditures must have been incurred no more than 60 days prior to issuer’s official intent (*i.e.* inducement) resolution.
- Costs of issuance payable from bond proceeds are capped at 2% of bond proceeds.
- Average bond maturity limited to 120% of useful life of facilities.
- Generally, no more than 24.99% of bond proceeds may be used for land acquisition.
- Issuer limited to earning up to 1.5% over bond yield, depending on the facts of the transaction.

Miscellaneous

Low-Income Housing Tax Credits 101

April 19, 2022

Holland & Knight

LIHTC Background

- Part of 1986 Tax Reform to Encourage Public-Private Partnership for the Construction and Rehabilitation of Affordable Rental Housing
- Administered by the Treasury Department and allocated by State Agencies
- Contained in Section 42 of the Tax Code
- Objective: To incentivize and leverage private-section investment capital for the creation and preservation of rental housing units in each state affordable to households earning 80% or less of Area Median Income.
- Credit is a dollar-for-dollar tax reduction

LIHTC Background (cont'd)

- The LIHTC program is administered by each state's housing finance agency ("HFA").
- Each state receives an amount of credits annually to allocate to projects. LIHTC are allocated to states based on population. For 2022, each state received $2.60 per capita, with small states receiving a minimum of $2,975,000 of LIHTC.
- Each HFA must have a qualified allocation plan ("QAP"), which sets out the state's priorities and eligibility criteria for awarding LIHTC, as well as tax-exempt bonds and state credits, to housing projects.
- Developers apply to an HFA and compete for tax credit allocations (exception for bond-financed projects).

LIHTC Background (cont'd)

- Allocation criteria include project location, housing needs characteristics, sponsor characteristics, tenant populations with special housing needs, revitalization plans, public housing waiting lists, projects intended for eventual tenant ownership, energy efficiency and the historic nature of the project.

- LIHTC awarded to a project cannot exceed the amount the state agency determines is necessary for the financial feasibility and long-term viability of the project. The agency must consider sources and uses of funds, amounts expected to be generated by tax benefits (i.e., equity for LIHTC and losses) and reasonableness of development and operating costs.

Tax-Exempt Bond Projects

- No allocation of credits needed.
- In order to generate LIHTC, tax-exempt bonds must be taken into account under the volume cap provisions of Section 146 of the Code.
- The ceiling on private activity bonds for calendar year 2022 is the greater of $110 multiplied by the State population or $335,115,000. This is a slight increase over 2021.
- If 50% or more of the aggregate basis of any building and the land on which the building is located is financed with tax-exempt bonds, LIHTC attributable to the entire Eligible Basis may be allowed without an allocation of credits from the HFA.

Industry Participants

- Congress
- IRS/Department of Treasury
- State Tax Credit Agencies
- Developers/Owners
- Property Managers
- Syndicators/Investors
- GSEs
- Nonprofits
- State/Local Governments
- HUD
- Tenants
- Tax Professionals

Who Can Use Credits?

- C Corporations can use Credits and losses against ordinary income and taxes
- Limitations on “closely-held” corporations
- Individuals limited under passive loss rules

Why Invest in LIHTC: Tax Benefits

- Predictable 10-Year Credit stream based on the cost of constructing or rehabilitating residential rental housing
- Depreciation losses
- One year carry back; twenty-year carry forward

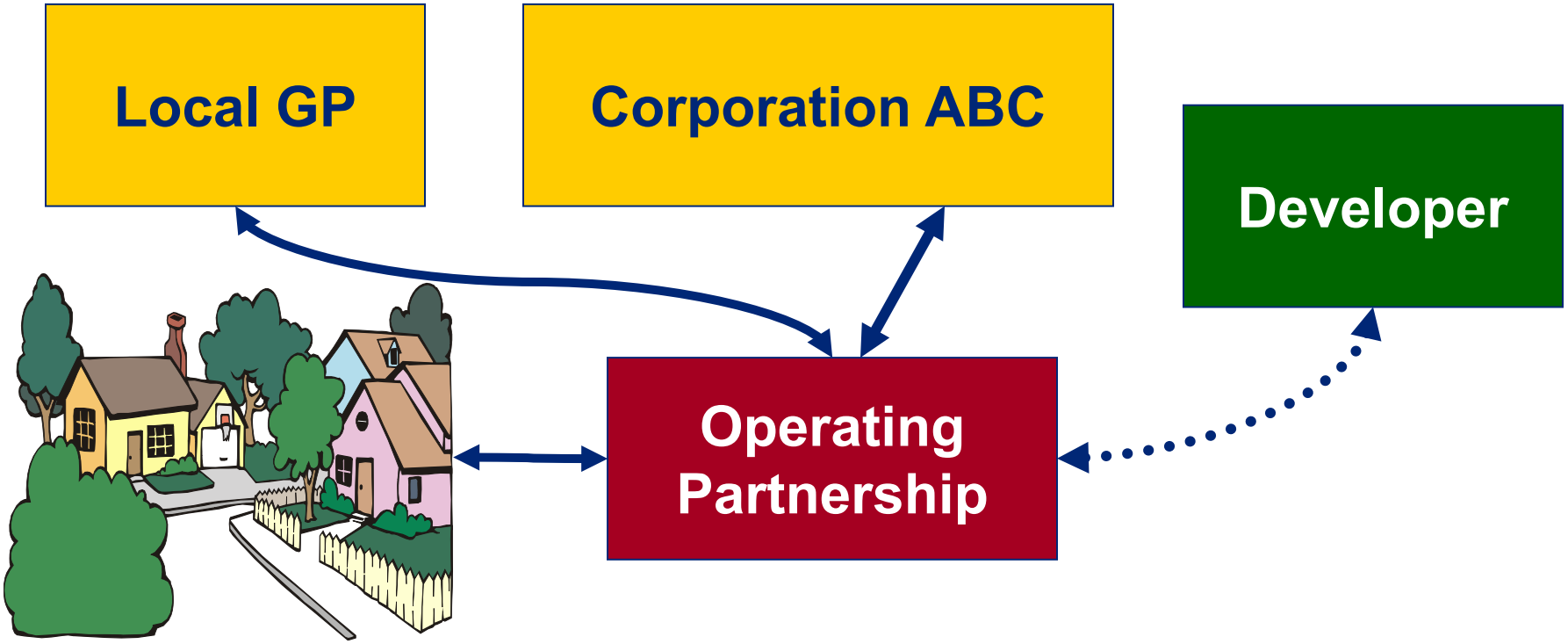
Why Invest in LIHTC: Other Benefits

- **Potential Economic Benefits:**
  - Cash Flow and Sale/Refinancing Sharing (But Not Generally Underwritten)
  - Asset Management Fee Revenue
- **Social Benefits:**
  - Community Reinvestment Act ("CRA") Qualification
  - Shareholder Relations
  - Social Responsibility
  - Some Projects May Qualify as Green Investments
- **Geographic Flexibility:**
  - Can Provide Geographic Diversification
  - Can Target for Local Priorities and Visibility

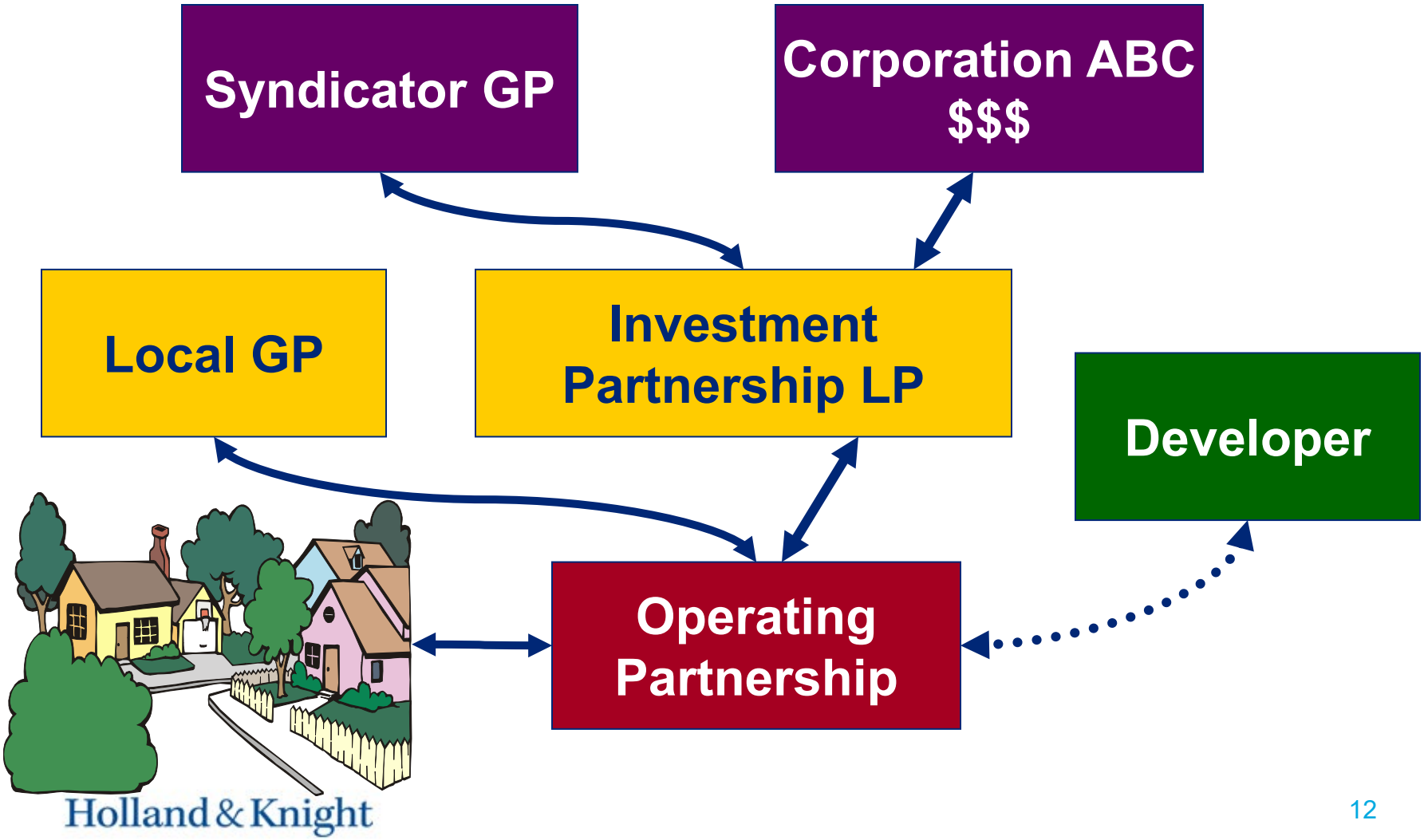
Common Investment Structures

- **Direct Investment:** Investment directly into the Project Partnership which is the Owner of the housing development
- **Proprietary Investment:** Investment in a particular housing development through a Fund managed by a Syndicator without other Investors
- **Multi-Investor Investment:** Investment in a particular housing development through a Fund managed by a Syndicator with other Investors
- **Secondary Investment:** Purchased during the 10-Year Credit Period from Original Investor
- **Guaranteed Investment:** Certain Sponsors may guarantee a specific yield and/or against specific investment risks

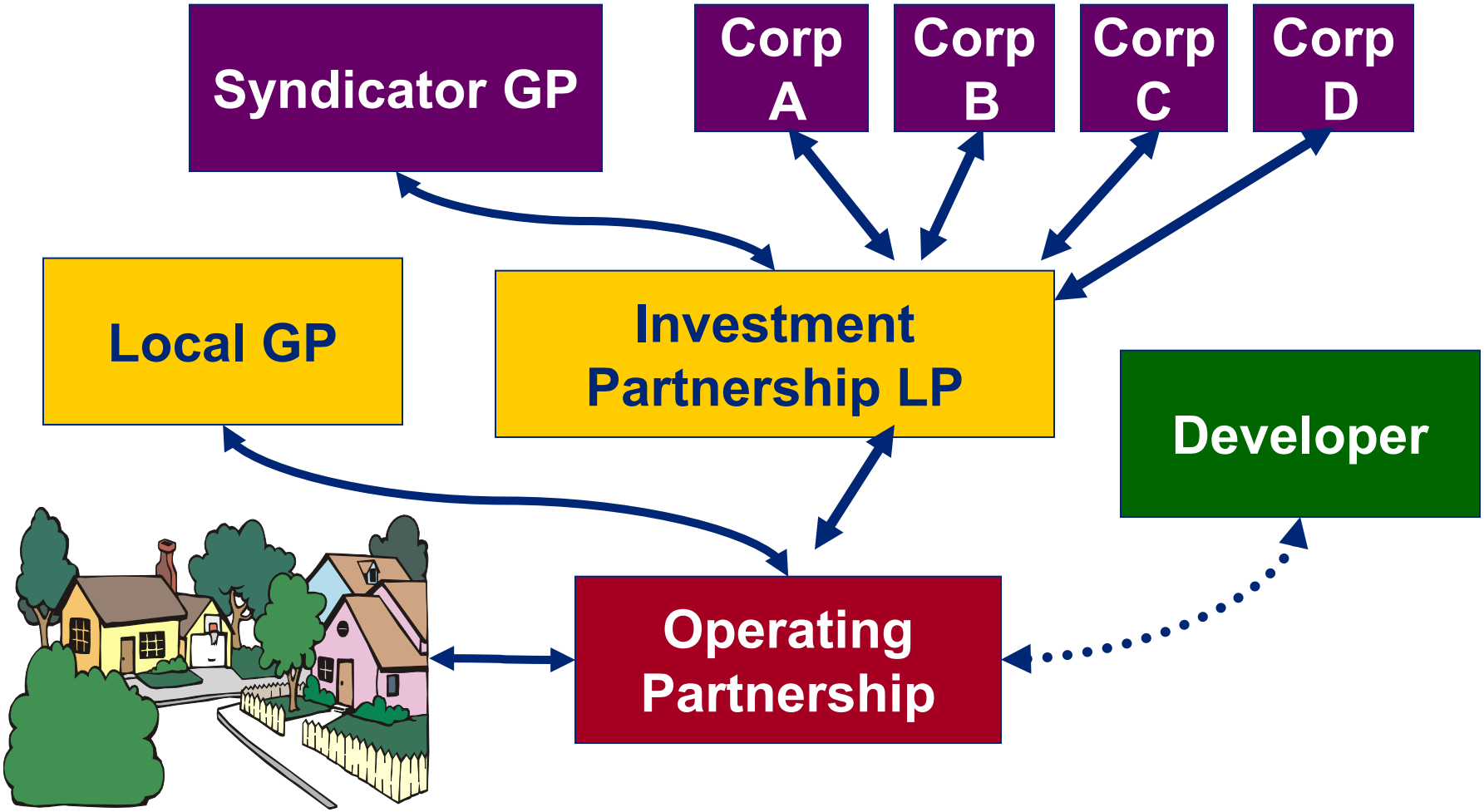
Direct Investment Structure



Syndication Structure (Proprietary Investment)



Syndication Structure (Multi-Investor)



Thank you!

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Financing Multi-Family Housing: Structuring the Low-Income Housing Tax Credit and Tax-Exempt Bonds

STRAFFORD WEBINAR

DATE: APRIL 19, 2022

PRESENTED BY: M. CHRYSA LONG

4% and 9% Federal LIHTC – IRC Sec. 42

- Qualifying for the 4% Credit (Sec. 42(h)(4))
  - Tax-Exempt Bond Financing
  - Application for LIHTC resource limited by volume cap
  - 50% Test (Sec. 42(h)(4)(B))
- Qualifying for the 9% Credit
  - Building Is Not "Federally Subsidized"
    (tax-exempt bond financing is a considered a federal subsidy)
  - Application for LIHTC resource limited per state population
    ($2.60 for 2022, $2,975,000 small state minimum)

Low Income Housing Tax Credit Overview

- Annual LIHTC Amount = Applicable Percentage X Qualified Basis
- Annual LIHTC Amount Available for each of 10 Years
- Credit Period Begins When a Building Is Placed in Service Unless the Taxpayer Elects to Defer the Start of the Credit Period to the Next Taxable Year (Sec. 42(f)(1))
- First Year Credit Reduced Proportionately for Qualified Occupancy During First Credit Year
- To Define Qualified Basis, Start by Defining Eligible Basis

Eligible Basis

- New Construction = Adjusted Basis (Generally, Development Cost Less Land)
- Acquisition = Acquisition Cost of Building
- Substantial Rehabilitation = Capitalized Rehabilitation Expenditures (24-Month Rule)
- Must Subtract Federal Grants
- 130% Increase in Qualified Census Tracts ("QCTs") and Difficult Development Areas ("DDAs") as Defined by HUD.
  - Local/State DDA designation is not available to tax-exempt bond financed projects.
- Excludes Commercial Space But Includes Common Areas

4% LIHTC for Acquisition

- Based on the Acquisition Cost of an Existing Building
- Purchase from an Unrelated Party (50% Related Party Rule)
- Ten-Year Rule
  - Certain Placements in Service Ignored for 10-year rule
    - Carryover Basis
    - Acquired from Decedent
    - Placement in Service by Governmental Unit or Nonprofit Entity
    - Foreclosure
    - Projects Substantially Assisted, Financed or Operated Under HUD or RHS Housing Programs or Similar State Housing Programs

4% LIHTC - Substantial Rehabilitation Requirement

- To Be Eligible for Acquisition LIHTC, Must Fulfill Substantial Rehabilitation Requirement
- Expenditures During a 24-Month Period Selected by the Taxpayer Must Equal the Greater of:
  - $7,400 Per Low-Income Unit (for 2022, Adjusted for Inflation), or
  - 20% of Adjusted Basis
- Separate New Building
- 4% (Tax-Exempt Bond Financed) or 9% LIHTC on the Expenditures

9% LIHTC for New Construction or Substantial Rehabilitation

- If No Tax-Exempt Bonds
- Federal Grants Must Be Excluded from Eligible Basis
- Financing sourced with bond proceeds (e.g., Affordable Housing Trust Funds) must be backed out of Eligible Basis in order to preserve 9% Credits

Qualified Basis

- Qualified Basis = Eligible Basis X Applicable Fraction
- Applicable Fraction Is the Lower of:
  - Number of Occupied Low-Income Units Divided by the Total Number of Residential Units, or
  - Floor Space Fraction
- Calculated Building by Building

Applicable Percentage

- With Qualified Basis Defined, Now Define Applicable Percentage
- Two Rates:
  - 4% LIHTC = As of 2021, not less than 4.00%
  - 9% LIHTC = not less than 9.00%
  - Owner Elects to Set Applicable Percentage for 4% LIHTC (i) When Receives a Binding Commitment from the State (or When Tax-Exempt Bonds Are Issued), <u>or</u> (ii) When Building Is Placed in Service

Example of LIHTC Calculation

- 100 Unit Project/70 Low-Income Units
- Total Development Costs (Including Land) = $5,500,000
- Land Cost = $500,000
- Eligible Basis = $5,000,000
- Qualified Basis = $3,500,000 ($5,000,000 X 70%)
- Applicable Percentage = 4.0%
- Annual LIHTC = $140,000 ($3,500,000 X 4.0%)
- 10-Year LIHTC Stream = $1,400,000

Equity Calculation

- Pricing/Investment Typically Based on Total LIHTC Available to Investor (and Timing of Delivery) and Market Conditions
- In Above Example, if Investor Invests $0.95 Per LIHTC Dollar, Equity = $1,329,867 ($1,400,000 X 99.99% X 0.95)
- Equity Generally Paid in Several Installments (Often 4 or 5 Installments) Based Upon Negotiated Benchmarks
- If 9% Deal, Equity = $2,992,201[($5,500,000 - $500,000) X 70% X 9% X 10 X 0.95 X 99.99%]

Affordability Commitment

- Minimum 30-Year Affordability Commitment
  - 15-Year LIHTC Compliance Period
  - 15-Year Extended Use Period (minimum)
  - Additional Bond regulatory restrictions
  - State Qualified Allocation Plan requirements ("QAP")
- Extended Use Agreement
- Early Termination of 30-year Affordability Commitment
  - Foreclosure (or Instrument in Lieu of Foreclosure)
  - Qualified Contract Process

Income Restrictions

- Minimum Set-Aside Election of:
  - 20% of Units at 50% of Area Median Income ("AMI"), or
  - 40% of Units at 60% of AMI
  - Average Income – Overall Average of 60% AMI for total Project within bands less than 60% AMI and up to 80% AMI (10% increments)
    - Limited use per State QAPs
    - Existing EUAs are not amended to allow this 3rd test
    - IRS updated guidance needed, current risks are disincentive to investment
- Election Upon Placement in Service
- Must Meet Minimum Set-Aside by End of First Credit Year and for the duration of the Compliance Period
- HUD Publishes Area Income Figures Annually

Rent Restrictions

- Rent (Including Utilities) Cannot Exceed 30% of Qualifying Income for Assumed Family Size; Based on Bedrooms Per Unit
- Rent Limits Change Annually With Publication of New Area Median Incomes
- Rent Will Not Decrease Below Original Floor
- Gross Rent Does Not Include Section 8 (or Similar Rental Subsidies)
- Gross Rent Must Include Utility Allowance for Tenant-Paid Utilities (i.e., Deduct from Rent to Owner)

Recapture

- Recapture on Non-Compliance:
  - Accelerated Portion of LIHTC Recaptured (1/3 of LIHTC in First 10 Years, Decreasing Through Year 15)
  - If Minimum Set-Aside Fails, All Accelerated LIHTC Recaptured
  - Otherwise, Unit-by-Unit (Extent of Decrease in Qualified Basis)
- Full Recapture on Transfer of Project or Interest Therein
  - De Minimis (1/3 Ownership) Exception
- Recapture Tax (Up to 1/3 of LIHTC Previously Claimed), plus Additional Interest Charge
- No Right to Receive Future LIHTC

Primary Structure for LIHTC Investment

- Projects owned by limited partnership or LLC - a pass-through entity
- Limited Partner generally is allocated (pass-through) 99.99% of Losses and Profits and Depreciation and LIHTC follow Losses
- Limited Partner pays Capital Contributions in installments to defer LIHTC delivery risk, based on negotiated development, financing and performance benchmarks
- Limited Partner Protections given by General Partner (see below
- Exit and Liquidation strategies – Year 15

Major LIHTC Investment Risks

Tax: Recapture of a portion of previously-allocated Credits and loss of Future Credits for Projects that do not comply with income, rent and other Project restrictions during the initial fifteen-year Compliance Period – including compliance with tax-exempt bond regulations

-Failure to issue tax-exempt bonds

Construction and Lease-up: Units must be "Placed in Service" with deadlines and rented to Qualifying Tenants to receive LIHTC

Operational: Loss of property through foreclosure resulting recapture and loss of future LIHTC

Sponsor Risk: Inexperienced or overextended Sponsor

Key Risk Balancing Terms

- LIHTC Adjusters
  - Eligible Basis Adjuster
  - Timing Adjuster
  - Compliance Adjuster
- Construction Completion/Stabilization Guaranty
- Operating Deficit Funding Guaranty
- Subsidy Guaranty/Reserve
- Removal of General Partner/Additional General Partner
- Removal of Investor Partner/Resale of LIHTC
- Removal of Management Agent

Key Risk Balancing Terms

- Reporting Requirements/Accountants
- Repurchase of Investor Interest
- Removal of General Contractor
- Operating/Replacement Reserves
- Personal Guarantees, including Recapture Guaranty

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