Financing Affordable Housing with 501(c)(3) Bonds

Justin Cooper, Jeffrey Philp and Barbara Jane League

orrick

Rise of 501(c)(3) Bonds

- As volume cap becomes more difficult to obtain, we are seeing a rise in the use of 501(c)(3) bonds to finance affordable housing projects

- 501(c)(3) bonds may be used to provide permanent financing for a project or may be used as bridge financing until volume cap is available

- 501(c)(3) debt also may be issued by the 501(c)(3) entity directly into the taxable market or may be issued as tax-exempt obligation by a conduit issuer for the benefit of the 501(c)(3) entity

Overview of Tax-Exempt Qualified 501(c)(3) Bonds for Affordable Housing

Tax-Exempt 501(c)(3) Bond Features not in Typical LIHTC Deals

- Requires a 501(c)(3) entity – not just any nonprofit
- Ownership requirement (100%)
- Private business use limitations apply
  - 5% limit
  - Management contracts must be QMAs
  - Private business use includes use by 501(c)(3) organizations engaged in activities that are unrelated trade or businesses
- Acquisition of existing property requires income limits or substantial rehab (Donnelly Amendments), but see Rev. Proc. 96-32
  - Rev. Proc. 96-32 requires some 501(c)(3) entities to meet a separate charitable purpose requirement that imposes a more stringent affordability test for affordable units

Tax-Exempt 501(c)(3) Bond Features not in Typical LIHTC Deals, cont.

- Land acquisition limits do not apply
- Substantial user limits do not apply
- Can finance de minimis working capital
- $150 million limit applies to some financings
- Bank qualification possible
- <u>**Volume cap not required**</u>
- Local property tax exemptions often available
- Questionable if SROs may qualify as affordable units when financed by 501(c)(3) bonds
- Reasonable expectations test must be met

Tax-Exempt 501(c)(3) Bond Features Typically Found in LIHTC Deals

- 95/5 test for good costs, but applied differently
- Costs of issuance limitation (2%)
- Conduit issuer required
- Affordability covenants apply
- Developer may still be involved
- Targeted populations allowed, but limited
- TEFRA hearing required

Donnelly Amendment

- Section 145(d) (a.k.a. the “Donnelly Amendment”) prohibits 501(c)(3) bond proceeds from being used to provide, directly or indirectly, “residential rental property for family units.”

- Provides exceptions to the prohibition for
  1. New residential rental property,
  2. Affordable housing that meets 142(d) low income set aside minimums, or
  3. Property that will be substantially rehabilitated (generally, rehabilitation expenditures <u>at least equal adjusted basis of building</u>) within a 2-year period beginning 1 year after the date of acquisition of such property.

Donnelly Amendment cont.

- Purpose of Donnelly Amendment was to subject qualified 501c3 bonds to low-income requirements.

- Otherwise, a 501c3 developer could use the proceeds of qualified 501c3 bonds, which do not require an allocation of volume cap, to acquire an existing low-income multifamily housing development and convert the project to housing for higher income residents, particularly seniors.

Frequent Tax Issues

- All payments must be at FMV
- Ownership must be 100% vested in 501(c)(3) for entire term of bonds
- More stringent affordability covenants or much higher rehab requirement must be met
- Making sure purchase of facility is a true acquisition
- Low-income set-aside requirements when purchasing an old LIHTC deal

Using Tax-Exempt Qualified 501(c)(3) Bonds as a Bridge to LIHTC

orrick

Some Issues to Consider

- **If transition to LIHTC is planned on Day 1, transaction must still meet reasonable expectations test**
- If LIHTC is desired in the future, the future LIHTC deal must meet all LIHTC requirements including 50% basis test and 95/5 good costs test
- Future LIHTC deal must be set up as an acquisition, which require 15% rehabilitation requirement to be met (may provide motivation not to maintain property during interim period)

Some Issues to Consider, cont.

- If financing an existing property, 501(c)(3) deal must be structured as an acquisition.
  - If purchasing a property that previously had LIHTC, need to determine what ownership of property will be when investor exits at end of project period. If 501c3 gets more than 50% interest, then need a different 501(c)(3) for acquisition

- Generally, the exempt purpose of the 501(c)(3) has included specifically the provision of affordable housing, as evidenced by the application to the IRS for exempt status

Securities Act Issues

Securities Act Exemption

- Securities issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual are exempt securities for purposes of the registration requirements of the Securities Act of 1933.

- If 501c3 bonds are being issued on a taxable basis without a conduit issuer, reliance on this exemption will be necessary.

- Requires the same level of tax diligence as if issuing bonds as tax-exempt based on 501c3 status.

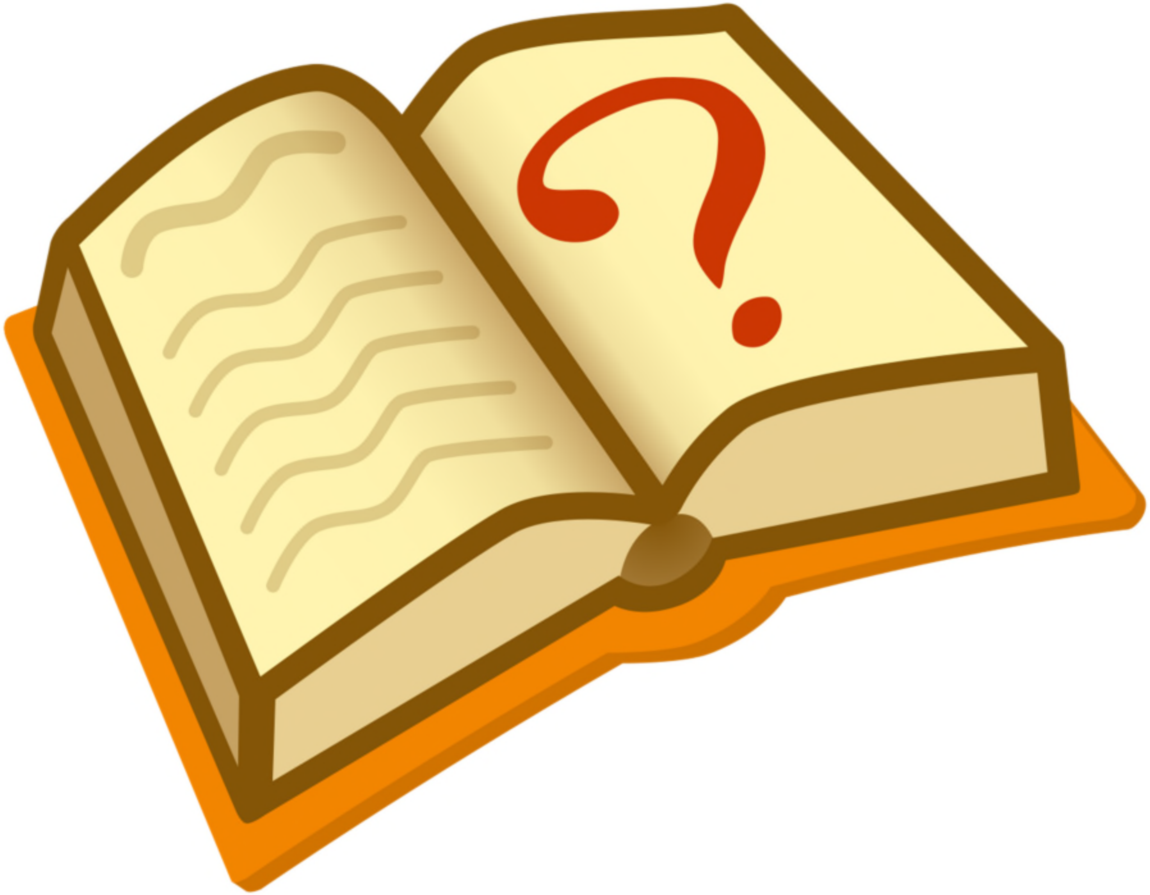
Case Study

Century Housing – CityView Apartments

- $43,745,000 issued through California Municipal Finance Authority
- 15-year bullet bond, priced at 109.903%
- Acquisition and rehabilitation of a 296-unit senior multifamily housing project in Long Beach, CA.
- Borrower is a CA limited partnership, the sole members of the GP and the ILP are organizations described in §501c3
- Equity
- Conduit issuer and no traditional commercial lender.
    - Covenants
    - Reserves
    - Redemptions

Century Housing – CityView Apartments

Questions?



orrick