# FINANCING HOUSING PROJECTS IN OREGON WITH 501(c)(3) REVENUE BONDS

ACCESSING LOWER COST CAPITAL WITHOUT VOLUME CAP AND LIHTC FOR AFFORDABLE AND MIDDLE RENTAL HOUSING PROJECTS

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#### INTRODUCTIONS –



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- The Work We're Doing ....
  - Fast approaching 100 Private Activity
     Bond Financed Projects in just over
     3 Years
  - More than \$1 Billion in PAB Issuance over this period, fully utilizing Private Activity Bond Volume Cap
  - With projects across Oregon and almost all projects leveraging both State or local gap-funding sources





• HEADWINDS – a wind blowing directly in front, opposing forward motion

Rising Interest Rates

## Rising Construction Costs

Lack of Sustainable Gap Funding Limited Volume Cap

## • CAN I FINANCE MY HOUSING PROJECT WITHOUT VOLUME CAP & LIHTC?



# OVERVIEW

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**Revenue Bond Basics** Private Activity Bonds and Volume Cap in Oregon 501(c)(3) Tax Compliance Financing Housing Projects with Tax-exempt Bonds Traditional Use of Tax-Exempt Bonds for Housing Projects Mixed- and Middle-Income Housing "Lessening the Burdens of Government" Potential Middle Housing Financing Structures Other things to Consider **Oregon Issues and Issuers** Leaning in on Innovation



#### CONDUIT REVENUE BOND BASICS

- Conduit Bonds are issued by a qualified State or local Government Issuer for the benefit of a qualified private entity, with the Issuer loaning to the private entity the proceeds of the Bonds generated by their sale to the Investor(s).
- The Bonds are payable solely from the revenues and security pledged by the private borrower, without recourse to the tax or other revenues or assets of the Issuer.
- Subject to compliance with federal tax requirements (and State law), interest on the Bonds is tax-exempt to the investor/bond purchaser, resulting in a lower cost of funds for the capital project being financed.
- Tax-exempt conduit bonds are issued as either private activity bonds 1) requiring an award of private activity bond volume cap or 2) as 501(c)(3) bonds.



#### PRIVATE ACTIVITY BONDS AND VOLUME CAP IN OREGON

- Volume Cap is a federal limit on certain types of tax-exempt bonds that can be issued in a state in a year
- Oregon volume cap is just over \$500 Million Annually
- Historically, demand was far less than annual cap amount, allowing unused cap to be carried-forward for use in the following 3 years, allowing several hundred million dollars in PAB capacity and related LIHTC to be "banked" for future projects
- This carry-forward amount has now been depleted with acceleration of affordable housing production, with cap now subject to competitive criteria established by OHCS via amendments to State QAP
- Cap is monitored, managed and optimized by Treasurer's Office and the Private Activity Bond Committee in combination with the Biennial Bond Bill
- In recent years almost all volume cap has been allocated to multifamily 142(d) Bonds issued by OHCS and Local Housing Authorities to generate maximum LIHTC and leverage State and Local gap funding sources

## **Comparison of Housing Bonds**

	501(c)(3)		Governmental	Exempt-Facility*	
Volume Cap Required	No		No	Yes	
LIHTC Eligible	No		No	<u>New Volume Cap</u> Yes	Recycled Volume Cap No*
For-Profit Ownership	No		No	Yes	
Qualified Management Contracts Required ***	Yes		Yes	No	
TEFRA Required	Yes		No	Yes	
95% Good Costs	Yes****		No	Yes	
2% Costs of Issuance Limit	Yes		No	Yes	
"Private Use" Limitation	5%		5%/10%	None	
Income Set-Asides (Federal)	Acquisition 20@50 or 40@60 & (ii) New Const. requirements below <u>New Const.</u> Depends on Charitable Purpose**	<u>New Const.</u> depends on charitable purpose	None/Contractual	20%@50% AMI or 40%@60% AMI	
Issuer Jurisdiction Requirement	No		Yes	No	
State and Local Requirements	Varied		Varied	Varied	

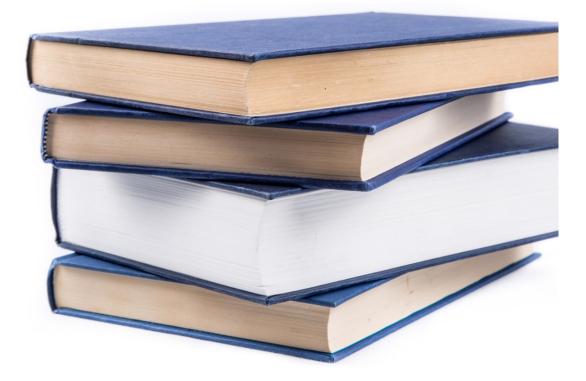
## **General Considerations**



- 501(c)(3) bonds are tax-exempt qualified private activity bonds issued by a state or local government, the
  proceeds of which are used by a 501(c)(3) organization to further its mission and exempt purpose\*
- Eligible borrowers include nonprofit corporations recognized by the IRS (except in limited circumstances) as a 501(c)(3) organization
  - Note: Not all nonprofit organizations are 501(c)(3) organizations and not all 501(c)(3) organizations may finance affordable housing
- 501(c)(3) organizations may form one or more single member LLCs (SMLLCs) for which the 501(c)(3) organization is the sole member to act as the borrower. SMLLCs that do not elect other tax treatment are disregarded entities for this purpose
- \*501(c)(3) bonds are technically private activity bonds, but not the same private activity bonds that affordable housing industry knows and loves

## **General Considerations, cont.**

- Eligible projects for 501(c)(3) bonds may include capital expenditures, refunding prior debt (under certain circumstances), reimbursing prior expenditures (under certain conditions), (limited) working capital, costs of issuance, capitalized interest and debt service reserve funds.
- 501(c)(3) bonds are hybrids that have characteristics of governmental purpose bonds and private activity bonds
- Conduit issuer required



## Qualified 501(c)(3) Bonds - Use Tests

Qualified 501(c)(3) bonds must satisfy two use tests:



**Ownership Test**. All property financed by the net proceeds of a 501(c)(3) bonds must be owned, <u>at all times while the bonds are outstanding</u>, by either a 501(c)(3) organization or a state or local governmental unit.



**Modified Private Business Test.** 501(c)(3) bonds become taxable if they exceed the limits set forth in the modified private business test. 501(c)(3) bonds exceed these limits if both the private business use limits and the private security or payment limits, as modified, are exceeded.

## **Ownership Test**



Ownership test requires continuous ownership during entire time 501(c)(3) bonds are outstanding

Ownership can be by multiple 501(c)(3)entities directly or through an LLC or LP, as long as no member/partner is a for profit or a nonprofit that is not a 501(c)(3) entity

Long-term leases that convey tax ownership to the lessee qualify as ownership for purposes of this test

Incidences of ownership held by other parties, such as a developer, can cause this test to be failed

## **Modified Private Business Test**

- The modified private business test contains two limits, both of which must be met for 501(c)(3) bonds to be issued on a tax-exempt basis
- Private Business Use Limit No more than 5% of net proceeds may be used, directly or indirectly, for a private business use
  - Note: Proceeds used to pay costs of issuance are treated as if used for a private business use
- Private Security/Payments Limit No more than 5% of bond debt service may be derived from private business use and or be secured by privately used property

## **Private Business Use**



The Private Business Use Test is generally met if more than 5% of the proceeds are used in a trade or business carried on by any person other than 501(c)(3) entity or a "governmental unit"

Any activity carried on by a person other than a natural person is automatically treated as a "trade or business"

Use by members of the "general public" is not taken into account

Uses by 501(c)(3) organizations with respect to activities that <u>do</u> <u>not constitute</u> unrelated trade or business activities (determined by applying 513(a)) generally are good uses

All uses by 501(c)(3) organizations with respect to activities that <u>do constitute</u> unrelated trade or business activities (determined by applying 513(a)) are private business uses

## **Additional Types of Private Business Use**

- A "special entitlement" of a business user to use bond-financed property. Examples include:
  - Nonqualified management and service contracts
  - Leases of bond-financed property, including cell tower leases
  - Rights of first refusal
  - Equity-like interests in the property
  - Naming rights
  - Preferential rates for certain customers

#### **Qualified Management and Service Agreements ("QMAs")**

- <u>Non-employee</u> service providers operating within tax-exempt bond financed space can give rise to "private business use"
- Over the years, the IRS has published "safe harbor" management and service agreement rules that, if satisfied, provide that non-employee management and service agreements do not give rise to private business use of bond financed property
  - Compensation under the agreements is analyzed for fixed/variable, timing, reasonableness, reimbursement of expenditures, profit-sharing, incentive compensation, term of contract, etc.
  - Relationship between the parties is analyzed for control over managed property, who bears risk of loss, inconsistent tax positions, reimbursement of expenses of operations

## QMAs, cont.

- A management agreement is generally a QMA if it provides for
  - compensation that is reasonable and in no way based on the net profits derived from the operation of the managed property;
  - the service provider does not, in substance, bear any share of net losses from the operation of the managed property;
  - the governmental unit (or 501(c)(3) organization, as appropriate) to exercise a significant degree of control over the use of the managed property;
  - a term, including renewal options, that does not exceed the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property; and
  - an explicit agreement by the service provider to not take any tax position that is inconsistent with its
    role as a service provider with respect to the bond-financed property (e.g., the service provider must
    agree not to claim any depreciation or amortization, investment tax credit, or deduction for any
    payment as rent with respect to the managed property).

## QMAs, cont.

- A management agreement is generally a QMA if it provides for (cont.)
  - the service provider cannot have any role or relationship with the 501(c)(3) organization that substantially limits the or 501(c)(3) organization's ability to exercise its rights under the contract. In addition, the 501(c)(3) organization, rather than the service provider, must bear the risk of loss from damage or destruction of the property.
  - reasonable compensation and no sharing of net profits or net losses.
    - compensation to the service provider "will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon either the managed property's net profits or both the managed property's revenues and expenses ... for any fiscal period".
  - ability to defer comp to manager is limited.



- <u>Agreements with employee</u> service providers generally are okay if no part of the employee's compensation is derived, directly or indirectly, from the net profits of the operation of the facility
- <u>Bottom Line</u>: Analyzing management and service agreements requires more legal analysis and judgement than ever before and contracts should be reviewed by bond counsel <u>prior to execution</u>

## **\$150 Million Limit**

- General Rule The amount of 501(c)(3) bonds that may be issued to benefit a 501(c)(3) organization, except certain bonds issued to benefit hospitals, is limited to \$150 million.
- Exception There is an exception for bonds issued
  - after August 5, 1997, and
  - At least 95% of the net proceeds will be used to finance capital expenditures.
- Bonds are allocable to a 501(c)(3) organization under a set of "test period beneficiary" rules that bring in bond issues benefitting certain related entities, and another rule that treats organizations under common management or control as one entity.
  - Note: As a result, the \$150 million limit can be exceeded well after the issue date for a bond issue in the event of a merger or similar transaction



## Additional Requirements of Qualified 501(c)(3) Bonds



**Special Maturity Limitation** – Generally, weighted average maturity of private activity bonds must not exceed 120% of the reasonably expected economic life of the facilities being financed.



**TEFRA Public Approval Requirements** – Prior to issuance, 501(c)(3) bonds must be approved by (1) the governmental entity issuing the bonds or on behalf of which the bonds were issued and (2) each governmental entity having jurisdiction over the area in which the bond-financed facility is to be located.



**Costs of Issuance Limitation** – No more than 2% of the proceeds of the bonds may be used to pay costs of issuance.

# Additional Requirements of Qualified 501(c)(3) Bonds, cont.

**No Federal Guarantees –** No tax-exempt bond will be treated as tax exempt if the payment of principal or interest is directly or indirectly guaranteed by the federal government or any agency or instrumentality of the federal government.

**No Hedge Bonds** - A "hedge bond" is any bond that is part of a bond issue that fails either of the following requirements: (1) The issuer must reasonably expect that 85% of the spendable proceeds of the issue will be used to carry out the qualified purpose within the three-year period beginning on the date the bonds are issued ("spendable proceeds" means proceeds from the sale of the issue, less the portion invested in a reasonably required reserve or replacement fund or as part of a permitted "minor portion"). (2) Not more than 50% of the proceeds of the issue are invested in nonpurpose investments having a substantially guaranteed yield for four or more years.

**Bonds Must Be in Registered Form -** All tax-exempt bonds must be issued "in registered form" unless the obligation is of a type not offered to the public or has, at the date of issue, a maturity date of not more than one year.

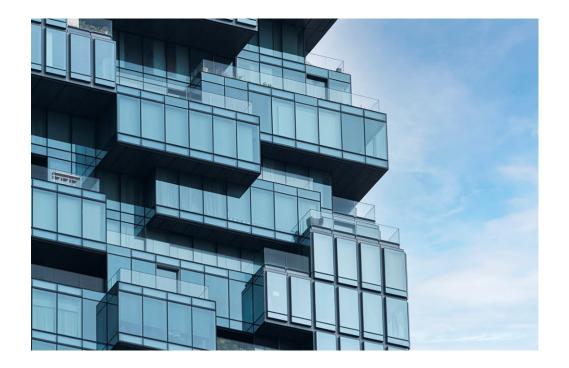
## **Donnelly Amendment**

- 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 construction residential rental property,
    - Note: Refinancing of taxable debt after placed in service date is allowed in limited circumstances
  - 2. Affordable housing that meets 142(d) low income set aside minimums, or
  - Property that will be substantially rehabilitated (generally, rehabilitation expenditures <u>at least equal</u> <u>adjusted basis of building</u>) within a 2-year period beginning 1 year after the date of acquisition of such property.



## **Donnelly Amendment**

- Purpose of Donnelly Amendment was to subject qualified 501(c)(3) bonds to low-income requirements.
- Otherwise, a 501(c)(3) developer could use the proceeds of qualified 501(c)(3) 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.
  - Note: Acquisition of existing property may require income limits under the Donnelly Amendment. However, Rev. Proc. 96-32, discussed above, may add additional more burdensome income limits in order for the borrower to qualify as a 501(c)(3) entity. <u>The set-asides under both Donnelly and Rev. Proc.</u> <u>96-32 must be met in some circumstances</u>.



## Charitable Purposes that May Include Provision of Affordable Housing

- The two primary charitable purposes that the IRS has recognized as including the provision of affordable housing include
  - relief of the poor, the distressed, or the underprivileged; and
  - lessening the burdens of government
  - Other purposes may include combatting community deterioration, elimination of discrimination and prejudice, lessening neighborhood tensions, and relief of the distress of the elderly and physically handicapped. However, a discussion of these purposes is beyond the scope of this presentation.
- Each purpose has different requirements that must be met in order for a 501(c)(3) entity with that purpose to provide affordable housing to further its charitable purpose
- <u>Example</u>: XYZ Charity has the relief of the poor, the distressed or the underprivileged as a charitable purpose. It would like to build new market rate workforce housing in a distressed community to help spur additional economic development in that community. The provision of market rate workforce housing (i.e., housing that is not subject to low income set asides) is not in furtherance of XYZ Charity's exempt purpose.

## **Relief of the Poor, Distressed or Underprivileged**

- Rev. Proc. 96-32 sets forth the following safe harbor under which organizations that provide low-income housing will be considered 501(c)(3) entities because they relieve the poor and distressed
  - (1) For each project (a) at least 75 percent of the units are occupied by residents with incomes not in excess of 80% of an area's median income (i.e., the low-income limit); and (b) either at least 20 percent of the units are occupied by residents with income not in excess of 50% of an area's median income (i.e., the very low-income limit) or 40 percent of the units are occupied by residents that also do not exceed 60 percent of the area's median income.
  - (2) The project actually is occupied by poor and distressed residents.
  - (3) The housing is affordable to the charitable beneficiaries.
  - (4) If a project consists of multiple buildings and each building does not separately meet the above requirements, then the buildings must share the same grounds.



## **Lessening the Burdens of Government**



- Rev. Rul. 85-1 states that for an organization to be lessening the burdens of government, two facts-and-circumstances tests must be met:
  - 1. The organization must be conducting activities that a governmental unit considers to be its burden, and
  - 2. The activities actually must lessen the governmental burden.

## Lessening the Burdens of Government, cont.



#### Rev. Rul. 85-1 also states

- Lessening the burdens of government occurs only if the governmental unit formally recognizes the activities of the organization to be its burden
  - This objective manifestation may be evident in the interrelationship between the organization and the governmental unit.
  - The organization's activities were an integral part of a larger governmental program and the organization funded governmental expenses.
- The fact that a governmental unit expresses approval of an organization's activities doesn't establish that the organization is lessening the burdens of government.

- POTENTIAL 501(c)(3) MIDDLE HOUSING FINANCING OPPORTUNITIES
  - Preservation of Naturally Occurring Affordable Housing
  - Development and Construction of Middle/Workforce Units
  - Purchase of New Construction Units Prior to Placed in Service
  - Essential Worker Units in Rural Communities
  - Mixed Income Projects

#### – <u>DONNELLY AMENDMENT</u>

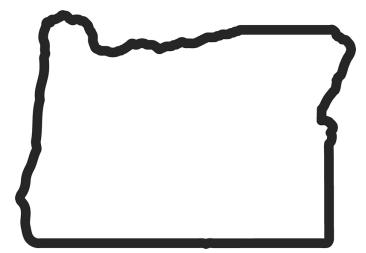


# • OTHER THINGS TO CONSIDER

- Fair Housing Compliance
- Property Tax Exemption
- Prevailing Wage



- OREGON ISSUES AND ISSUERS
  - Issuer Income and Rent Limits
  - Eligible/Permitted Investor Requirements
  - Public Gap Funding Eligibility
  - Oregon Housing & Community Services Department
  - Oregon Facilities Authority



## LEANING IN ON INNOVATION

- Public Private Partnerships (P3s)
- Employer Buy-In/Investment
- PRI & Impact Investment
- Public Investment across continuum
- Local Government Toolboxes
- Development of Best Practices
- Advocacy



