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Tax-Exempt Bonds in Affordable Housing Development

BNY

Tax-Exempt Bonds in Affordable Housing Development

Katie Moriarty
Director, Knowledge & Networks Division
Council of Development Finance Agencies
Columbus, OH

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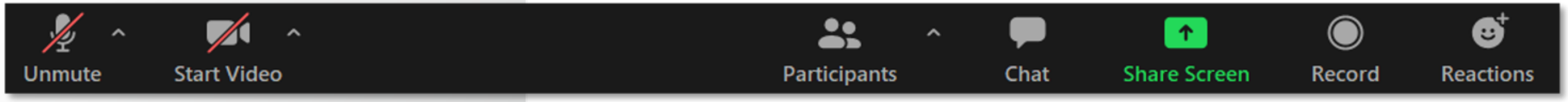

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Tax-Exempt Bonds in Affordable Housing Development

Patricia Trlak

Senior Vice President, Relationship Management
BNY Mellon
New York, NY

Tax-Exempt Bonds in Affordable Housing Development

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Alex Hassinger
Director
CohnReznick LLP

Charlie Rhuda III
Partner
Novogradac & Company LLP

Dan Bronfman
Managing Director, Affordable Housing & Community Development Lending
Banc of California

Tax-Exempt Bonds in Affordable Housing Development

Alex Hassinger

Director
CohnReznick LLP

Presenter:

Alex Hassinger
Director, Project Finance and Consulting
CohnReznick Advisory, LLC
(617) 603-4513
Alex.Hassinger@cohnreznick.com

Objectives

- Summarize 4% low-income housing tax credit process
- Discuss structuring considerations for Tax-Exempt Bonds

4% LIHTC Process

4% Credits

- 4% credit – originally designed to subsidize 30% of the low-income unit costs in a project.
  - As part of the Consolidated Appropriations Act of 2021, the applicable percentage for LIHTC allocations received after December 31, 2020, the credit rate shall not be less than 4%. This also applies to a building, for which a portion is financed by tax exempt bonds issued after December 31, 2020.
  - 4% credits are awarded "as of right" in conjunction with tax-exempt bonds, although the tax-exempt bond financing is limited by the state's volume cap
  - Except for the 4% acquisition credits that can be combined with the 9% credit, all other projects claiming 4% tax credits use tax exempt financing

Allocation Process

- 4% Credit – process/timeline
  - IRC 42(m)(1)(D) requires that projects receiving 4% credits meet the requirements of the agency's qualified allocation plan
  - Bond Issuer's board votes to approve the issuance (inducement, official action status, official intent)
  - Agency issues a 42(m) letter stating that the project is financed with tax-exempt bonds and that the 4% credits are no more than necessary to achieve feasibility of the project – this occurs prior to closing
  - Investor and issuer will want to see that the bond amount is underwritten to pass the 50% test
  - Issuer and bond counsel will want to see that the project has sufficient qualified costs to pass the 95-5 test
  - Agency will do a feasibility check after the project is placed in service as well and can reduce the 4% credits if necessary.

Structuring considerations

Volume Cap Scarcity

- Half of the states are oversubscribed and 11 more are using all of their volume cap
- Many issuers are requiring projects to underwrite the 50% test with a cushion of 1.5% to 3% to limit the impact on volume cap
- Consider carving out market rate, commercial, or ineligible site costs via condominium or long-term lease
- Ground leases can be helpful, but there should be an appraisal that values the leasehold interest in the land
- Recycled or taxable bonds

Balancing the 95/5 & 50% Tests

- Recycled tax-exempt bonds

- The exclusion of Seller take back loans and assumed debt from qualified acquisition costs could severely limit the amount of tax-exempt bond proceeds for which a project will qualify – can you borrow enough to meet the 50% Test?

- Problems where acquisition of existing building occurred more than 60 days prior to inducement resolution – again, can you borrow enough to meet the 50% Test?

- New tax credit syndications within the existing partnership/LLC

Tax-Exempt Bonds in Affordable Housing Development

Charlie Rhuda III

Partner
Novogradac & Company LLP

50% Test and 95-5 Test Considerations

Charles A. Rhuda III, CPA
Partner
Novogradac
charlie.rhuda@novoco.com

Presented to CDFA
Tues., April 22, 2025

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Additional questions:
charlie.rhuda@novoco.com

50% Test

Timing Issues

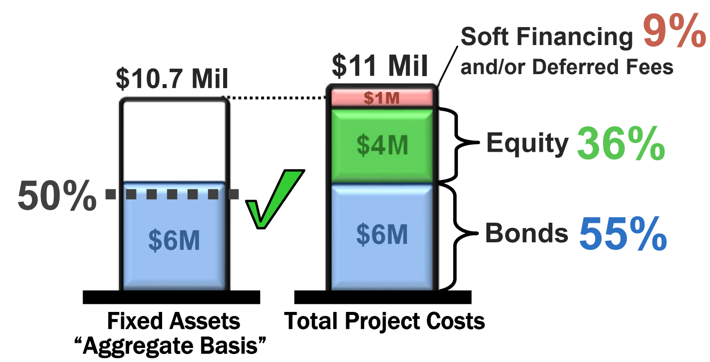
Timing Issues

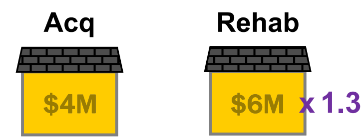
Q: When is the earliest I can pay off the bonds while still satisfying the 50 percent test?

A: Anytime after placed-in-service date for new construction or after the minimum rehab threshold has been met for acq/rehabs

Q: I complete the property in May and pay off the bonds in November. Am I passing the 50% test even though the bonds have been paid prior to 12/31?

A: Yes!





100%

	Acq		Rehab	
Eligible basis (w/ QCT)	$	4 Mil	$	7.8 Mil
Applicable fraction	x	100%	x	100%
Qualified basis	$	4 Mil	$	7.8 Mil
Tax credit percentage	x	4%	x	4%
Annual tax credits	$	160k	$	312k
Ten years	x	10	x	10
Total tax credits	$	1.6 Mil	$	3.12 Mil

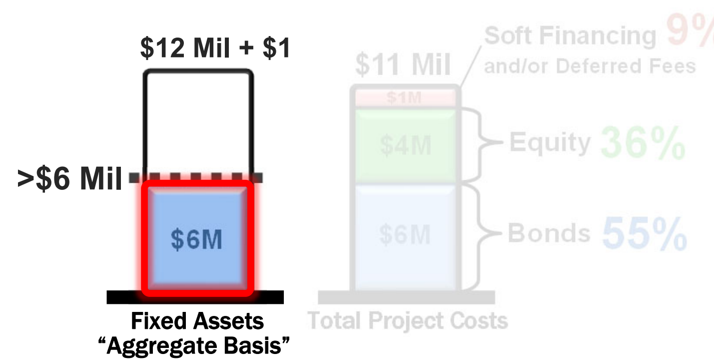
$4.72 Mil

Additional questions:
charlie.rhuda@novoco.com

50% Test

Common Pitfalls

- Cost overruns
  - Cause the denominator (aggregate basis) in the 50% test to rise, which can lead to a failed test
  - Remedies:
    - Issuing more bonds
    - Reducing aggregate basis via the developer fee
    - Reducing aggregate basis via other fees/costs
- Not drawing down the full amount of the bonds prior to the first year of the credit period/year rehab is placed in service
  - Funds held in escrow and not "used" don't count toward the 50% test



	Acq		Rehab	
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50% Test

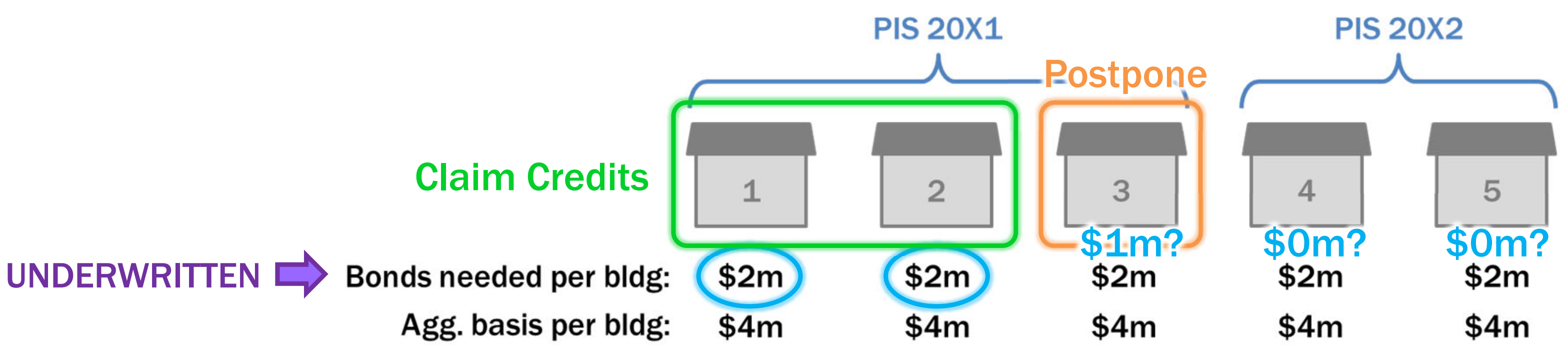
Multi-building Considerations

Scenario:

- 5 residential rental buildings of equal size
- $20m aggregate basis
- $17m construction contracts
- $11m in PAB proceeds
- 10% ($1.7m) contractor retainage withheld until after Building 5 is placed in service
- Assume Buildings 1-3 placed-in-service (PIS) during 20X1; Buildings 4 and 5 PIS in 20X2

Does it matter whether there is one project or multiple projects per Line 8b of the 8609s in meeting the 50% test?

How might this example property fail the 50% test?



What if, as of 12/31/20X1, only $5 million in bond proceeds are drawn?

Is it reasonable to assume that ZERO bond proceeds would have been expended for Buildings 4 and 5 at this point?

Additional questions:
charlie.rhuda@novoco.com

The 50% Test

Summary and Additional Notes

The outstanding amount of private activity bonds has to be 50% or more of the aggregate basis of the building comprising the Project and the land on which the building is located.

The aggregate basis includes commercial costs and offsite costs. (Back of the envelope calculation can simply use total project cost for the denominator to be conservative.)

The numerator is generally fixed unless the owner can apply for more private activity bonds.

Bonds must be drawn and <u>expended</u> for purposes of the 50% test.

50% test cutoff date could be the placed-in-service (PIS) date for the building or the last day of the first year of the tax credit period. IRS does not specify the cost cutoff date, but the amounts on the final cost certification are generally used because the bonds financed those costs.

PLR 9816018 has guidance that allowed the bond financing to be construction or permanent as long as the bonds have financed the building and land by the close of the first year of the credit period.

Cost overruns can be problematic, and some partnership agreements require the developer fee to be reduced to pass the 50% test.

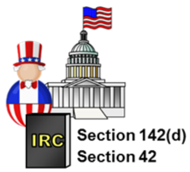
Private activity bonds are required to be used to pay for the aggregate basis of the building comprising the project and the land on which the building is located. However, direct tracing of the bond proceeds to specific costs is not required by the tax code.

CPA 50% test report may be required at tax credit application and at the placed-in-service package, and possibly investor request.

Repayment – redemption of the private activity bonds at any time on or after the placed-in-service date will not, in and of itself, result in a determination that the project was not financed by private activity bonds.

Qualified Costs vs. Unqualified Costs

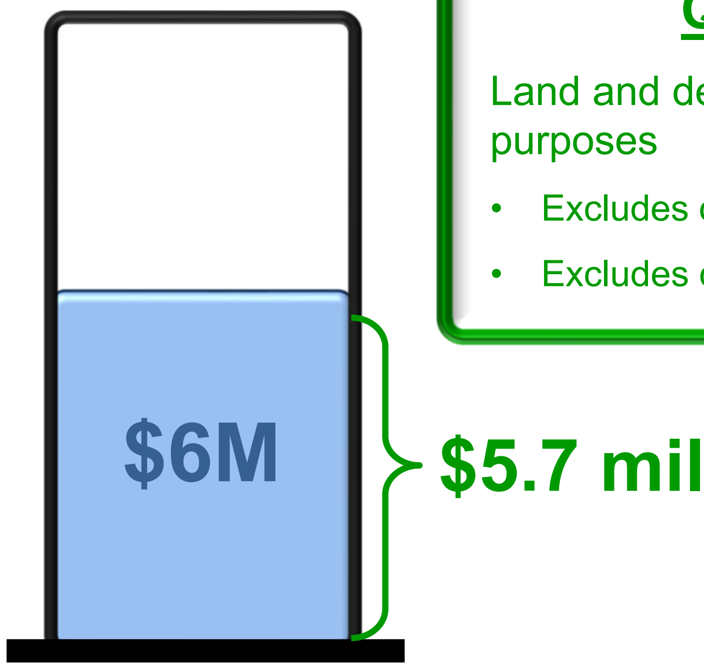
95% of proceeds must be used for qualified costs



Qualified Costs

Land and depreciable costs for income tax purposes

- Excludes commercial property
- Excludes community service facilities



Fixed Assets
"Aggregate Basis"

IRC §142(a)
Treas. Reg. §1.103-8(a)(3)

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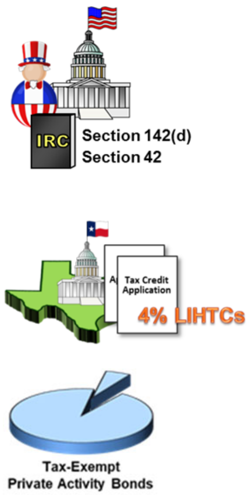
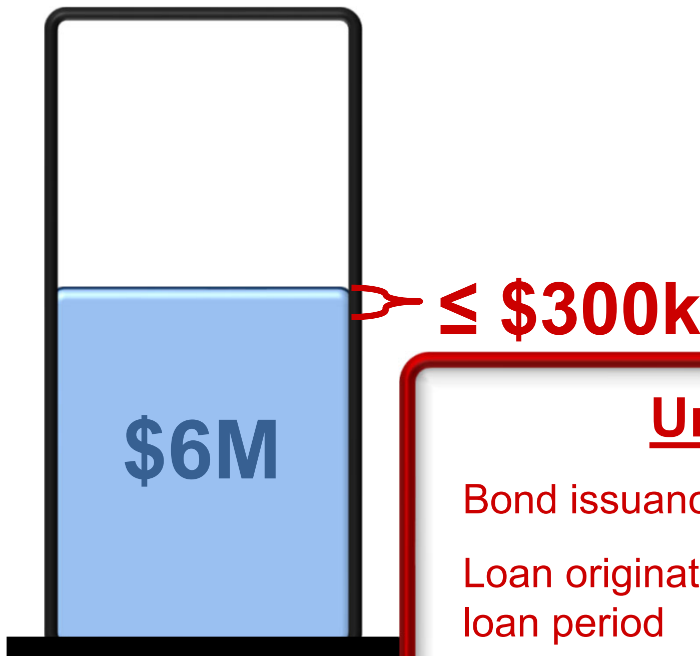
charlie.rhuda@novoco.com

Qualified Costs vs. Unqualified Costs

95% of proceeds must be used for qualified costs





Fixed Assets
"Aggregate Basis"

Unqualified Costs

- Bond issuance costs and underwriting
- Loan origination fees amortized over the perm loan period
- Related-party profit (also non-reimbursable)
- Other intangible assets

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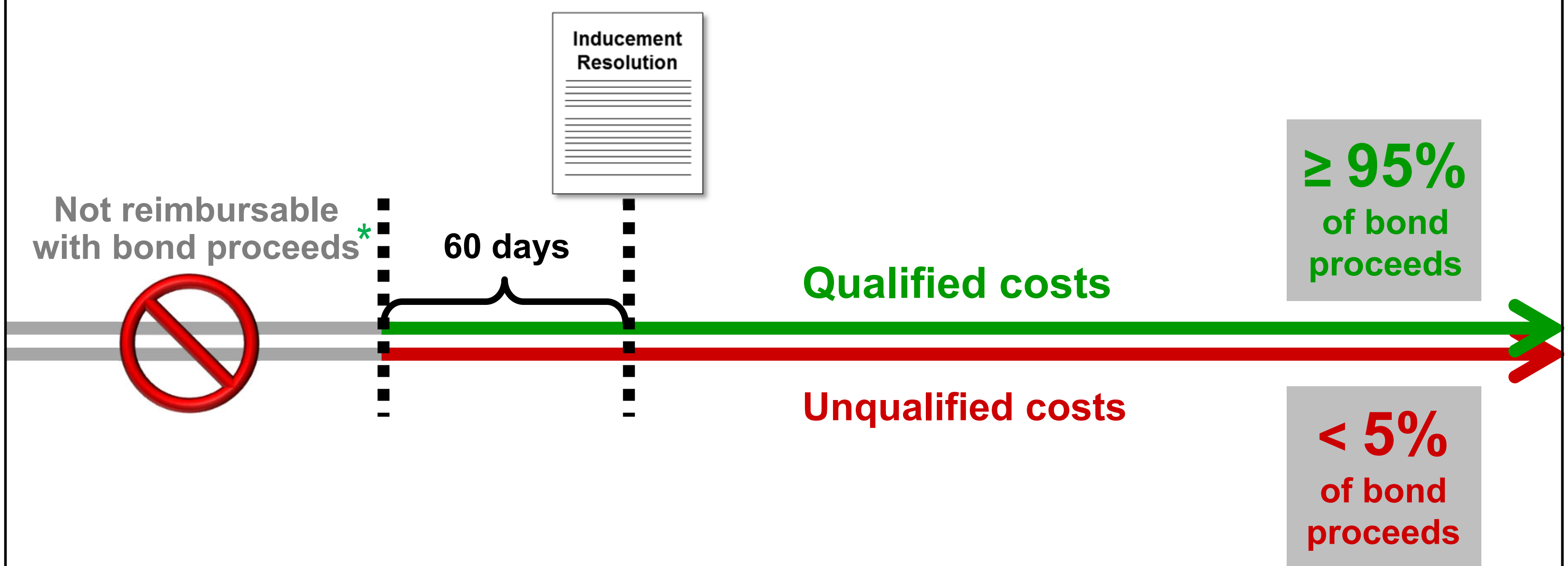
Qualified Costs vs. Unqualified Costs

95% of proceeds must be used for qualified costs



* "Preliminary expenditures" **are** reimbursable with bond proceeds (and qualified costs) even if they are incurred prior to the 60-day window as long as they are less than 20% of the bond issue.

Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

Treas. Reg. § 1.150-2(f)(2)

Additional questions:
charlie.rhuda@novoco.com

Qualified Costs vs. Unqualified Costs

95% of proceeds must be used for qualified costs

Summary and additional notes

- At least 95% of private activity bond proceeds from issuance must be used to pay or reimburse qualified (i.e. "good" costs).
- Generally, only costs paid or incurred after **60 days** prior to the bond inducement resolution are reimbursable, 95% of which must be qualified costs.
- Qualified costs are expenditures associated with the depreciable residential building, including capitalizable soft construction costs and the real property (land) itself.
- Unqualified costs generally include intangible assets such as partnership organizational costs, bond issuance costs (legal and underwriting fees) and loan origination fees that are amortizable over the permanent term of the private activity bonds.
- If 2% or more of the private activity bonds' proceeds are used to pay for the bond issuance costs, such as attorney fees, then the tax-exempt status of the bonds is lost.

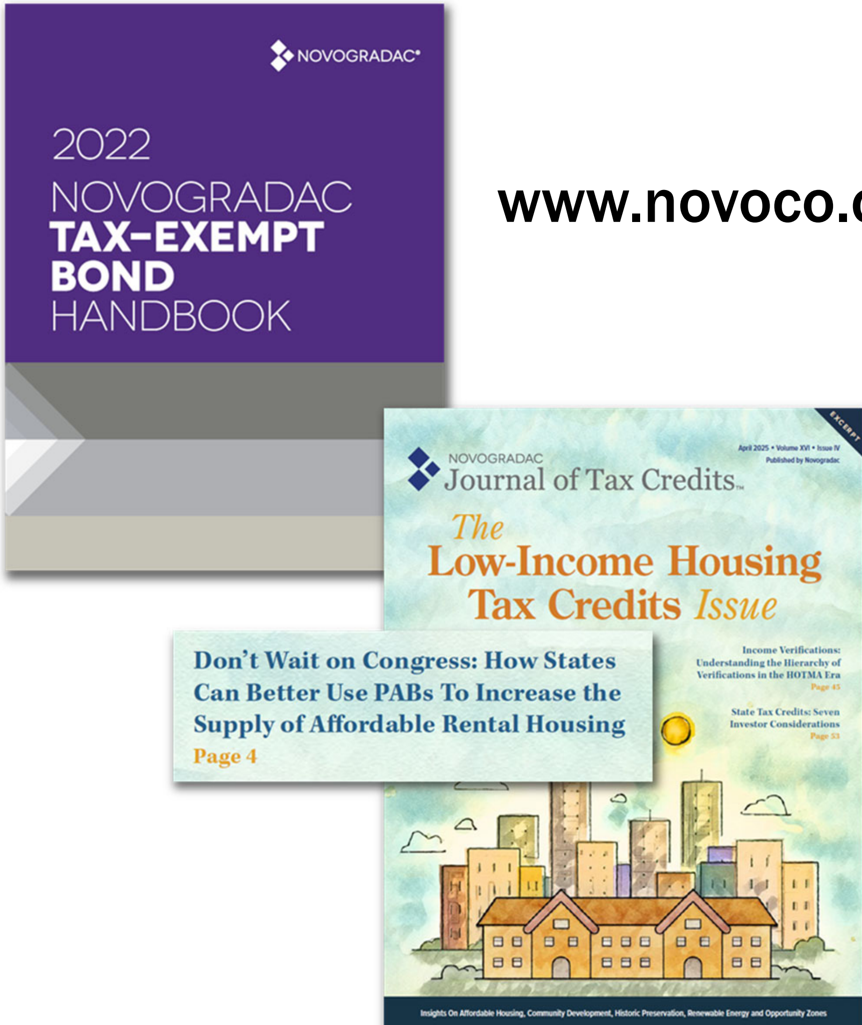
Additional questions:
charlie.rhuda@novoco.com

Instructors:

Charles A. Rhuda III, CPA
Partner
Novogradac
charlie.rhuda@novoco.com

Charles A. Rhuda III is a partner in the Boston office of Novogradac. He has more than 25 years of experience in the real estate industry, predominately in affordable housing and historic rehabilitation. Rhuda works with tax credit developers, managers, syndicators and investors on structuring, financing, syndicating and disposing/restructuring low-income housing tax credit, historic rehabilitation tax credit and opportunity zone transactions, in addition to providing traditional audit and tax services. He is a frequent speaker at regional and national seminars on topics in the affordable housing industry, as well as a contributor to industry trade publications. Rhuda graduated from Pace University with a bachelor's degree in public accounting. He is licensed as a certified public accountant in Connecticut, Maryland, Massachusetts, New Jersey and New York.

Additional questions:
charlie.rhuda@novoco.com



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Dan Bronfman

Managing Director, Affordable Housing & Community Development Lending
Banc of California

CDFA // BNY Development Finance Webcast

Tax-Exempt Bonds in Affordable Housing Development

April 22, 2025

www.bancofcal.com

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Presenter:

Dan Bronfman

Managing Director

Affordable Housing Lending

Banc of California

9701 Wilshire Boulevard, Suite 700

Beverly Hills, CA 90212

dan.bronfman@bancofcal.com

Office: (925) 386-0760

Cell: (310) 779-7729

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Overview – Tax-Exempt Financing:

- At the top of the capital stack.
- Highest priority, or senior position, to receive the financial benefits of the project:
  - Project Cash Flow – Gets paid first.
  - Project Assets – Land, Building, Fixtures, Furnishings, etc.
- Subordination of other debt/obligations in the capital stack – Subordination is Critical!
- Usually the largest source of funds.
- Often the last party to the table. Developers spend more time & effort filling-in the lower levels of the stack.

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Tax-Exempt Financing & Affordable Housing:

Driven by the Law/Tax Code:

- Required to combine 4.00% LIHTCs and tax-exempt financing.
- 50% Test – Tax-exempt proceeds have to fund at least 50% of project cost basis.

Lower Interest Rates:

- Interest not subject to Federal taxation.and not a preference item for determining Alternative Minimum Tax (AMT).
- Interest rate subsidy from the Federal Government.
- Lowers borrowing costs by an estimated 20% to 25%
- Supports larger permanent financing, as project Net Operating Income (NOI) has more debt service capacity.

Tax-Exempt Financing Debt Executions:

- Construction Vs. Permanent Financing Phases – Might need different lenders for each phase.
- Possible financing options:
  - Public Sale of Bonds – Need an investment grade rating or insurance.
  - Private-Placement of Bonds.
  - Insurance Companies.
  - Bank Loans
  - Government-Sponsored Enterprises/Lenders (GSEs) – Fannie Mae, FHA, Freddie Mac, etc.
  - State & Local Housing Agencies & Authorities.

Picking a Tax-Exempt Financing Structure:

- Transaction Complication – Understand structure, process & requirements, both now & in the future.
- Ease of Execution – Required time commitment from management & staff…and lawyers.
- Transaction Costs – Often hard to compare "apples to apples." On-going costs and funded reserves are considerations. Can costs & fees be fixed or capped?
- Flexibility – "Attractive" options often come with less flexibility.

Subordination & Tax-Exempt Financing:

All parties down the capital stack to be subordinate to the tax-exempt financing, including tenant income and use restrictions,…but might be room for negotiation.

Counting on parties down the capital stack to ensure the success of the project:

- Developer – Reputation risk. Guarantee completion & fees earned or deferred.
- Tax-Credit Investors – Complicated accounting/financial situation with project failure.
- City/County/State – Want affordable units available in the community.

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Case Study – Water Street Apartments:

Location – Santa Cruz, California
41-Unit Affordable Housing Project – 22 One Bedroom, 19 Two Bedroom
8-Units set aside for Developmentally Disabled
Per Unit Cost – About $512,000

Case Study – Capital Stack:

Amounts Rounded:		
	Construction Phase:	Permanent Phase:
Bank Debt – Tax-Exempt Loan:	$13,000,000	$8,450,000
Tax-Credit Equity:	$1,000,000	$6,500,000
City Fee Deferral:	$550,000	$550,000
City Loans:	$4,400,000	$4,400,000
Earned/Deferred Developer Fee:	$1,700,000	$630,000
Other/Misc.:	$350,000	$470,000
Total Project Cost:	$21,000,000	$21,000,000

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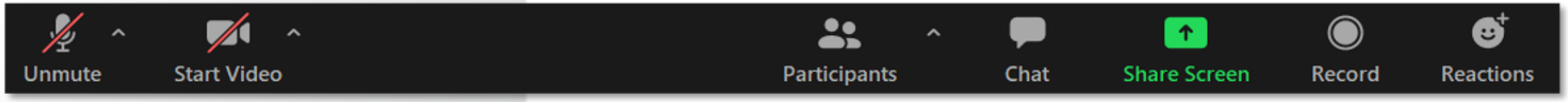
Audience Questions



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Intro Revolving Loan Fund Course
May 12-13 // 12:00 – 5:00 PM Eastern

Advanced Revolving Loan Fund Course
May 14-15 // 12:00 – 5:00 PM Eastern

CDFA // BNY Development Finance Webcast Series: Using P3 to Unlock Infrastructure Development
May 20 // 2:00 – 3:00 PM Eastern

Contact Us

Patricia Trlak
BNY
Senior Vice President, Relationship Management
312-827-1369
patricia.trlak@bny.com

Katie Moriarty
Council of Development Finance Agencies
Director, Knowledge & Networks Division
614-705-1314
kmoriarty@cdfa.net