Financing Multi-Family Housing: Structuring Low Income Housing Tax Credit and Tax-Exempt Bonds
Documenting Transactions for Investors and Developers

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Today’s faculty features:
Ryan Bowen, Senior Counsel, Chapman and Cutler, Chicago
Delphine G. Carnes, Crenshaw Ware & Martin, Norfolk, Va.
Brent L. Feller, Partner, Chapman and Cutler, Chicago

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

Prepared by Ryan J. Bowen and Brent L. Feller, Chapman and Cutler LLP
Introduction to Multifamily Housing Revenue Bonds and Tax Reform Update
Multifamily Housing Bond Basics

General

- Bonds are 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, financing through an issuance of tax-exempt bonds permits a developer to receive an allocation of 4% low income housing tax credits.
Qualified Private Activity Bonds

- Private activity bonds are bonds in 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 bond meets certain requirements and is a “qualified private activity” bond under the Internal Revenue Code.

- Residential rental facilities (i.e. multifamily housing developments) are a classification of qualified private activity bond.
Tax Reform Update

- **October 26th** – Congress passed a joint budget resolution with reconciliation instructions authorizing an increase to the federal deficit by $1.5 trillion over the course of 10 years.

- It is projected that every 1% reduction in the corporate tax rate will reduce federal revenues by $100 billion over a decade.

- **November 2** – Chairman Brady (House Ways & Means Committee) released a tax reform bill (Tax Cuts and Jobs Act) that provides for a 20% corporate tax rate, cap of mortgage interest deduction and repeal of the state and local tax (SALT) deduction, among other things.

- **November 16** – The Tax Cuts and Jobs Act was passed by the House of Representatives.

- *The Tax Cuts and Jobs Act, as drafted by the House of Representatives, would among other things, eliminate private activity bonds and advance refunding transactions, effective January 1, 2018.*
Tax Reform Update

- Senate Finance Committee proposed legislation concerning tax reform.
- The legislation proposed in the Senate, as currently proposed, would not eliminate private activity bonds, but would eliminate advance refunding transactions, effective January 1, 2018.
Termination of Tax-Exempt Private Activity Bonds

- The House Bill would prohibit the issuance of any tax-exempt private activity bonds after December 31, 2017:
  - This eliminates private activity tax-exempt financing for airports, port facilities, solid waste facilities, single family housing programs, multifamily housing developments and certain other exempt facility bond projects.
  - This also generally eliminates tax-exempt financings for § 501(c)(3) entities such as charter schools, non-profit hospitals, non-profit universities, cultural institutions and other exempt organizations.
  - Other types of tax-exempt and tax-advantaged financings are also adversely impacted.
Impact on Tax-Exempt Private Activity Drawdown Bonds and Forward Commitments, Etc.

- The House Bill would eliminate ability to issue or fund private activity bonds on a tax-exempt drawdown basis or take any tax-exempt additional draws after December 31, 2017.
- Future reissuance and current refunding concerns.
Timing for Passage of Tax Reform

- Congressional Republicans and the Trump Administration has stated goal of passage by the end of 2017.
- Extension of debate into 2018, even if private activity bonds are preserved, the House Bill will have an impact on the market and could potentially freeze new issuance activity until tax reform is passed or ultimately defeated.
FINANCING MULTI-FAMILY HOUSING: STRUCTURING THE LOW INCOME HOUSING TAX CREDIT AND TAX EXEMPT BONDS

Documenting Transactions for Investors and Developers

Using Low Income Housing Tax Credits (LIHTC)

By Delphine G. Carnes
Crenshaw, Ware & Martin, P.L.C.
Established by the Tax Reform Act of 1986 (P.L. 99-514) to encourage private investment in affordable housing. Was made permanent in 1993

Codified in Section 42 of the Internal Revenue Code ("Code")

Goal of the program is to provide financing for the construction and rehabilitation of affordable rental housing

Today, the LIHTC program is the main federal financing tool for the production and renovation of affordable rental housing. As of 2015, approximately 2.4 million affordable housing units were created using LIHTC
Developers of qualified projects who receive LIHTC in turn use the credits themselves or “sell” them to investors.

The investors’ equity contributions reduce the amount of debt the project would otherwise need.

With lower debt service payments, the projects can succeed with lower rents.
Dollar-for-dollar reduction of federal tax liability for the owner of the qualified project

Amount of credit based on cost of building new affordable units or renovating existing housing developments

Credits claimed over a 10 year period

Tax Credit Compliance period is 15 years

But the restrictions extend for at least 30 years
PARTIES TO THE TRANSACTION

- Developer
- State Housing Finance Agency
- Lender
- LIHTC investor
- Residents
- Consultant, General Contractor, Architect, Engineer, Surveyor, Title Company, Locality, Attorneys, Accountants
While it is a federal credit, the program is administered by state housing finance agencies.

States receive tax credits based on population, therefore the amount of available 9% credits is limited. The State allocation limits do not apply to 4% LIHTC.

State agencies allocate credits to developers. Selection priorities and procedures vary in each state and are outlined in a Qualified Allocation Plan (“QAP”).
QUALIFIED ALLOCATION PLANS (QAP)

- State housing finance agencies must adopt QAP to allocate credits

- QAP must set forth priorities that govern allocation

- QAP must identify a procedure for notifying IRS of non-compliance

- Projects financed with tax-exempt bonds must satisfy QAP
The types of projects eligible for LIHTC include apartment buildings, duplexes, townhouses and single family dwellings.

State agency will only allocate amount of credits necessary for the project’s feasibility.

Items to be considered include:
- Sources and uses of funds
- Equity to be generated by tax credits
- Reasonableness of development and operating costs
- Market study

Evaluation occurs at application, allocation and completion of project.
Ownership Structure in LIHTC Transactions

- Owner of the units is a for-profit entity (limited partnership)
- Tax credit investor is the limited partner and typically owns 99.99% of the entity (99.99% of tax credits, profits and losses)
  - Investor will invest its equity in the form of multiple capital contributions made according to negotiated benchmarks.
- General Partner typically owns 0.01% and oversees operations
  - General Partner guarantees construction completion, stabilization, operating deficits, as well as total amount of credits and timing of delivery of credits
OWNERSHIP CHART for LIHTC TRANSACTION

Limited Partnership

0.01%

General Partner (Developer)

99.99%

Limited Partner (Investor)
INVESTORS

- Typically, the investors rely on the credits as their primary return on investment. That return varies depending on the price they pay for the tax credits.
- In addition, investors receive tax benefits related to any tax losses generated by the project’s operating costs, debt service payments, and depreciation deductions.
- Investors have a primarily passive role in the partnership. The developer, as the general partner, controls the construction of the project and the day-to-day operations.
- The majority of investors are large corporations or financial institutions, some of whom invest through syndicators. Some investors are driven by a need to meet their Community Reinvestment Act (CRA) obligations, while others only look for a favorable rate of return.
**TYPES OF LIHTC**

- The subsidy is realized by claiming the credits each year for 10 years, with the actual credit amount calculated to yield a present value of 70% (with the 9% LIHTC) or 30% (with the 4% LIHTC) of eligible costs

- 9% LIHTC are the best you can get
  - Finances new construction without additional federal subsidies
  - More equity – 70% value
  - But much more competitive because limited amount in each State
  - Must include a minimum amount of rehabilitation per unit ($15,000 currently in Virginia)
4% LIHTC with Tax-Exempt Bonds

- Finances new construction that uses additional federal subsidies or the acquisition and renovation of existing units
- Less equity – 30% value
- Easier to obtain (bonds are competitive but 4% credits are automatic and not subject to the per capita limit)
- More complex financing structure
- Higher closing costs
- Must include a minimum amount of rehabilitation expenditures to qualify ($10,000 per unit currently in Virginia)
In IRS Rev. Proc. 2017-58, the IRS announced an increase in the LIHTC and private activity bond volume caps for 2018:

- The LIHTC state ceiling has gone up from $2.35 to $2.40 multiplied by the state population. The minimum for small states has gone up from $2,710,000 to $2,765,000.
- The amount used to calculate the state ceiling for the issuance of bonds has also increased; it will be the greater of $105 multiplied by the state population or $311,375,000. Previously, the state ceiling was the greater of $100 multiplied by the state population or $305,315,000.
CREDIT CALCULATION

- The credit earned depends on three variables:
  - the amount spent on the building (eligible basis)
  - the portion of the building devoted to low-income units (qualified basis)
  - the applicable rate (applicable percentage)
- The credit is calculated building by building
- Annual credit amount is available each year for 10 years, beginning with the year in which the building is placed in service (unless the taxpayer elects to defer the start of the credit period by one year)
- The credit is calculated to provide a yield over a 10 year period equal to 70 percent (9% LIHTC) or 30 percent (4% LIHTC), as applicable, of the building’s qualified basis
- In the first year, the credit amount is reduced to reflect qualified occupancy in that year
CREDIT CALCULATION, continued

ELIGIBLE BASIS

- Credit based on Eligible Basis, not total development costs. The determination of a building’s Eligible Basis is the starting point for the computation of the credit
  - Most costs, minus non-depreciable items (Eligible Basis includes rehabilitation costs, reasonable developer fee, common areas)
  - Examples of non-eligible costs: land, syndication costs, financing costs, legal fees related to the acquisition of land, costs of surveys, federal grants, commercial space
QUALIFIED BASIS

- Qualified basis: Eligible basis x applicable fraction
  - The qualified basis of a building is that portion of the building’s Eligible Basis that is attributable to low-income tenants (number of low income units compared to total number of units, or floor space fraction)
APPLICABLE RATE

- The 9% and 4% credits are adjusted based upon the Applicable Federal Rate (AFR), published by the IRS each month. The floating rate for the 9% credit has been around 7.5% in the past 2 years.
- The applicable percentage is set either when the State issues the credit reservation or when the building is placed in service.
- When the 9% LIHTC program was created, the applicable rate was 9%. Since then, rates have declined based on the federal cost of borrowing, thereby reducing the amount of tax credit equity available to build affordable housing.
- Since July 2008, several laws have temporarily fixed the 9% tax credit rate at 9%. In December 2015, Congress passed the Protecting Americans from Tax Hikes (“PATH”) Act of 2015, which permanently sets the minimum 9% tax credit rate at 9%.
- The 4% credit is still subject to adjustment based on the AFR. For November 2017, the rate for the 4% credit is 3.23%.
CREDIT CALCULATION, continued

- Eligible basis \( \times \) percent qualified units \( \times \) applicable percentage \( \times \) 10 years = total tax credits

- Total tax credits \( \times \) price per credit = investor total equity

- Note that most of the investor’s equity will not be contributed to the owner entity until the project is completed
Example of Tax Credit Calculation

- 300 Unit Project/240 Low-Income Units
- TDC (including land) = $40M
- Land Cost= $4M
- Eligible Basis= $36M
- Qualified Basis= $28.8M ($36M x 80%)
- Applicable percentage for 9% credit = 9%
- Annual credit= ($28.8M x 9%)= $2,592,000
- Credits over 10 years = $25.92M
Sample Equity Installment Structure

- Capital contributions by Investor
  - 5% at closing
  - 75% at 100% completion of project
  - 15% at project’s breakeven or stabilization
  - 5% at issuance of Forms 8609 / final cost certification
LIHTC PROGRAM REQUIREMENTS

- Occupancy/Income Requirements
  - Either 20% of units occupied by households with incomes at or below 50% of AMI, adjusted for family size ("20/50")
  - Or 40% of units occupied by households with incomes at or below 60% of AMI, adjusted for family size ("40/60")
  - The set-aside election is made on IRS Form 8609 upon placement in service
  - The requirements of the minimum set-aside must be met no later than the close of the first year of the credit period and must continue throughout the compliance period
  - Tenant income must be reviewed and documented at least annually throughout the compliance period
Rent Requirements

- The gross rent (including utilities) for a LIHTC unit may not exceed 30% of the imputed income limit applicable to such unit size
- Rent limits change annually when new area median incomes are calculated
- Rent never decreases below original floor
- Rent subsidies (including Section 8) are not included in calculating gross rent

Maintain habitability standards
The occupancy/income and rent restrictions are in place for the 15 year tax credit compliance period.

An additional extended use period of at least 15 years applies to most developments pursuant to recorded extended use agreement.
CARRYOVER ALLOCATIONS

- 10% of Reasonably Expected Basis must be incurred within one year of the date of allocation

- Reasonably Expected Basis is the anticipated basis of the land and building at such time as the building is placed in service

- Building must be placed in service by December 31 of the second year after carryover
RECAPTURE

- 10 year credit period / 15 year compliance period means the credits are “accelerated”, i.e. claimed faster than they are earned
- Recapture percentage depends on year in which recapture event occurs. Only the accelerated portion of the credit is recaptured
- Recapture occurs if there is a decrease in qualified basis
- Recapture amount calculated based on the decrease in qualified basis / new applicable fraction, plus interest
  - Interest on recapture amounts accumulates from the due date of tax returns on which credits were claimed
RECAPTURE EVENTS/CURES

- **Building Disposition**
  - Sale to new owner or foreclosure
  - Recapture avoided if it is reasonably expected that building will continue to be operated as low-income building

- **Non-Qualified Units**
  - Decrease in the applicable fraction of a building occurs when units no longer qualify
  - Examples: over-income household moves into low-income unit, owner charges above limit rent, low-income units rented to household comprised entirely of full time students, leasing on a transient basis
  - Recapture avoided if owner corrects noncompliance within reasonable time after noncompliance is, or should have been, discovered
RECAPTURE EVENTS/CURES, continued

- Casualty Loss/Damaged Units
  - Fire, flood, hurricane or other damage to building or portion thereof
  - Recapture is avoided if damage is repaired (units restored and placed back in service) prior to year-end in which casualty occurred or damage reported
COMPLIANCE

- State housing finance agency monitors projects

- Record keeping requirements:
  - Total number of units and number of LIHTC units in project
  - Income certifications
  - Qualified and eligible basis amounts
  - Rent amounts

- Annual compliance certifications
CONCLUSION

- LIHTC is a critical tool to help finance affordable housing

- Tax exempt bonds in 4% transaction add value, but transaction is more complex

- Potential impact of tax reform

- Evaluate the project carefully
  - Consider the economic value of the credit and any additional subsidies, compared to the reduced revenue due to lower rents and the administrative burden of ongoing compliance with LIHTC rules (and bond rules for 4% LIHTC)

- Select good partners
ADDITIONAL RESOURCES

- *Low-Income Housing Tax Credit Handbook*, Novogradac & Company LLP


- National Low Income Housing Coalition [http://nlihc.org](http://nlihc.org)

Structuring a Multifamily Housing Bond Transaction
Typical Structure of Multifamily Housing Financing

- Underwriter
- Housing Finance Agency
- Bond Trustee
- Bondholders
- Borrower
- Credit Enhancer
- Development

Flow of Funds:
- Bonds purchased by Underwriter from Housing Finance Agency.
- Bondholders receive bonds.
- Bond Trustee manages bond payments.
- Borrower receives loan from Bond Trustee.
- Bond Debt Service Payments made to Bondholders.
- Project Revenues contribute to Debt Service Repayments.
- Development is funded by loan proceeds.
Public Offering Versus Private Placement

Different Ways to Sell Bonds

- **Public Offering**
  - Bonds sold to public
  - Institutional investors (investment funds, commercial banks and other accredited investors)
  - Retail (individuals)
  - Bonds are offered to public pursuant to an Official Statement
  - Bonds held by The Depository Trust Company on behalf of “beneficial owners”

- **Private Placement**
  - Sold to banks or institutional investors
  - Generally no offering document is prepared; sometimes, a private placement memorandum
  - Purchasers typically sign investor letter (acknowledging they are sophisticated investors and agreeing to only resell to other sophisticated investors)
  - Often, privately placed bonds are non-rated
Fixed Rate Versus Variable Rate Bonds

Different Ways Bonds Bear Interest

- **Fixed Rate Bonds**
  - Interest rates fixed for the life of the bonds (serial bonds; term bonds with sinking fund redemptions)

- **Variable Rate Bonds**
  - Interest rates adjust periodically (daily, weekly, monthly)
  - Interest rates are determined by an index or a remarketing agent
  - Often, bondholders have a right to sell back their bonds at any time (tender or put)
  - Often requires liquidity (for puts) or credit support from a bank
Standard Documentation for Multifamily Housing Bond Transactions

- **Inducement Resolution** – Passed by housing finance agency. Has significance for federal tax purposes.

- **Trust Indenture** – Entered into between housing finance agency and trustee. Provides for the issuance of the bonds and contains the terms of the bonds.

- **Loan Agreement** – Entered into between housing finance agency and the borrower in multifamily bond financings. Contains the terms of the loan of the bond proceeds to the borrower, the terms of repayment and certain covenants.
Standard Documentation for Housing Bond Transactions

- Regulatory Agreement — Entered into among housing finance agency, the borrower and the trustee on multifamily financings. Contains the terms of all income restrictions required by federal and state law and is recorded in county land records.

- Bond Purchase Agreement — Entered into between housing finance agency and the underwriter (in a public offering) or the purchaser (in a private placement). Sets forth the terms of the bonds and the conditions for closing of the bond transaction.

- Bond Resolution — Passed by housing finance agency. Approves the issuance of the bonds and the forms of the various financing documents.
Standard Documentation for Housing Bond Transactions

- Partnership Agreement – Entered into among the developer and the tax credit investor and sets forth the terms of the partnership. General partner owned by housing finance agency is a party when “partnership structure” is used.

- Other Documents – Other documents include various certificates and a tax agreement which sets out covenants regarding the maintenance of the tax-exempt status of the bonds for the term of the bonds.
Parties to a Bond Transaction

- **Issuer**
  - Must be a (i) state or local government or political subdivision, (ii) “on-behalf-of” issuer, or (iii) other type of issuer permitted under tax code.
  - An issuer must be authorized under state law to issue bonds.

- **Borrower**
  - Generally, a for-profit entity or 501(c)(3) entity that develops, builds (or rehabilitates), owns and manages the development.
  - Borrowers are loaned the proceeds of the bond issuance by the housing finance agency under the loan agreement.
Parties to a Bond Transaction

- **Bond Trustee**
  - A bank or trust company generally serves as the trustee for the bondholders. Issuer assigns the right to payments on the bonds to the bond trustee under the trust indenture.
  - Administers the trust indenture, continuing disclosure and makes payments to bondholders.

- **Underwriter (public offering)**
  - The underwriter is responsible for structuring the bond transaction.
  - With respect to publically-offered bonds, the underwriter makes the initial public offering of the bonds.
  - Underwriter purchases bonds at closing and then sells to other entities.
Parties to a Bond Transaction

- **Purchasers**
  - Public offering to institutional and retail investors
  - Direct purchase by bank or other institutional investors

- **Remarketing Agent**
  - If bonds are sold as variable rate bonds which can be optionally tendered for purchase, a remarketing agent will be appointed to resell or “reremarket” the tendered bonds to the public.
  - The remarketing agent and the underwriter are frequently the same entity.
Parties to a Bond Transaction

- **Rating Agencies**
  - Publicly-offered bonds are often rated by Standard & Poor’s Rating Services, Inc., Moody’s Investors Service and/or Fitch Inc.
  - Ratings impact interest rates on the bonds.

- **Purchasers**
  - Public offering to institutional and retail investors
  - Direct purchase by bank or other institutional investors
Parties to a Bond Transaction

- **Credit/Liquidity Providers**
  - Providers include FHA, GNMA, FNMA, Freddie Mac and large banking institutions.
  - A bank may provide credit and/or liquidity support for the bonds.
  - Credit Support: principal and interest payments.
  - Liquidity Support: bond tenders only.
  - Bond Insurers: insure payment of principal and interest, used infrequently since 2008.

- **Construction Phase Credit Provider**
  - Some credit enhancement providers will not accept construction risk.
  - In such instances, a different credit provider will provide enhancement during construction and rent-up phases.
Parties to a Bond Transaction

- **Tax Credit Investor**
  - Purchases low income housing tax credits through capital contribution in partnership.

- **Financial Advisor**
  - Advises housing finance corporation on plan of finance, bond structure and terms, pricing/fees and other financial matters.
  - Has a fiduciary duty to the housing finance corporation.

- **Rebate Analyst**
  - Provides arbitrage rebate calculations and renders periodic reports to the housing finance corporation.
Parties to a Bond Transaction

- **Attorneys**
  1. **Bond Counsel**
     - Delivers a legal opinion to the effect that interest on the bonds is exempt from federal income taxation.
     - Drafts bond documents.
  2. **Issuer’s Counsel**
     - Responsible for ensuring legal compliance with state law.
     - Negotiates bond documents on behalf of the housing finance corporation and advises on issuer risk considerations.
     - Gives enforceability opinion with respect to documents executed by the issuer.
Parties to a Bond Transaction

- **Attorneys**

  3. **Partnership/General Partnership Counsel**

     - Represents the general partner and partnership on multifamily transactions in which the housing finance agency is a part of the ownership structure.
     
     - Advises on general partner risk considerations and certain matters relating to low income housing tax credits.
     
     - Gives enforceability opinion with respect to documents executed by the general partner and the partnership.

  4. **Other Counsel**

     - Trustee, Underwriter/Purchaser, Borrower, Credit Provider, Tax Credit Investor and Remarketing Agent each are typically represented by separate counsel.
Trends in Multifamily Housing Revenue Bonds

- Private activity bond volume cap usage rose significantly according to a survey conducted by the Council of Development Finance Agencies
  - Increase is largely attributable to multifamily housing
- Increasing prevalence of short-term, cash-collateralized structure
- In states where structure works, “partnership structure” is commonly implemented to reduce construction and operating costs through exemptions from state and local taxation.
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.
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 bonds 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 25% of bond proceeds may be used for land acquisition.
- Issuer limited to earning 1.5% over bond yield.
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Thank You

Ryan J. Bowen
rbowen@chapman.com

Brent L. Feller
feller@chapman.com

Chapman and Cutler LLP
Attorneys at Law • Focused on Finance

Charlotte
201 South College Street, Suite 1600
Charlotte, NC 28244-0009
980.495.7400

Salt Lake City
215 South State Street, Suite 800
Salt Lake City, UT 84111-2339
801.533.0066

Chicago
111 West Monroe Street
Chicago, IL 60603-4080
312.845.3000

San Francisco
595 Market Street, 26th Floor
San Francisco, CA 94105-2839
415.541.0500

New York
1270 Avenue of the Americas, 30th Floor
New York, NY 10020-1708
212.655.6000

Washington, DC
1717 Rhode Island Avenue NW, Suite 800
Washington, DC 20036-3026
202.478.6444

chapman.com