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New Opportunities for Affordable Housing Preservation Through Transfer of Ownership to a Section 501(c)(3) Owner Using Tax-Exempt Bonds Under Section 145 of the Code

- Emerging Private Activity Bond Volume Shortage in Certain States
  - Tax-exempt private activity bond volume for tax-exempt bonds under Section 142(d) of the Code which primes 4% LIHTC (25-45% of total development costs) now in short supply in a number of states – Connecticut, New York, Massachusetts, New Jersey, Tennessee, Minnesota, Utah and Washington state.
  - Reminds us of the 1990s – before private activity bond volume was indexed for inflation in 2000 and demand subsided in 2001 – for certain projects volume was simply unavailable.
  - In some states, like Texas, which allocated no volume to multifamily, almost all affordable multifamily rental housing financings were through Section 501(c)(3) owners using tax exempt bonds under Section 145 of the Code.
  - In the years ahead, could we go there again for some projects in some states? Possibly.

Disadvantages/Advantages Versus 142(d) + 4% LIHTC

- BIG disadvantage versus §142(d) / 4% LIHTC financings
  - No 4% LIHTC! Finances 25-45% of total development costs when available.
- Advantages versus §142(d) / 4% LIHTC financings
  - Qualifies for real estate tax relief in almost all jurisdictions.
  - In some states, may qualify for sales tax and other favorable tax treatment.

Disadvantages/Advantages Versus 142(d) + 4% LIHTC

- May compete more successfully for federal, state or local government subsidies or private loans or grant monies.
- Under Section 145(d), regulatory requirements similar to §142(d) (e.g., 20% at 50% of AMI or 40% at 60% of AMI) will apply unless project involves new construction or sub rehab; but only one regulatory agreement (not two) and may not involve guarantees such as those required by tax credit syndicators.
- Some affordable housing Section 501(c)(3) organizations have decades of experience and thousands of units which they own and manage and are highly credible owner/operators.

Two Recent Transactions

- Our firm just served as Bond Counsel on two fascinating transactions which used this financing model.*

- In each of the two transactions, an experienced affordable housing developer sold the **100% project-based Section 8 subsidized projects** (contracts renewed for 20-year terms) to a **highly experienced Section 501(c)(3)** owner/operator for **prices close to the full appraised market values**.

*At the request of the Purchaser/Seller, the information in this outline is general, but illustrates the broad parameters of how such a financing might be structured in today's markets.

Financing Structure

- **Two layers of debt** financing provided the funding sources:
  1. A **senior taxable loan** from a GSE in an amount equal to about **75% of total development cost** (75% LTV; 1.50% DSCR; 30-year level loan amortization; all-in interest rate of about **4.50%**.
  2. **Subordinate "Seller Take Back" tax-exempt bonds** in an amount equal to **about 25% of total development cost** bearing interest at about **6.0%** payable semi-annual interest payments over a 35-year term payable from **75% of net cash flow** after operating expenses and payments on senior loan, interest-only for 10 years; followed by 25-year level amortization of principal through maturity in year 35.
- Depending on the facts and circumstances the **senior lender may or may not permit a second deed of trust**. If permitted, the second deed of trust will be **fully subordinated** and subject to a complete **standstill agreement**.
- **Cash flow projections** with reasonable assumptions (e.g., **2.5% growth in revenues; 3.0% in expenses**) showed **initial debt service coverage of 110%** growing to almost 200% in year 30 and higher thereafter.

Public Finance Authority – Nationwide Issuer

- Bonds were issued by the **Public Finance Authority ("PFA")** out of Madison, Wisconsin.
- PFA is a **nationwide issuer** of 501(c)(3) and certain other tax-exempt bonds with a **highly professional staff**, **frequent/flexible meeting schedule**, and a **very low fee structure** (**upfront** fee equal to **only 0.20% of bonds*** and 0.03% **(3 basis points) per year ongoing** for 501(c)(3) borrowers).
- **Allows the borrower to choose** from among PFA's recognized Bond Counsel, underwriter, if applicable, and other **financing participants** and **financing structure**.
- Very **reasonable issuer requirements** for unrated private placements.
- **Does require a local governmental body** where project is located **to approve** the financing for Wisconsin state law purposes and to meet federal TEFRA requirements.

*For issues up to $20 million; subject to $15,000 minimum upfront fee; slightly higher for larger financings.

Other Efficiencies/Advantages of Structure

- **Very low issuance costs** – no underwriting fee, underwriter's counsel, rating agencies or other fees associated with a public offering.
- Simple issuer requirements; **PFA can process and close quickly**.
- Bonds are exempt from federal and in some states, state income taxes.
- **Seller can accept the series B tax-exempt bonds as part of purchase** price without making a cash payment from a bridge loan or other funds.
- Having seller take back the series B bonds gives **great flexibility in structuring to meet requirements of senior lender** as long as seller has confidence in the established 501(c)(3) operator.

Pitfalls to Avoid

- **Critical to pick** a **highly experienced 501(c)(3) buyer** with a great track record in affordable subsidized projects, reasonable balance sheet and cash reserves. The 501(c)(3) buyers in our two examples own and operate over 140 projects encompassing over 15,000 units in nine states; over 25 years' experience.
- Must be sure to **fund sufficient upfront rehab** and ongoing **reserves for replacements** to provide safe, habitable dwelling units for tenants.
- Rehab was over $20,000 per door in above examples, supported by appraisals and CNAs.
- Avoid the "Global Ministries Foundation" problem.

Overall Results for Seller/Purchaser

- **Seller**
  - **Received full appraised purchase price** for projects.
  - Ball park 6.0% rate on tax-exempt subordinate series B bonds ≈ **10.0% after tax return** for high bracket tax payers, with possible state income tax benefits as well.
  - **Highly predictable** (100% §8 supported) **income stream** with top-flight project operator in control.
- **§501(c)(3) Purchaser**
  - Assumes **ownership of projects with stable, predictable cash flows** and ascending debt service coverage.
  - Stable way to **expand portfolio and charitable mission**.

Overall Results for Seller/Purchaser

- Where viable:
  - **Probably smaller, non-urban locations** where less demand for projects on the buy-side by tax credit developers and abundant demand for §142(d) tax-exempt debt and 4% LIHTC from banks and other CRA motivated investors.

and/or

  - States where **private activity bond volume is scarce** or not available.