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ESTABLISHING A MULTIFAMILY RESIDENTIAL RENTAL HOUSING BOND RECYCLING PROGRAM*

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As has been widely discussed, more and more states are facing an increasing shortage of private activity bond volume versus the growing demand. While bond volume recycling provides only a limited response to this growing restraint on tax-exempt affordable rental housing bond financing**, it can provide some relief to promote more affordable rental multifamily housing. Our firm has been quite involved in the active multifamily housing bond volume recycling programs in Washington State and Colorado through their state agencies, and we are presently heavily involved with the largest issuer of tax-exempt affordable multifamily rental housing debt in California (the California Municipal Finance Agency) and its bond counsel in setting up its multifamily housing bond volume recycling program. This article focuses on the basic steps involved in setting up a tax-exempt multifamily residential rental housing bond recycling program.

The Rapidly Emerging Oversubscription of Private Activity Bond Volume

As we know from recent experience in California and other states, once a state's annual issuance of private activity bonds exceeds its annual private activity bond volume allocation, it can very quickly "eat through" its carryforward volume and become volume constrained. For example, California now gets an annual \$4.3 billion allocation of private activity bonds. In early 2019, it had \$900 million of carryforward volume. In 2020, it had exhausted that carryforward and had much more demand for private activity bond volume than the \$4.2 billion of new volume it received that year. Thus, **in one year**, it became **volume constrained**. For 2021, CDLAC, the volume allocator, projects that California will be more than 2:1 oversubscribed. Washington State is now oversubscribed by a ratio of 4:1; up from about 3:1 last year. In 2020, Texas had 130 applications for all of that year's \$3.1 billion of annual bond volume. This year, it had **100 applications in the first round alone**, all but 5 or 6 for multifamily

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** States where we believe demand for tax-exempt multifamily housing bond volume currently exceeds supply include Massachusetts, Minnesota, New York, California, Connecticut, Colorado, Tennessee, Texas, Georgia, and Washington State. Jurisdictions which we believe could become volume limited this year include Oregon, Hawaii, District of Columbia, and Virginia.

housing. It will be substantially oversubscribed in 2021. These major market examples demonstrate how quickly a jurisdiction can go from a surplus of private activity bond volume to seriously oversubscribed. It is important for Issuers to focus on setting up a bond volume recycling program at the first signs of seeing a decline in carryforward bond volume in order to focus on this in advance. An effective bond volume recycling program can take some time to set up*.

Background

The 2008 Housing and Economic Recovery Act (“HERA”) added Section 146(i)(6) to the Internal Revenue Code which authorizes, among other things, the reuse or “recycling” of multifamily private activity bond volume cap to finance new affordable multifamily rental housing projects under certain conditions. Such “recycled” bond volume does not entitle the new project to which it is allocated to qualify for 4% low income housing tax credits, but it produces a much lower borrowing rate on the debt side of the new project financing, which can be a critical factor in the feasibility of these financings.

Assessing the Feasibility of a Recycling Program

As discussed below, two years or more before an Issuer believes it may become volume constrained, it may wish to consider establishing a multifamily bond volume recycling program. Generally, the feasibility of such a program will depend upon that issuer having issued a sufficient volume of tax-exempt multifamily housing bonds or loans over the past two to three years, so that the projected pay downs or pay offs of that volume over the several years prior to the establishment of the program will justify the complexity and cost of setting up and operating such a program. A bond volume recycling program will not be practically efficient for many Issuers with limited tax-exempt multifamily housing bond issuance. In this article, we will try to share some of the basics of what we have learned about setting up such a program.

Principal Sources of Tax-Exempt Multifamily Housing Bond Recycling Volume

We anticipate there will be at least two primary sources of recycled multifamily housing bond volume that an issuer can utilize in a multifamily bond volume recycling program (and possible others) (i) the pay down at “Conversion” from the construction phase to the permanent phase of privately placed tax-exempt debt on many tax-exempt loans and bonds previously issued by the Issuer and (ii) the repayment at maturity or on the initial mandatory tender date of tax-exempt short-term “cash backed” bonds previously issued by the Issuer which are used with FHA and other low rate taxable loans to satisfy the 50% Test under the Code.

* While recycling can help, even if it is expanded under the ACHIA provisions discussed in the footnote on page 4, it cannot provide major relief in markets that are oversubscribed by a ratio of 2:1 or more. The best hope for this kind of relief is the AHCA proposal to reduce the 50% Test for 4% LIHTC to 25%, or to allocate more private activity volume to various uses, including multifamily housing. Reducing the 50% Test to 25% is one of two top priorities of the affordable housing lobby this year, according to Dave Gasson of the new lobbying firm MG Housing Strategies (the other is increasing 9% LIHTC by 50% over 2 years). These proposals are expected to be part of the infrastructure bills currently under consideration in Congress. Mr. Gasson believes the prospects for passage this year are positive, although there are no assurances. If adopted, this proposal could provide **major relief** from the shortage of private activity bond volume in the states that are volume constrained.

Steps in Setting up a Bond Volume Recycling Program

Multifamily bond volume recycling programs involve two steps, as shown in Exhibit A.* Federal tax law requires the issuer to incur a “borrowing” for federal tax law purposes, the proceeds of which are used, or are deemed to be used, in the first step of the recycling process to pay down or pay off the prior tax-exempt issue at the time that the loan which had been made by the Issuer to the borrower, pursuant to the prior tax exempt issue, is repaid. Thus, rather than just using the loan repayment from the ultimate borrower to repay the bonds or tax exempt loan, the prior tax exempt debt is repaid, or deemed to have been repaid, from an alternative source and the repayment from the borrower is then transferred to the Issuer, or deemed to have been transferred to the Issuer, to make a new loan to another ultimate borrower. The “borrowing” by the Issuer to repay the prior tax exempt debt could be a taxable cash-backed short-term municipal bond issue or a taxable loan from a bank or other entity, but we think most recycling issuers have found that setting up a warehouse credit line is the most efficient funding mechanism.

Step 1: Under the first step, the Issuer enters into what is sometimes styled as a “Funds Exchange Agreement (Prepayment)” with the trustee or fiscal agent or the holder of the prior tax-exempt debt which is being paid off or paid down. On the date of the pay down or pay off, the Issuer draws a warehouse credit line or incurs another “borrowing” (for federal income tax purposes) in an amount equal to the amount of the pay down or pay off. If Bond Counsel approves, this Funds Exchange Agreement might recite that the funds from the Issuer’s warehouse credit line draw or other borrowing are “deemed” by the parties to have been advanced to the prior tax-exempt debt trustee or fiscal agent or to the holder of the prior tax-exempt debt and to have been used by that transferee to retire, pay down or pay off the prior tax-exempt debt. This Funds Exchange Agreement will further recite that the prior tax-exempt debt trustee or fiscal agent or tax-exempt debt holder shall be deemed to have simultaneously transferred to the Issuer the loan prepayment which has been made by the borrower on the prior tax-exempt issue in an amount equal to the Issuer’s credit line draw to reimburse the Issuer for transferring the proceeds of its credit line draw to pay down or pay off the prior tax-exempt debt. Of course, there could be an exchange of wires, but some major bond counsel have been comfortable that these recitations in the documents will enable them to render the necessary opinions.

If the Issuer and warehouse lender agree, the Issuer’s obligation to repay the warehouse credit line draw might be structured as an unsecured general obligation of the Issuer. On the other hand, to minimize borrowing costs, subject to Bond Counsel guidance, we believe the funds drawn on the warehouse credit line may be deposited into a special segregated Issuer account and pledged to the warehouse lender to secure the Issuer’s obligation to repay to the warehouse lender the principal of the warehouse credit line draws, although for tax purposes those funds are allocated to repayment of the prior tax exempt bonds or tax exempt loan and the repayment of its prior borrower loan by the original borrower is allocated to the segregated Issuer account. Under such an arrangement investment of the pledged funds would probably be limited to liquid, high

* The procedures outlined here are procedures which we believe would form the basis for an effective multifamily bond volume recycling program, but there may be other procedures which would also be effective in achieving this result. Of course, any Issuer will want to discuss the details of any proposed recycling program in detail with its primary bond counsel firms. They will write the necessary opinions and process the transactions. We believe the steps outlined here have been approved by other major bond counsel firms involved in other recycling programs, but this is an important dialogue for any issuer to have with its bond counsel in setting up a recycling program.

quality investments as agreed by the warehouse lender and the Issuer and the drawn funds might be held under a deposit account control agreement or other arrangement acceptable to the warehouse lender. If so structured, each warehouse credit line draw would therefore be 100% cash collateralized as to repayment of principal. This may minimize the cost of the warehouse credit borrowing line.

Under federal tax law, these arrangements create a “borrowing” by the Issuer which federal tax law requires during the period on which the bond volume is “carried” by the Issuer before being applied by the Issuer to provide financing for a new qualified multifamily residential rental housing project. Under current federal tax law, the volume so carried by the Issuer must be allocated to finance a new qualified residential rental housing project under Section 142(d) of the Code within six months of the original tax-exempt bond pay-down or pay-off, or the tax-exempt bond volume will expire.*

To implement a recycling program the Issuer would enter into substantial discussions with the Trustees, Fiscal Agents and in some cases holders of the tax-exempt debt on prior tax-exempt the Issuer issues which it believes will be eligible for inclusion in its recycling program. In a few cases, some approval of prior Borrowers or other parties may also be required. Of course, because the implementing the arrangements for the pay down or pay off described above is dependent upon the co-operation of other parties, and close coordination with both steps of the recycling process within the time frame permitted by federal law, the Issuer cannot guarantee that recycled bond volume will be available in any specific amount to any particular future project until it has captured the volume in Step 1 which it can allocate it to a new qualified residential rental housing bond project under Section 142(d) which expects to close before that block of bond volume expires.

Step 2: For tax purposes, when the recycled payment from the original borrower is loaned to a new borrower, the Issuer will typically issue new tax exempt bonds or a new tax exempt loan, the proceeds of which are treated as used to refund the warehouse loan. Thus, prior to the issuance by the Issuer of new tax-exempt debt to provide funding for another qualified residential rental housing project, the Issuer will enter what is sometimes styled as a new “Funds Exchange Agreement (New Loan)” with the trustee or fiscal agent on the new tax-exempt issue or, in the absence of the forgoing, the proposed purchaser of the new tax-exempt issue. This second Funds Exchange Agreement will recite that on the closing date of the new issue, the recycled bond volume (i.e., the borrower loan repayment made by the original borrower) carried by the Issuer will be transferred to the trustee, fiscal agent or other new tax-exempt debt purchaser to pay or reimburse costs of the new project against the simultaneous transfer by that party to the Issuer of

* Under current federal tax law, the volume carried forward must also be reallocated to the new qualified multifamily residential rental housing project no later than four years after the prior tax-exempt debt was issued. Moreover, the tax-exempt debt on the new qualified multifamily residential rental housing project to which the carried forward volume is reallocated must mature no later than 34 years after the original tax-exempt debt was issued. These 6-months and 4-year deadlines would be expanded under the provisions of the recently proposed Affordable Housing Credit Improvement Act of 2019 (the “AHCIA”) to 12 months and 10 years, respectively. The AHCIA provisions would also permit single-family volume to be used for multifamily and vice versa. Under these provisions, if adopted, recycled multifamily volume could be channeled to single family, freeing up new single-family volume for multifamily, which new bond volume would carry with it an entitlement to 4% LIHTC. Not nearly as effective as dropping the 50% Test to 25%, but a major gain. It is expected that these AHCIA provisions will be included in the infrastructure bills which are presently under discussion in Washington and that these provisions have a reasonable chance of adoption later this year.

a like amount of proceeds of the new tax-exempt issue, which the Issuer will use to retire that amount of its credit line borrowing.

For purposes of the volume cap rules under Section 146, the basis for the tax-exempt status of the new issue funding the new qualified residential rental housing project will often be (i) Section 146(i) for the recycling portion, and (ii) a traditional allocation of volume cap under section 146(a) (or, if carryforward 146(f)) for the balance. In other words, the new project being financed must be a qualified residential rental housing project under Section 142(d). While any tax-exempt bonds not using recycled volume cap must obtain volume cap in the traditional manner, the new tax-exempt bonds relating to the recycled bond volume will be tax-exempt “current refunding” bonds, which require no new tax-exempt private activity bond volume allocation, and will be documented as such by bond counsel. Other than this nuance regarding the volume cap rules, bonds that use recycled volume cap will generally be subject to the exact same set of rules as bonds that utilize traditional volume cap.

Once again, in Step 2, it is possible that no actual exchange of funds will need to take place. Assuming bond counsel approves, this may simply be a recitation in the legal documents for federal tax law purposes. At the time of reallocation, the Issuer will simply retire that portion of its credit line draw from the pledged funds in the segregated account securing the credit line or possibly from its general funds.

Sample Bond/Tax-Exempt Loan Document Recycling Provisions

Normally, the pay-downs or pay-offs that produce recycled volume which can be captured in Step 1, will occur from 12 to 24, or 30 months or a slightly longer period following the closing of the issue, the volume of which is to be recycled (although, as mentioned above, the recycling bond issuance cannot take place more than four years after the date the original bonds were issued). Also as discussed above, once a jurisdiction begins to “eat through” its carryforward volume, it can very quickly become volume constrained. This suggests that at least two years or more before the date on which an Issuer believes it may become volume constrained, it may be prudent for an Issuer to begin to include in its tax-exempt bond or loan documents provisions which specifically contemplate capturing bond volume in Step 1 for recycling, and which are designed to obtain the agreement of the parties to cooperate in that effort. Sample bond/tax-exempt loan provisions of this type depending on whether the outstanding tax-exempt debt uses “bond” or “tax-exempt loan” terminology, are set forth below:

Sample Indenture/Funding Loan Agreement Provisions

Recycling Transactions. Notwithstanding any provisions of this [Indenture/Funding Loan Agreement] or the [Bond/Governmental Note] to the contrary, the [Issuer/Governmental Lender] shall be permitted to direct payments of the Borrower Note prepayments to be transferred to a custodian or trustee selected by the [Issuer/Governmental Lender], in lieu of application to prepay a like portion of the [Bond/Governmental Note], so long or tax-exempt debt holder as the [Issuer/Governmental Lender] simultaneously causes other funds to be applied to prepay such portion of the [Bond/Governmental Note]. The preceding provisions shall apply only for purposes of preserving or “recycling” private activity bond volume cap in accordance with Section 146(i)(6) of the Code.

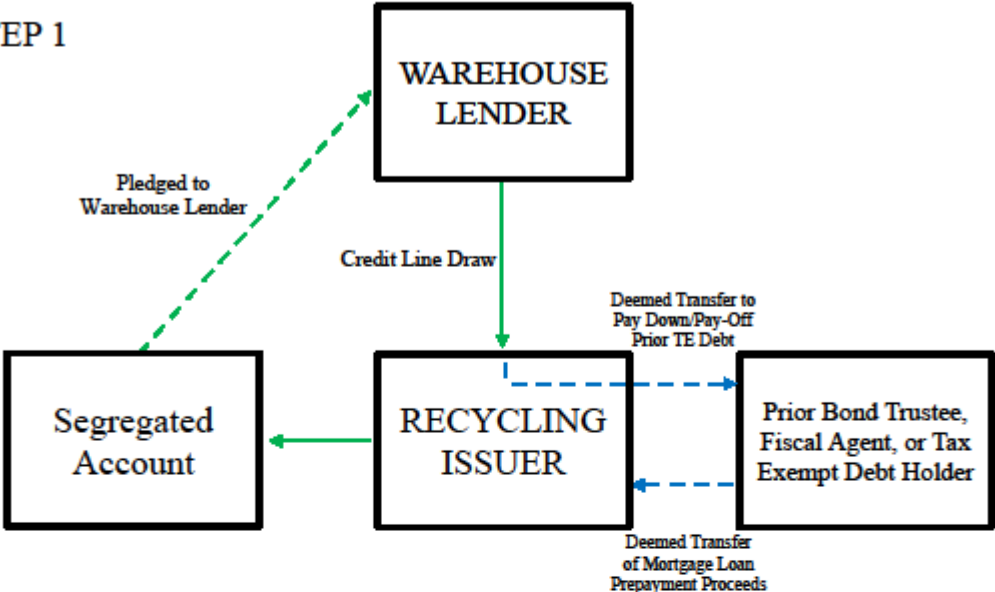
Sample Borrower Loan Agreement Provisions

Borrower Cooperation in Recycling of Allocation. The Borrower agrees to provide to the [Issuer/Governmental Lender] at least [30] days' notice of any prepayment of the [Bonds/Governmental Note] and that it will cooperate with the [Issuer/Governmental Lender] and provide all reasonably requested notifications, certifications and actions necessary in connection with applying the private activity bond volume authority for the Bonds to another project pursuant to Section 146(i)(6) of the Code at no cost to the Borrower.

There are a number of other important issues an Issuer must address in setting up an effective multifamily housing bond recycling program. These include assessing the feasibility of a multifamily bond volume recycling program for a particular Issuer; the potential warehouse credit facilities and other potential funding sources which may be called upon for such a recycling facility; the magnitude, timing and structure of the fees an Issuer might need to charge to cover the costs of its recycling program; and other issues. Based on our experience with these programs, our firm has very specific thoughts on these issues. We hope this memo will provide some helpful introductory thoughts. We would be glad to share our thoughts on recycling with Issuers and other industry colleagues who might be considering the establishment of a multifamily housing bond recycling program.

THE RECYCLING “TWO STEP”

STEP 1



STEP 2

