

FEDERAL TAX LAW REQUIREMENTS APPLICABLE TO TAX-EXEMPT BOND FINANCINGS FOR SECTION 501(c)(3) BORROWERS IN LOW AND MIDDLE INCOME HOUSING BOND FINANCINGS – GENERAL SUMMARY*

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* Copyright © September 30, 2025 by R. Wade Norris, Esq. All rights reserved. This document may not be reproduced without the prior written permission of the author. This discussion assumes the assets being financed are the same type of units as qualified residential rental housing facilities under Section 142(d) – *i.e.*, units we commonly think of as “apartments.” This is not intended to cover such financings for student housing facilities, nursing homes or certain other facilities which can be financed for Section 501(c)(3) borrowers with tax-exempt bonds under Section 145 of the Code. **In addition, this summary is not intended to be anything other than a very general “high point” summary of these financings under Section 145 of the Code, which are subject to a substantial array of complex rules and regulations.**

Federal Tax Law Requirements

Applicable to Tax-Exempt Bond Financings for Section 501(c)(3) Borrowers in Low and Middle Income Multi-Family Rental Housing Bond Financings – General Summary

Three Types of Tax-Exempt Multifamily Rental Housing Bonds

There are **3 different categories of tax-exempt multifamily residential housing bonds**, each with its own set of rules **depending on** the nature of **the owner** of the residential rental housing property. In recent years, roughly \$20 billion of such bonds have been issued nationwide.

1. **Tax-Exempt Volume Limited Private Activity Bonds under Section 142(d)** of the Code for profit motivated owners, the vast majority of which are paired with 4% LIHTC (most complex rules, by far the biggest category).
2. **Tax-Exempt “Section 501(c)(3)” Private Activity Bonds under Section 145** of the Code for certain nonprofit owners. No private activity bond volume required but cannot be paired with 4% LIHTC (somewhat less complex but substantial body of rules).
3. **Essential Function Bonds under Section 103 of the Code** for facilities owned by a state or political subdivision – *e.g.*, a city, county, housing authority or housing forward corporation or a controlled affiliate (simplest rules).

This PowerPoint focuses primarily on Section 501(c)(3) Bonds under Section 145 of the Code (Category 2) and to some extent Essential Function Bonds (Category 3).

General Background on Section 501(c)(3) Corporations

- To achieve Section 501(c)(3) status a non-profit organization must have filed an application with the Internal Revenue Service for Section 501(c)(3) status on Form 1023. This filing will include its Articles and By-Laws and the charitable purpose or purposes under Section 501(c)(3) which the organization intends to pursue. In our case this would presumably include “relief of the poor and distressed” and/or “lessening the burdens of government,” which are discussed below.
- Obtaining a Section 501(c)(3) determination letter from the Service can take as long as 6-12 months, most of which consists of the time for IRS review. The Service has recently issued some determination letters more promptly and may grant expedited review for a good cause submitted by the borrower.
- Each year a qualified Section 501(c)(3) corporation must submit a report or Form 990 to the IRS describing its activities over the past year in order to maintain its Section 501(c)(3) status, which must be maintained for so long as any Section 501(c)(3) bonds issued to finance its activities remain outstanding. Failure to satisfy these requirements could cause any bonds issued to be deemed taxable from the date of the original issuance.
- No more than 5% of the proceeds of a tax-exempt issue under Section 145 of the Code may be used for a “private business use” over the life of the issue. A private business use is, very generally, any use of the project by any party (even a governmental unit or another Section 501(c)(3) corporation) in a trade or business that is other than the Section 501(c)(3) corporation borrower’s charitable mission.
- Generally speaking, the outstanding amount of non-hospital tax-exempt bonds allocated to a Section 501(c)(3) borrower and certain affiliates within a test period cannot exceed \$150 million, but this test does not include bond issues where 95% or more of the net proceeds are used to finance capital expenditures, which is often the case.

Donnelly Amendment:

Potentially Applicable to Any Multifamily Rental Housing Financing Under Section 145

- **Under Section 145(d) of the Code** (the so-called “Donnelly Amendment”), **unless the financing involves new construction or acquisition/substantial rehab financing** where the cost of the rehab exceeds the adjusted basis of the building being acquired (**very substantial rehab** indeed), **the project must elect either 20 at 50 (at least 20% of units reserved for tenants < 50% of AMI) or 40 at 60 (at least 40% of the units for tenants at 60% < AMI)**, as would apply to a private activity multifamily housing project under Section 142(d).*
- The remaining units can be targeted to “middle income” tenants, but the rentals on the 20 at 50 or 40 at 60 units are likely to be much lower than what can be charged to tenants at 80% of AMI and above. As a result this charitable purpose generally will not work for what we generally refer to as “middle income” or “workforce” housing.

* As in a financing under Section 142(d), these income levels are for a family of four and are adjusted up or down for family size. In an acquisition subject to these requirements, they will be set forth in a recorded regulatory agreement, and these requirements must be satisfied within 12 months following the acquisition. These targeting requirements under Section 145(d) expire on the latest of (i) 15 years after 50% occupancy, (ii) the date on which no tax-exempt bonds of the issue remain outstanding or (iii) the date on which any project-based Section 8 housing subsidy expires.

“Relief of the Poor and Distressed”

- Most participants in tax-exempt multifamily housing bond financings for Section 501(c)(3) borrowers are accustomed to dealing with borrowers whose charitable mission is **“relief of the poor and distressed.”** **Rev. Proc. 96-32 provides a safe harbor** under which, if the requirements of Rev. Proc. 96-32 are met, the financing will be generally deemed to fall within the Section 501(c)(3) borrower’s charitable purpose.
- In summary, the Rev. Proc. **requires either 20 at 50 or 40 at 60 targeting as described above, and that at least 75% of the total units be held for tenants at 80% of AMI or below. Of the total units, 25% can be market rate.** In addition, the **borrower must show that rents charged on all units are affordable to the project’s tenants** at these income levels (generally at least somewhat below comparable market rents).*
- A small number of tax-exempt middle income or “workforce” multifamily housing bond financings have been closed for such Section 501(c)(3) borrowers complying with Rev. Proc. 96-32. It is unlikely tax-exempt bond investors would provide funding for such a financing which did not comply with Rev. Proc. 96-32.
- However, such financings, due to the targeting required, are challenging from a financing standpoint and fall outside what is generally considered “workforce” or “middle income” housing.

* As with the Donnelly Amendment described above, these requirements will generally be embodied in a recorded regulatory agreement, and for financings involving the acquisition of an occupied building, there is also a 12-month transition period allowed to achieve compliance with these requirements. While these requirements are not a “bright line” test like the targeting requirements under Section 142(d) and Section 42 of the Code, any material deviation risks loss of a claim to the safe harbor exemption. Unlike any targeting restrictions imposed to satisfy the requirements of the Donnelly Amendment, if applicable, as described in the footnote on Slide 4, these restrictions will lapse on the date when no tax-exempt bonds remain outstanding.

“Lessening the Burdens of Government”

- “Lessening the Burdens of Government” is another charitable purpose under Section 501(c)(3) which is much more compatible with “workforce” or “middle income” housing financings, since there are no targeting requirements such as those under Rev. Proc. 96-32, which does not apply to these financings.
- However, establishing that a financing falls within and will further the Section 501(c)(3) borrower’s charitable purpose is a much more complex undertaking, is based in large part on facts and circumstances (as discussed below) and does not benefit from safe harbor guidelines.*
- Careful coordination is required in advance with bond counsel and Section 501(c)(3) borrower’s counsel on the front end of any proposed financing to assure that the unqualified opinions these firms are required to deliver for closing of this type of tax-exempt bond financing can be obtained.

* Too broad a statement of the Section 501(c)(3)’s charitable purpose can make it difficult to conclude that a financing will satisfy these requirements. A Section 501(c)(3) borrower can attempt to clarify these aspects of its charitable activities in its annual filing on Form 990, but the IRS no longer issues revised determination letters in response to such changes.

- Two IRS Revenue Rulings – 85-1 and 85-2 – set forth the basic requirements that apply:

“First, **whether the governmental unit considers the organization’s activities to be its burden**; and second, **whether these activities actually lessen the burden of the governmental unit.**”

- With regard to the **first requirement**, Rev. Ruling 85-1 states:

“An activity is a burden of the government if there is an **objective manifestation by the governmental unit** that it considers the activities of the organization to be its burden. The **interrelationship between the governmental unit and the [Section 501(c)(3)] organization** may provide evidence that the governmental unit considers the activity to be its burden.”

- With regard to the **second requirement**,

“**Whether the [Section 501(c)(3)] organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances.**”

The following is a further **very general** discussion of these basic requirements:*

1. The governmental unit whose burdens are being lessened must have firmly established that there is an unmet need for, in our case, affordable workforce or middle income multifamily rental housing, in its jurisdiction, which it desires to take concrete steps to meet.
 - While not absolutely required, depending on facts and circumstances, the existence of a program under which that governmental unit provides subordinate loan financing or other support for such housing is highly helpful, as might be the leasing of city or county owned land for the project for a low or nominal sum and similar types of support. A formal resolution passed by a governmental body can be an important element in satisfying this criterion. A mere statement by the mayor that “we really need more workforce housing” won’t be enough.
 - A history of long and frequent discussions between the Section 501(c)(3) borrower and the governmental unit to meet the need, as noted above, can also be quite helpful.

* The summary set forth in this PowerPoint is solely the responsibility of the author. However, in an excellent Orrick September 15, 2023 webinar with Justin Cooper and Rich Moore at Orrick and Matt Clausen at Adler & Colvin, these and other requirements applicable to these types of Section 501(c)(3) financings were discussed in detail. A replay of the webinar is available at <https://www.orrick.com/en/Events/2023/09/Theory-and-Practice-501c3-Bonds-for-Housing>.

2. The charitable purpose of the Section 501(c)(3) borrower should reasonably target the governmental unit and be consistent with a statement of its charitable purpose which reasonably and not too broadly targets the governmental unit where burdens are being lessened. A broad targeting of “any city or county” will probably not suffice.
 - In addition, the financing should demonstrate that it will materially assist the governmental unit in achieving its clearly established goals for more affordable workforce housing. “Words are cheap; actions count.”

This is a **very broad** summary. As noted above, careful consideration with the governmental unit and its counsel and any financial advisor, as well as with bond counsel and Section 501(c)(3) borrower’s counsel, at the very outset of any such proposed financing is a must.

Closing the Financing Gap in Section 501(c)(3) (and Essential Function) Bond Financings

- **A major challenge** in any Section 501(c)(3) bond financing, as is true with essential function bond financings (where the borrower, as well as the issuer, is a state or a political subdivision of a state) is **how to cover total development cost in the absence of federal and state low income housing tax credits**, which often fund 35-45% of total development cost in financings for profit-motivated sponsors under Section 142(d).
- For many years, the **cash flow freed up from real estate tax relief**, and, in some instances, sales taxes on construction materials and other taxes, has been an important or even an essential element in closing this funding gap. Of course, the **requirements** to create real estate and probably other tax relief **vary widely from state to state** and even within a state.
- Over the **past four years**, the willingness of tax-exempt bond funds to purchase high yield long-term (*e.g.*, 40-year) bonds **using a soft “turbo” amortization structure and accepting an underwriting model which assumes 3%/year growth in rents as well as expenses in high growth markets has increased debt side proceeds by 25% or more** in a number of financings. Unfortunately, in today’s very challenging market where these bond fund buyers are seeing substantial outflows of investor funds, **many of these financings do not work without additional subsidies or other financial support**, even when paired with real estate and possibly other tax relief.

- Such additional support may take the form of **federal, state and/or local low-rate subordinate loans** or grants, or a **long-term lease of governmentally or non-profit owned land** at nominal or low annual lease rates.
- In addition to these sources, our clients and we often use **other structuring techniques** to close these funding gaps, often in combination with the above. These may include:
 - Multiple layers of tax-exempt debt. It is quite common in these financings for the **substantial majority of the capital to be funded from senior debt**, which may or may not be credit enhanced, and which generally carries a debt service coverage ratio of 1.15-1.25:1 and is sold to institutional (if non-credit-enhanced) or public (if credit enhanced) investors.
 - Such debt is **often combined with a subordinate tax-exempt series** which may have a lower coverage ratio (*e.g.*, 1.05:1, or perhaps a bit higher, *e.g.*, 1.10:1, if sold or delivered to the developer or an affiliate) to provide another 5-10% of the funding. These bonds may be sold to other purchasers in a private placement, or they may be conveyed to a project and/or land seller as a non-cash part of the purchase price and/or delivered to a developer or other private party, as discussed below, as a part of a reasonable and competitive compensation package.

- **Another technique** we have used is delivery to a **project seller of junior subordinated convertible capital appreciation bonds**, which accrete at a tax-exempt rate of 8 or 10% or so to an outstanding accreted value at year 30, 35 or 40 when the foregoing series of tax-exempt bonds have been retired. The accreted value of these bonds is then paid down from all or most of project net cash flow after operating expenses during a short period (*e.g.*, 5 years) following retirement of the more senior tax-exempt debt.
- Of course, the ability to obtain **necessary opinions that each of the foregoing series are tax-exempt debt (and not equity**, which would be fatal to the tax exemption), is dependent on being able to establish to the satisfaction of bond counsel and other counsel that, based on reasonable assumptions, it is **reasonable to expect that each of these series of debt can be repaid over their scheduled maturities which do not exceed the project's expected life.**
- **The challenge** on both Section 501(c)(3) and essential function bond financings for workforce or more deeply targeted housing is to work creatively with the underwriter or placement agent and other members of the financing team to **develop a combination of funding sources which will cover total project costs.**

Developer Roles and Compensation in Section 501(c)(3) (and Essential Function) Housing Bond Financings

- **A number of Section 501(c)(3) corporations, like some cities, counties, housing authorities or other governmental units, have major portfolios of affordable multifamily rental housing, and they and their staffs are quite capable and experienced in all aspects of development, ownership and operation of these assets.***
- Other Section 501(c)(3) corporations, public bodies and governmental units may play an important role in affordable multifamily rental housing ownership and/or operation but have little experience in the purchase and sale or development of these facilities.
- **In any case, developers and other private participants may play a significant role in the development, financing, and operation of facilities financed with Section 501(c)(3) bonds and essential function bonds.**

* For example, the author had the privilege of working with Sister Lillian Murphy on the financing of two of Mercy Housing's first affordable apartment communities – Mercy Terrace and Mariposa Apartments – in San Francisco in 1982. Today, Mercy Housing provides affordable housing for over 48,000 households! There are a number of other Section 501(c)(3) corporations as well as public agencies and authorities who have a full set of real estate development capabilities and may themselves perform a number of these functions.

- The broad concept is the same: **100% of the project ownership must reside in the Section 501(c)(3) or governmental borrower. But developers and other profit-motivated entities can perform services and assume risks and be paid for doing so.**
- **Compensation** for services rendered or risks assumed by such participants **must be reasonable and on competitive terms** when compared to such services rendered or risks assumed where tax-exempt financing is not involved. A finding by the IRS that any ownership has effectively been given to a private party through excessive compensation (“private inurement” in the Section 501(c)(3) context) could jeopardize the tax-exempt status of the bonds on either type of financing and could jeopardize the Section 501(c)(3) status of the borrower.

- While it is likely that bond counsel and Section 501(c)(3) counsel will apply similar standards regarding reasonable compensation when existing projects are being moved to governmental ownership in a number of the recent tax-exempt essential function workforce housing bond financings, **these tests may be somewhat different and may be somewhat rigorously applied to Section 501(c)(3) ownership financings under Section 145 of the Code.** In addition, underwriters and placement agents and their counsel, as well as bond and Section 501(c)(3) borrower's counsel, will certainly perform due diligence on the Section 501(c)(3) borrower's Section 501(c)(3) status and charitable purpose and assure themselves that the proposed financing, if based on a lessening of the burden of government charitable mission, responds to an established governmental need, fits the borrower's stated mission, and will materially assist in lessening that burden, as outlined above.
- It might be very broadly stated that if the customary acceptable total developer's compensation under the model for the **transfer of a stabilized project to Section 501(c)(3) or governmental ownership** from the three sources often used in these financings (upfront cash, delivery of subordinate tax-exempt bonds and ongoing asset management fee) makes the existing project transfer **financings a "4 to 6 point deal" for the developer.**
- Obviously, **in a new construction or sub-rehab financing the developer's role may go far beyond that.** The developer may have significant money and time at risk for substantial periods of time. In addition, it may often select consultants and obtain entitlements and permits, arrange construction and permanent debt financing, provide payment and completion guaranties, in all likelihood have a significant role in managing and/or monitoring construction and rent up through stabilized occupancy and perform various other roles not required where an existing stabilized asset is being transferred. The compensation should and can be consistent with that.

- One would expect the total compensation for a financing where a developer is performing most or all of the typical developer functions described above to be twice the level described above or more, **probably “10 or 12 points” or slightly greater (e.g., up to “15 points”) consideration** to cover the developer’s costs, services performed and risks assumed and to be competitive with compensation opportunities available to developers in other commercial real estate development transactions.
- As stated above, the bottom line is that compensation of any private parties must be reasonable and competitive.
- Any **ongoing management or other service contracts** with private entities will be required to meet the **safe harbor guidelines set forth in Revenue Ruling 2017-13**. Among other requirements under Rev. Ruling 2017-13, developers or other service providers cannot receive any compensation which is based, even in part, on net profits and cannot be responsible for net losses. The term of a services contract cannot exceed 30 years, or 80% of the remaining useful life of the project, if shorter. The Section 501(c)(3) owner of the project must exercise control over the project, including major operational aspects (such as setting rates and charges and budget planning) and sale or disposition.
- **A developer proposing to perform these functions in a Section 501(c)(3) bond financing should set aside substantial time on the front end of the financing to review each of the functions it proposes to perform and the proposed related compensation with the issuer and its counsel and financial consultant, if any, bond counsel, Section 501(c)(3) borrower’s counsel and the underwriter or placement agent and its counsel.** Not only should the nature and magnitude of this compensation be reasonable, but counsel will want to describe it in a way that does not imply any ownership interest is being transferred to the developer or any other party. These elements will ultimately be incorporated into an agreement with the developer/project administrator in these financings.

- **Tax-exempt Section 501(c)(3) financings**, like essential function bond financings, **are difficult and complex. However, we have seen substantial growth in these financings over the past four years, and we believe it is likely that we will continue to see continued substantial growth in such financings in the months and years ahead.**
- We hope these very general guidelines will be helpful to parties anticipating participation in these financings, and we would welcome the opportunity of discussing this rapidly evolving area of tax-exempt multifamily housing bond financing with any interested parties.

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