

CREATING CASH WITH CASH-BACKED BONDS

2026 UPDATE*

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Presented by:



R. WADE NORRIS, ESQ.
DINSMORE & SHOHL LLP
801 Pennsylvania Avenue N.W.
Suite 610
Washington, D.C. 20004
wade.norris@dinsmore.com
(202) 744-1888 (C)



REGGIE J. NORRIS, ESQ.
DINSMORE & SHOHL LLP
1775 Sherman Street
Suite 2600
Denver, CO 80203
reggie.norris@dinsmore.com
(202) 441-3996 (C)

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IMPACT OF THE OBBBA IN 2026 AND BEYOND

- As we all know, the One Big Beautiful Bill Act (the “**OBBBA**”) **incorporates** several major affordable housing industry goals. These include a **12% permanent increase** in the allocation of **9% LIHTC** beginning in 2026 and a **reduction in the 50% test to 25%** under Section 42 for using volume-limited private activity bonds issued in 2026 and thereafter under Section 142(d) of the Code to prime 4% LIHTC.
- **More taxable versus tax-exempt debt may raise borrowing costs** and a **higher volume of tax credits in the market may adversely affect 4% LIHTC equity pricing.**
- Of course, the 50% Test may not immediately drop to a 25% Test for all projects and in all jurisdictions.
- These two developments **are likely to adversely affect, but we think will not eliminate, certain advantages of using Short-Term Tax-Exempt Cash-Backed Bonds.**

REALIZATION OF SPECIAL POTENTIAL BENEFITS FROM TAX-EXEMPT CASH-BACKED BONDS

- This summary presentation examines the principal benefits of Cash-Backed Tax-Exempt Bonds under three scenarios in this new environment:
 1. Short-Term Tax-Exempt Cash-Backed Bonds used with FHA-insured and USDA-guaranteed (“RD”) loans.
 2. Publicly offered “Forward” Fannie Mae M.TEBs and Freddie Mac guaranteed (“GSE-Backed”) fixed-rate tax-exempt bonds providing permanent phase financing for new construction/sub rehab projects.
 3. Adding Short-Term Tax-Exempt Cash-Backed Bonds to the front end of tax-exempt perm loan private placements.
- As before, any of **these executions** will be **more effective for** projects with **longer** (*e.g.*, above two years) **construction/rehab periods** and **projects located in a QCT or DDA**.

- **Both the widely used Short-Term Cash-Backed Tax-Exempt Bonds with FHA and RD loans and the Fannie Mae and Freddie Mac “GSE”-backed “forward” public offerings (items 1 and 2 above) involve a form of Cash-Backed Bonds.** GSE-backed “forward” public offerings for new construction and sub rehab are effectively cash-backed bonds until Conversion to the perm loan GSE-backed phase.
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- GSE-Backed “Forward” Public Offerings also **may include an additional series of Short-Term Tax-Exempt Cash-Backed “Side Car” Bonds** to meet the now 25-30% up to 50-53% Test, as applicable (we are using the term “25% to 50% Test” to reflect the potential applicable ranges).
- If proper steps are taken on structures using Cash-Backed Bonds, there may, now as before, be **two big advantages:**
 1. **Substantially increasing 4% LIHTC basis and proceeds, and**
 2. **Retaining some portion of the positive arbitrage to cover qualified project costs.**

- Since interest rates started rising in early 2022, **yields on Short-Term Cash-Backed Tax-Exempt bonds** (“Cash-Backed Bonds”) **rose** from about 1% **to almost 4.0%**. Today, they hover **just below 3.0%**.
- Due to this, for the past 24 to 30 months, developers have **added** a series of Short-Term Tax-Exempt **Cash-Backed Bonds** to the front end of **tax-exempt “forward” perm loan private placements for new construction and sub rehab projects** (item 3 above) to satisfy the 25-50% Test (and have converted what would have been a tax-exempt draw-down construction loan to a taxable draw-down loan).

What Are the Details of the Two Major Benefits?

Advantage 1: Increased 4% LIHTC Basis and Proceeds.

- **Cash-Backed Bonds, under any of the above structures, involve two streams of construction period interest: (i) that on the fully funded Cash-Backed Bonds and (ii) that on the taxable draw-down loan which funds construction or acquisition and rehabilitation. Interest on both of these loans through the placed-in-service date when a certificate of occupancy is obtained or rehab is complete can be added to 4% LIHTC basis under Section 42, if proper steps are taken.**
- Assuming the tax-exempt cash-backed bonds are targeted and sized based on 28% to 30% of basis test, **Cash-Backed Bonds** with a 3.0% coupon **can produce 3-4 points (of Total Development Cost) of additional 4% LIHTC basis for a project with a 3-year construction period, or 1.3 times this amount, or up to 4-5% (of Total Development Cost) of additional 4% LIHTC basis for a project in a QCT or DDA.** This increased LIHTC benefit can translate to **additional net cash (after costs) at closing equal to as much as about 1.0% of Total Development Cost** for such a project, even in a 25% Test scenario.
- If the 25% to 50% Test falls higher in that range the benefits will be even greater, potentially approaching twice as great if the 50% Test still applies and as other steps are taken.

There are two primary steps developers and 4% LIHTC investors now take to support the claim to additional basis:

1. **Section 266 Election.** Most Borrowers and their accountants will now make an election under Section 266 of the Code to treat the interest paid on the Cash-Backed Bonds during construction as a construction period-related capital item instead of an expense. This is believed to provide substantial additional basis for including this additional construction-period interest in basis.
2. **Paying Federal and State Income Tax on Escrow Earnings.** Because the Borrower is benefiting under Section 42 of the Code from this additional basis claim, most Borrowers will allocate to a partner or member in the Borrower the obligation to pay federal and state income tax on the earnings in the escrow supporting the Cash-Backed Bonds. This will often be allocated to the tax-credit investors, who are generally 21% federal income taxpayers (as compared to 39% for many developer general partners). Some, but not all, tax-credit investors, especially if different from the taxable draw-down construction period lender, may reduce tax credit equity pricing by 1 or 2 cents (a 1¢ reduction is equal to about 0.5% of TDC) to offset this. On the other hand, if a bank is both the draw-down construction lender and the tax-credit investor, the benefit of serving in both roles may largely offset or more than offset this potentially negative factor.

Advantage 2: Using a Portion of the Positive Arbitrage to Offset Qualified Project Costs.

- **In today’s environment, this U.S. Treasury escrow earnings yield will be about 3.70%, or perhaps very roughly 80 basis points above the short-term tax-exempt bond coupon or yield of about 2.90%.**
- **Most, but not all, bond counsel will allow a “blending” of the lower yield (e.g., 2.9%) on the Cash-Backed Bonds with the higher tax-exempt perm loan yield (e.g., 6.0%) for the purpose of determining the borrower’s rebate obligation, if any, for the first 5-year rebate computation period applicable to these issues.**
- **Over the past 12-18 months, under the typical fact pattern shown below, this “blended yield” has often been perhaps only 20-30 basis points below the U.S. Treasury escrow earnings yield, which creates an obligation to rebate some but usually not even a majority of the positive arbitrage. If this concept can be used, enables the borrower to use perhaps 2/3 to 3/4 of the excess earnings on the Cash-Backed Bonds to offset qualified project costs.**

- This “**blended yield**” will be determined by **two primary factors**: **(i) the number of months before conversion** to the tax-exempt permanent loan structure (“Conversion”) (**shorter is better** – *i.e.*, a higher blended yield) and **(ii) the size of the pay-down** of the tax-exempt debt at Conversion (**smaller is better**, but it can be 50% or more in high-cost markets).
- **In a 25% Test scenario, the size of any pay-down is likely to be much smaller.** Thus, the “blended yield” in many cases will be above the earnings yield.
- While the dollar amount of positive arbitrage will be smaller due to the smaller bond principal amount, **the borrower should be able to apply a much higher percentage or all of the positive arbitrage to Qualified Project Costs** in many scenarios.

Advantage 3: Cash-Backed Bonds Can Help Meet the All-Important 25% to 50% Test.

- In Revenue 2002-21, the Service has ruled that the interest earnings on the escrow supporting Cash-Backed Bonds can be counted as additional tax-exempt bond proceeds. So while one adds the increase in 4% LIHTC credit basis to the denominator in the calculations, one can also add an even greater dollar amount of interest earnings on the escrow to the numerator. **This can raise the 25-50% Test compliance ratio**, as shown in Appendix A, which can be an important plus on many financings.

- We have developed an Excel model to assist developers in computing the net additional net cash a borrower might expect to generate from these structures in the high short-term interest rate environment.
- Slides 12 and 13 show, respectively, the projected additional net cash as a percent of total development cost (“TDC”) for an assumed favorable conditions financing in today’s environment if (a) the old 50% Test (assumed to be 53%) applies and (b) the new 25% Test (assumed to be 28%) applies.
- This favorable fact pattern assumes a relatively long 33-month construction period, with 42 months projected to “Conversion” to the permanent phase, QCT and DDA status, 80 basis points of gross positive arbitrage, a blended yield about 20 basis points above the earnings yield,* and no downward adjustment in 4% LIHTC pricing.**

* Again, a 1-cent reduction in 4% LIHTC pricing might equal about 0.5% of Total Development Cost.

** We have assumed a 2-cent drop in 4% LIHTC pricing in 2026 due to the substantially increased 4% LIHTC supply we expect the OBBA will produce, with a more limited increase in demand.

DRAW DOWN TAX-EXEMPT PRIVATE PLACEMENT VS. CB BOND TO TAX-EXEMPT PERM LOAN STRUCTURE

50% TEST

Summary: Draw Down Tax Exempt Private Placement vs CB Bond to Tax Exempt Perm Loan Structure - 50% Test

CB Bond to TE Perm Loan Structure

Assumed Deal Facts	
CB Bond Amount	\$ 35,000,000
CB Bond Interest Rate	2.90%
Taxable Construction Loan Amount	\$ 40,000,000
Taxable Construction Loan Interest Rate	6.00%
US Treasury Reinvestment Interest Rate	3.70%
Estimated Construction Period- Placed in service date (Months)	36
Expected Conversion Date (Months)	42

Additional Costs of Issuance Specific to CB Bonds

Bond Underwriter Fee	\$ 250,000
Bond Underwriter Counsel Fee	\$ 75,000
Trustee Fee + Counsel	\$ 12,000
Trustee Counsel	\$ -
Rating Agency	\$ 10,000
Miscellaneous Bond Fees	\$ 313,000
Total Cost of Issuance*	\$ 660,000

**Can now be included in Tax Credit Basis*

Additional Federal Tax Credits

Construction Period Bond Interest	\$ 3,045,000
Additional Construction Period Loan Interest	\$ 134,896
Total Cost of Issuance	\$ 660,000
Total Additional Tax Credit Basis	\$ 3,839,896
Additional Federal Tax Credits (Annual)	4% 153,596
Applicable Fraction	100%
QCT/DDA Adjustment	Yes 130%
Federal Tax Credit Equity Pricing	\$ 0.8300
Additional 4% Federal LIHTC Proceeds	\$ 1,657,299

Positive Arbitrage Analysis

Investment Earnings on US Treasury Escrow	\$ 4,532,500.00
Interest on Tax Exempt Cash Backed Bonds	\$ 3,552,500.00
Positive Arbitrage	\$ 980,000.00
Blended Yield on Tax Exempt Debt over 5 year Rebate Computation I	3.49%
Yield on Short Term Treasury Bonds	3.70%
Yield Reduction Payment Due*	Yes
If Blended Yield > Investment yield, then no Yield Reduction Payment due	
Amount Required to be Rebated	\$ 260,143.66
Amount of Arbitrage Kept	\$ 719,856.34

**If Blended Yield > Yield on Short Term Treasury Bonds, then no Yield Reduction Payment due*

Draw Down Tax Exempt Private Placement

Assumed Deal Facts	
Tax Exempt Construction Loan Amount	\$ 35,000,000
Tax Exempt Construction Loan Interest Rate	5.75%
Taxable Loan (with Tax-Exempt Draw Down Loan) Amount	\$ 5,000,000
Taxable Loan (with Tax-Exempt Draw Down Loan) Interest Rate	6.00%
Estimated Construction Period-Placed in service date (Months)	36
Expected Conversion Date (Months)	42
Estimated Permanent Tax Exempt Loan Amount	17,500,000
Estimated Permanent Tax Exempt Loan Interest Rate	6.25%

Cost Comparison of Structures	Total
Tax Exempt Draw Down Loan	
Tax Exempt Loan Interest	\$ (4,108,854)
Taxable Construction Loan Interest	\$ (612,500)
	\$ (4,721,354)
CB Bond to Tax Exempt Perm Loan	
Additional Costs of Issuance	\$ (660,000)
Taxable Construction Loan Interest	(4,900,000)
Tax Exempt CB Bond Interest	(3,552,500)
Yield Reduction Payment	(260,144)
CB Bond US Treasury Investment Earnings	4,532,500
Additional LIHTC Equity	1,657,299
	\$ (3,182,845)
Net Benefit of CB Bond to Tax Exempt Perm Loan Structure	\$ 1,538,510
% of CB Bond Amount	4.4%
(If CB Bonds Equal 54% of Total Development Cost)	
Total Development Cost	\$ 70,000,000
% of Total Development Cost	2.2%

DRAW DOWN TAX-EXEMPT PRIVATE PLACEMENT VS. CB BOND TO TAX-EXEMPT PERM LOAN STRUCTURE

25% TEST

Summary: Draw Down Tax Exempt Private Placement vs CB Bond to Tax Exempt Perm Loan Structure - 25% Test

CB Bond to TE Perm Loan Structure	
Assumed Deal Facts	
CB Bond Amount	\$ 20,000,000
CB Bond Interest Rate	2.900%
Taxable Construction Loan Amount	\$ 40,000,000
Taxable Construction Loan Interest Rate	6.00%
US Treasury Reinvestment Interest Rate	3.70%
Estimated Construction Period- Placed in service date (Months)	36
Expected Conversion Date (Months)	42

Additional Costs of Issuance Specific to CB Bonds	
Bond Underwriter Fee	\$ 200,000
Bond Underwriter Counsel Fee	\$ 75,000
Trustee Fee + Counsel	\$ 12,000
Trustee Counsel	\$ -
Rating Agency	\$ 10,000
Miscellaneous Bond Fees	\$ 250,000
Total Cost of Issuance*	\$ 547,000

*Can now be included in Tax Credit Basis

Additional Federal Tax Credits	
Construction Period Bond Interest	\$ 1,740,000
Additional Construction Period Loan Interest	\$ 77,083
Total Cost of Issuance	\$ 547,000
Total Additional Tax Credit Basis	\$ 2,364,083
Additional Federal Tax Credits (Annual)	4% 94,563
Applicable Fraction	100%
QCT/DDA Adjustment	Yes 130%
Federal Tax Credit Equity Pricing	\$ 0.8300
Additional 4% Federal LIHTC Proceeds	1,020,338

Positive Arbitrage Analysis	
Investment Earnings on US Treasury Escrow	\$ 2,590,000.00
Interest on Tax Exempt Cash Backed Bonds	\$ 2,030,000.00
Positive Arbitrage	\$ 560,000.00
Blended Yield on Tax Exempt Debt over 5 year Rebate Computation I	3.89%
Yield on Short Term Treasury Bonds	3.70%
Yield Reduction Payment Due*	No
If Blended Yield > Investment yield, then no Yield Reduction Payment due	
Amount Required to be Rebated	\$ -
Amount of Arbitrage Kept	\$ 560,000.00

*If Blended Yield > Yield on Short Term Treasury Bonds, then no Yield Reduction Payment due

Draw Down Tax Exempt Private Placement	
Assumed Deal Facts	
Tax Exempt Construction Loan Amount	\$ 20,000,000
Tax Exempt Construction Loan Interest Rate	5.75%
Taxable Loan (with Tax-Exempt Draw Down Loan) Amount	\$ 20,000,000
Taxable Loan (with Tax-Exempt Draw Down Loan) Interest Rate	6.00%
Estimated Construction Period-Placed in service date (Months)	36
Expected Conversion Date (Months)	42
Estimated Permanent Tax Exempt Loan Amount	\$ 20,000,000
Estimated Permanent Tax Exempt Loan Interest Rate	6.25%

Cost Comparison of Structures		Total
Tax Exempt Draw Down Loan		
Tax Exempt Loan Interest	\$ (2,347,917)	
Taxable Construction Loan Interest	\$ (2,450,000)	
		\$ (4,797,917)
CB Bond to Tax Exempt Perm Loan		
Additional Costs of Issuance	\$ (547,000)	
Taxable Construction Loan Interest	(4,900,000)	
Tax Exempt CB Bond Interest	(2,030,000)	
Yield Reduction Payment	-	
CB Bond US Treasury Investment Earnings	2,590,000	
Additional LIHTC Equity	1,020,338	\$ (3,866,662)
Net Benefit of CB Bond to Tax Exempt Perm Loan Structure		\$ 931,255
% of CB Bond Amount		4.7%
(If CB Bonds Equal 54% of Total Development Cost)		
Total Development Cost		\$ 70,000,000
% of Total Development Cost		1.3%

QUICK SUMMARY

The **main points** of this discussion are these:

- **The main driver of this structure – increased net LIHTC proceeds from two streams of construction period interest – applies to any structure incorporating Cash-Backed Bonds.** This benefit is still available under any of these structures:
 - ❖ **Cash-Backed Bonds used with FHA-insured loans and USDA Rural Development guaranteed loans (“RD Loans”).**
 - ❖ **GSE-Backed “Forward” Public Offerings** (for new construction and acquisition/ rehab projects).
 - ❖ **Adding short-term Cash-Backed Bonds to the front end of a Tax-Exempt Private Placement Perm Loan** (and converting the draw-down Construction Loan to a taxable loan).
- **This benefit is likely to be lower in 2026** in light of the reduction of the 50% Test to 25% in ongoing financings in many jurisdictions. However, **if savings are even 1.0-1.5% of Total Development Cost, this can still be a major boost to the developer’s return.**
- **We therefore believe the benefits will still be material,** especially for new construction projects with a **longer construction period** in a **QCT or DDA**, and especially where the 50% Test has not dropped all the way down to 25%.

Bonus Benefit – All Cash-Backed Bonds: Help Meeting the 25% Test

- Another benefit of the **Cash-Backed Bond structure**, which may be significant, is that it **can assist the borrower in satisfying the 25% Test**.
- Under **IRS Revenue Ruling 2002-21**, described above, amounts received from investing the proceeds of tax-exempt bonds were deemed to be included in tax-exempt bond proceeds for purposes of the Borrower's satisfying the then **50% Test**.
- Thus, the interest earnings in the escrow go into the numerator in this calculation.
- Let's assume we have a \$20 million bond issue and eligible basis is \$70 million (roughly total development cost on a 100% affordable project assuming no commercial), and **we are not using Cash-Backed Bonds on the front end of the financing**. In that case, we **would have just met the 25% Test** ($\$20 \text{ million} / \$70 \text{ million} = 28.5\%$).
- Now let's **assume we have added short-term Cash-Backed Bonds to what would have been a tax-exempt private placement loan**, our **increase in basis** was 10% of our bond amount, or \$2 million on the \$20 million Bond issue in the example in Slide 12. This would amount to a \$2,000,000 addition to the denominator or \$22,000,000 in our example, **providing a denominator of \$72,000,000**.
- But the earnings in our example over 42 months to Conversion were about \$2,500,000 on \$20 million of Bonds, or 12.5% of the Bond amount. In this \$20 million Bond example that would be **bring our numerator up to \$22,500,000**.
- If we **now have a numerator of \$22,500,000 and a denominator of \$70,000,000**, the results are $\$22,500,000 \div \$70,000,000 = 31\%$ → a gain in our ratio from 28.5% to 31%.