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

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).

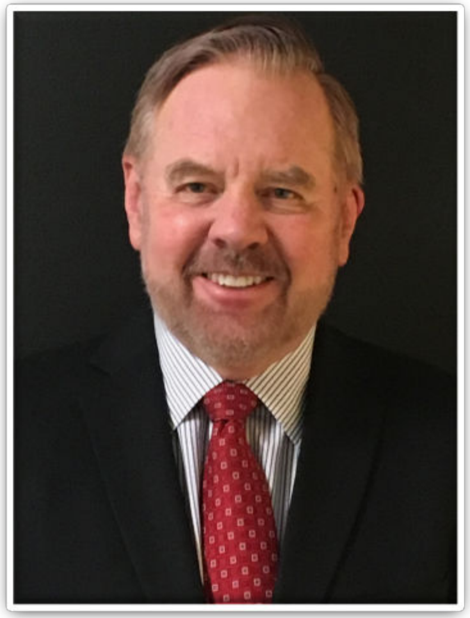
2. **Tax-Exempt "Section 501(c)(3)" Private Activity Bonds under Section 145** of the Code for certain nonprofit owners. No private activity bond volume required but cannot be paired with 4% LIHTC (somewhat less complex but substantial body of rules).

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 Panel 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), with one example of a Section 142(d) financing (Category 1).

A Short Client Pocket Guide for Section 501(c)(3) and Essential Function Tax-Exempt Bond Financings*

January 28, 2026



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Fold Here (It's a Pocket Guide!)*

Client Question:

"What are the minimum set-aside requirements for a qualified 501(c)(3) bond?

Is it 20@50 (or 40@60) and at least 75%@80%? I'm just not recalling the 20@50 test (as my online research has indicated)...

thought it could be 100@80, but figure you would know off the top of your head?"

Our Response:

"Well, that is a loaded question, but here goes."

- **Our First Question:**

  Does the financing involve new construction or substantial rehabilitation, by which we generally mean the amount that will be spent on rehabilitating the apartment complex equals or exceeds the amount that is being paid to acquire it. **If it does NOT**, there's a **statutory requirement** under **Section 145(d)** (the so-called Donnelly provisions), which requires for **acquisition light to moderate rehab financing** that at least 20% of the units be occupied by persons at 50% of area median income or at least 40% of units be occupied by persons at 60% area median income, or below, adjusted for family size (*e.g.*, **"20@50" or "40@60" targeting**).

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* Just kidding!

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- # Our Second Question:

What group of tenants are we trying to serve? Remember, on any section 501(c)(3) financing, the involvement of the Section 501(c)(3) corporation in the ownership and operation of the rental apartment project **has to serve a recognized charitable mission under section 145 of the Code**. Moreover, the Section 501(c)(3) corporation **borrower must have that charitable mission incorporated** in its articles and bylaws and in its submission for Section 501(c)(3) status with the Internal Revenue Service. If this is not the case, an amendment to these items may be required, which can take two to four or more months with the IRS.

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Client Answer: "Generally, people of lower or moderate income."

Our Response:

OK, that charitable mission under section 145 of the code is "relief of the poor and distressed." At this point, **we have good news and bad news**.

- The **good news** is that there is a **safe harbor provision** embedded in **Rev Proc 96-32** which, if satisfied, makes it very easy for Section 501(c)(3) counsel and bond counsel to render the clean opinion they need to render in order for us to do a tax-exempt bond financing under Section 145 of the Code for such a facility.
- The **bad news** is that Rev Proc 96-32 requires that **at least 75% of the units** (75 units on a 100-unit project) be rented to persons at **80% of AMI or below** and, **within that 75%, at least 20% of the units be rented to persons at 50% of AMI or below or 40% of the units** (20 units or 40 units in our example) **be rented to persons at 60% of AMI or below**, adjusted for family size (*i.e.*, the same requirements as in the Section 145(d) provisions described above or in a financing for a profit motivated owner under section 142(d) of the Code).* And the rents must be affordable to those tenants (generally, a bit below market rents for the same units).

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* Please note that this targeting **does not apply to housing for seniors and some other rental apartment financings** (like some student housing owned by 501(c)(3) corporations) which have a different charitable mission (*e.g.*, education at a nonprofit college or university).

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Different Client Answer:

"No, I'm thinking workforce housing – *i.e.*, tenants above 60% of AMI."

Our Response:

In this case while there could be another charitable mission or two that would work.* We are probably talking about "lessening the burdens of government."

Establishing that a section 501(c)(3) financing will address a charitable mission, such as lessening the burdens of government (or the other missions listed in the footnote), is more of a "touchy feely" exercise without the safe harbor protections afforded by Rev Proc 96-32 where it applies. It's a bit more like the Supreme Court saying with respect to obscenity, "I know it when I see it." (OK, it's really not **that** bad, but no safe harbor.)

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* A quick AI summary: The term charitable is used in its generally accepted legal sense and includes **relief of the poor, the distressed, or the underprivileged** (*e.g.*, Rev Proc 96-32 financings); advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; **lessening the burdens of government; lessening neighborhood tensions**; eliminating prejudice and discrimination; defending human and civil rights secured by law; and **combating community deterioration** and juvenile delinquency.

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On lessening the burdens of government, fortunately there are **two Rev Procs (85-1 and 85-2)** which establish **two basic requirements:**

- The **first** is that **the governmental unit whose burdens are being lessened has made clear formal pronouncements which establish that it truly believes it has an important governmental mission to provide the workforce housing which is not currently being satisfied and it needs assistance in doing so**. This cannot just be the mayor saying, "We need more affordable workforce housing." Formal resolutions or other adoptions are what is needed. It is also **quite helpful if the governmental unit** whose burdens are being lessened and/or other governmental units where the project is located are **contributing financially in some fashion** through tax relief, grants, low rate subordinated loans, free land and/or low cost long- term ground leases of governmental land and in other ways to contribute to the financial feasibility of the financing.

- The **second basic requirement** is that the **Section 501(c)(3) corporation's participation by being an owner of the project and in other ways will make a material contribution** to satisfying the unmet governmental burden. This could be the Section 501(c)(3) corporation's creating real estate and/or sales tax relief through Section 501(c)(3) ownership, its performing certain development and/or operational functions, its providing guarantees, grants or other subsidies and/or other material contributions to making the financing work whereas it otherwise might not.

- This charitable mission was rarely used up until 2 – 3 years ago but is **quickly becoming much more widely recognized** by Section 501(c)(3) and Bond counsel when they are properly briefed on recent developments, which we are glad to do!

New
Client Question:

"Gosh! That's awfully complicated, especially if we are financing workforce housing outside of Rev Proc 96-32.

What if I can get a state or local governmental entity, or a governmentally controlled subsidiary entity, to be the project owner?"

Our Response:

"**OK! Now we're talking!** We call that an 'Essential Function' or 'Governmental Purpose' Tax-Exempt Bond Financing."

- **MUCH simpler federal tax law rules!!!**
- **No specific targeting**, but generally for tenants up to 120% to 140% of AMI levels.
- Otherwise, **whatever type of housing state law authorizes the governmental unit to finance and own**.
- As in Section 501(c)(3) financings – the **governmental borrower must have 100% ownership – no private equity**.
- And don't forget **differing state law rules** for **real estate tax and/or sales tax relief and other entitlements** which may be critical components of a feasible financing plan.

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Final Client Question:

"What roles can a profit motivated developer play, and how can they get paid?"

Our Response:

"Basically, a **developer can perform the same functions as it would do on a Section 142(d) private activity bond financing** AND **get paid a competitive fee**."

Client: "Really?" *Us:* "Really!"

- **Permitted Developer Functions:** A profit motivated developer and/or its affiliates can perform all the front-end **traditional developer functions** (e.g., site identification and control, zoning, permitting, entitlements, etc.), **construction monitoring and servicing**, **provide completion, payment and performance guarantees** (subject to certain limitations), **serve as contractor and/or (under federal safe harbor guidelines) project management** and other functions.

- Compensation: The profit motivated developer and its affiliates **CANNOT be an owner**. **Fees for services rendered or other developer roles cannot be greater than such fees on projects which do not involve tax-exempt bond financings** (which would imply prohibited private ownership).

- Compensation may be upfront and/or over time and **often involves** the developer being paid in part through the delivery to it (without payment by it) of **one or more series of subordinate tax exempt bonds and/or taxable debt**.

- **Finally**, the financing structure needs to show **some periodic cash flow to Section 501(c)(3) or governmental** project owner **and some projected gain to the Section 501(c)(3) or governmental project owner on sale or refi**, based on reasonable assumptions.

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Our Lawyer's Disclaimer: Please note **this is a very broad, general summary of a very complex topic**.

Our Related Propaganda: We have two recent PowerPoints which explore these topics in greater detail:

1. *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* – dated September 30, 2025.

2. *An Emerging New Source of Tax-Exempt Workforce Housing Bond Financing – Section 501(c)(3) Borrowers Working with Local Counties, Cities and Towns to "Lessen the Burdens of Government"* – dated November 17, 2025.

Please capture the QR code on the next page with your cell phone! We will send these PowerPoints and one or two other current PowerPoints which may be of interest!

And remember, you and we should **always confer with Bond Counsel and Section 501(c)(3) or governmental counsel** in these matters **at the very outset** of any proposed financing because legal interpretations can vary!

Please don't hesitate to give us a call if it helps to further explore any aspect of these financings.

Best regards,

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Point your mobile phone camera here (and click on the link that appears) to request PowerPoints:

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