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Maximizing the Use of Federal 4% Low Income Housing Tax Credits in the Emerging World of Scarce Private Activity Bond Volume*

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It has now been documented that many cities and states face a critical and growing shortage of affordable rental housing. Single family home ownership in the United States has fallen from over 69% before the 2008 financial crisis to about 64.4% today. Many Americans have lost their homes or can no longer qualify for single family home mortgage loans. At the same time, continued net immigration in the U.S. and the entry of the post-World War II baby boom "echo" generation into the work force, and now the aging of the post-World War II baby boom generation, has added huge additional demand for rental housing in the United States. It thus comes as no surprise that based on an October 30, 2018 report from the U.S. Census Bureau, apartment rents have climbed by slightly over 42% in the U.S. since the recent bottom in 2009 (from just over $700/unit/month to just over $1,000).

While rental housing starts have quadrupled since the low of 90,000 units was reached in 2009, the shortage of affordable rental housing in the United States today is greater than any time in the recent past. Studies by the Joint Center for Housing Studies of Harvard University and others indicate that the shortage grows more acute every year. According to the 2016 Harvard Joint Centers Study, the number of American families who are "severely cost burdened" – paying over 50% of their income for housing – actually **grew** by 23% to 11.4 million from 2008 to 2014. The 2017 Harvard Joint Centers study states that over 75% of renter household with *incomes* below $30,000 are severely cost burdened, and that since 2015 **almost half of *all renter households* are "cost burdened"** – i.e., they spend more than 30% of their income on rent.

At the same time, cities, counties and states across the United States face increasing funding demands for education and social needs, deteriorating infrastructure, ballooning pension obligations and other financial burdens, often with declining revenues. In such times, it is imperative that city, county and state officials maximize any external sources of funding which can be brought to bear to address the critical shortage of affordable rental housing which exists in so many communities.

Role of 4% LIHTC in Multifamily Rental Housing Financings

A huge source of such external funding is the federal 4% low income housing tax credit (or the "4% LIHTC"). As those active in affordable housing are aware, on a 100% affordable project the 4% LIHTC can be syndicated for an amount of money sufficient to cover 25-35% of total development cost or, for projects in a "difficult to develop area" or "DDA", as much as 35-45% of total development cost.

It is estimated that the federal 4% LIHTC program and the even more powerful, but almost always dramatically over-subscribed (by a factor of 4 or 5:1) 9% federal Low Income Housing Tax Credit Program provided funding for almost one third of the slightly over 400,000 total rental apartments started in the United States in 2016 (roughly 75,000 units from tax exempt private activity bonds and 4% LIHTC and roughly 50,000 units for the 9% LIHTC program). Either the 9% or 4% LIHTC is involved in almost all U.S. affordable rental housing. The regulatory compliance track-record since these two programs were enacted in the early 1990's has been virtually unblemished, and the default rate, even in the darkest days of 2008 and 2009, has been almost non-existent.

Private Activity Bond Volume, Overall Usage and the 50% Rule

Since it is clear that 4% LIHTC, like 9% LIHTC, is a vital federal subsidy for affordable housing, one might ask, how much of this subsidy is available? The answer is, ironically, in most, but now not all, jurisdictions, much more of the 4% LIHTC federal subsidy is available each year than is presently being used. To be eligible for the 4% federal LIHTC, the so-called "50% Rule" under Section 42 of the Code requires that at least 50% of the eligible basis in the buildings plus land be financed with volume limited tax exempt private activity bonds (a term which includes tax exempt "loans") under Section 142(d) of the Code, and that these bonds be kept outstanding until the project's placed-in-service date (roughly the issuance of a certification of occupancy for a new construction project or the completion of rehabilitation for an acquisition/rehabilitation project). The purpose of the 50% Rule was, in the absence of a separate state authority allocation mechanism as was created under the 9% LIHTC program, to "piggyback" on each state's system for allocating this tax exempt private activity bond volume for multifamily housing to only the most meritorious (from a public policy standpoint) of the projects applying for these federal tax subsidies.

Under Section 146 of the Internal Revenue Code, each state is allocated in each calendar year, tax exempt private activity bond volume equal to the greater of, in 2019 (i) $316.7 million or (ii) $105 per resident (both limitations are indexed annually for inflation). Today, this formula results in about $35 billion of new private activity bond volume being allocated in the United States each year. At the end of each year, if proper steps are taken with the state volume allocating authority, unused private activity bond volume can be carried forward by certain designated issuers and used for the purpose it was carried forward (e.g., qualified residential rental housing) during the ensuing three (3) calendar years.

Private activity bonds are debt obligations which serve a designated public purpose but where the facilities are privately owned.[*] Types of private activity bonds subject to volume

[*] There were roughly $87 billion of private activity bonds issued in 2016, which comprised roughly one fourth of all municipal bonds. Not all categories of private activity bonds are subject to the private activity bond volume limitations. For example, three major categories – private activity bonds for nonprofit hospitals (roughly $33 billion issued in 2016), private activity bonds for nonprofit colleges and universities (roughly $12 billion issued in 2016), and private activity bonds for seniors, affordable and other housing, assisted living and nursing homes, in each case owned by Section 501(c)(3) charitable organizations (roughly $5 billion issued in 2016), are not subject to the private activity bond volume limitations. All of this private activity bond financing would have been abolished by HR1 if it had been if it had been enacted as passed by the House in 2017. About $20 billion of *volume limited* private activity bonds were issued in 2016, which comprised roughly 23% of the $87 billion of total private activity bonds issued that year.

limitations include single family mortgage revenue bonds, multifamily affordable rental housing bonds, industrial development bonds, pollution control bonds, student loan bonds and certain other uses. Each state is allowed to allocate its volume among these categories as it sees fit. **Over the past several years, over 84% of national private activity bond volume has been allocated to single family and multifamily rental housing**, with about **three fourths of that volume going to multifamily volume in 2016 and 2017**, as further discussed below. Some states allocate an even higher portion to multifamily housing. For example, in 2017 California allocated $3.35 billion or 85% of its $3.95 billion total private activity bond volume allocation to multifamily housing.

Two arguments suggest that this is sound state policy. First, the growing shortage of affordable rental housing is one of the most significant public policy issues faced by many cities, counties and states for which a solution is urgently needed. But the second reason is even more compelling. An allocation to tax exempt affordable multifamily housing bonds versus other private activity bond sources is **the only use of private activity bond volume which** not only provides low rate debt financing, but **also triggers another huge (25-45% or more of total development cost) federal subsidy** on the equity side through the 4% federal LIHTC**. No other use of the state's private activity bond volume provides this dramatic, powerful, double barreled "bang for the buck."**

As noted above, one might attempt to quantify the magnitude of the annual loss of federal subsidy from expiring bond volume as follows. A reasonable estimate is that in a typical affordable multifamily rental housing financing, the tax exempt private activity bonds might fund about 60% of total development cost, with tax credit equity and other sources providing the balance. This suggests that $60 million of private activity bond volume might be associated with roughly $100 million of affordable rental housing. If federal 4% LIHTC can be syndicated for, say, 30% of total development cost, as discussed above, then the expiration of $60 million of private activity bond volume might be associated with the loss of roughly $30 million of a direct federal 4% LIHTC subsidy for affordable rental housing in that state. To say the same thing a different way, **for every dollar of private activity bond volume which expires unused, a**

potential additional federal housing subsidy equal to roughly half that dollar amount of expiring bond volume is lost.

As noted above, once a state's yearly private activity bond volume has been allocated, if not used in that year, the issuers to whom the volume is allocated, or reallocated at the end of the year by the state's volume allocator, can file an election with the IRS to carry the volume forward for 3 years for use by other eligible projects of the same type, but if not used during that carry forward period, the volume simply expires. The sad fact is that, until very recently, in about every state outside of New York, Massachusetts and about six or eight other states, each year, tens of millions, and in some cases hundreds of millions, of dollars of private activity bond volume expires, which, if it could have been utilized, would have provided additional millions of federal funding for affordable rental housing in that state.

In response to this, over the years, a number of states, like California as noted above, have increased the share of their total private activity bond volumes devoted to multifamily. In addition, many state and local housing finance agencies have adopted policies which encourage the use of this major potential federal subsidy. For example, in the last ten years, the state housing finance agencies in California, New Jersey and other states have broadened their tax exempt multifamily housing bond programs from strictly balance sheet financed products, to also serve as "conduit" issuers for financings credit enhanced by FHA/GNMA, Fannie Mae and Freddie Mac, as well as private placements of non-credit-enhanced tax exempt bonds or loans with banks and other financial institutions. They have also eliminated artificial developer fee caps, detailed architectural design requirements and overly burdensome, duplicative loan underwritings to facilitate private activity bond financings and thus to prudently encourage more effective utilization of the huge, desperately needed federal subsidy represented by the 4% LIHTC.

The Growing Shortage of Tax Exempt Private Activity Bond Volume in a Number of States

It appears that the world of excess private activity bond volume is now becoming a thing of the past in a number of states. In 2016, for the first time in almost two decades, in certain states, the demand for tax exempt multifamily housing bond volume began to exceed the available supply. While this initially caught the industry off guard, in retrospect, this is not surprising. Just as total multifamily housing starts have more than **quadrupled** since a low of 90,000 units in 2009 to just under 400,000 last year, the portion of those units comprising **affordable** apartments has probably **quintupled** or more. In 2007, the highest year until the recent past, states used only 58% of their allowed private activity bond volume allocation; in 2014 that percentage was 38%.

This has changed dramatically over the past three years. Total private activity bond issuance has increased, according to the Council of Development Finance Agencies' latest report,[*] from about $13 billion in 2015 to about $20 billion in 2016 and a post- 2007 record of about $25 billion in 2017. The 2017 additional increase was due in part to acceleration of deals in November-December of 2017 to beat a proposed January 1, 2018 effective date of HR1, which if enacted would have abolished tax exempt private activity bonds and annual production of an estimated 75,000 (about two thirds) of the nation's affordable rental housing units. **During this period the percent of the United States' total annual private activity bond volume allocation utilized rose from approximately 37% in 2015 to 70% in 2017.** As noted above, during this period, **single and multifamily housing comprised over 84% of total volume limited private activity bond issuance** with **multifamily representing over 70% of these two categories in 2016 and 2017:**

Approximate Total Issuance ($Bil./% of Total Volume Limited Private Activity Bonds)

	2015	%	2016	%	2017	%
Multifamily	**$7.0**	**53.8%**	**$14.0**	**70.0%**	**$15.3**	**67.2%**
Single Family	4.9	37.7%	4.9	24.5%	5.7	22.8%
Other	1.1	8.5%	1.1	5.5%	4.0[**]	10.0%
Total	**$13.0**	100.0%	**$20.0**	100.0%	**$25.0**[***]	100.0%

[*] CDFA Annual Volume Cap Report, An Analysis of 207 Private Activity Bond & Volume Cap Trends, released September, 2018.

[**] This increase in the "other" represents a renewed growth in the use of IDB's and tax exempt facility financings.

[***] Approximately 70% of the $35.0 billion 2017 national private activity bond volume allocation.

In **2018**, it is generally believed that the **demand for multifamily private activity bond volume exceeded supply,** not only **in New York State and Massachusetts** (where this has long been the case), but also in **Arizona, Connecticut, New Jersey, Minnesota, Utah, Tennessee, Washington State** and possibly other states, **and** the demand for multifamily housing bond volume **came close to exceeding supply in Virginia and Texas**. Most of these states have finally exhausted their 3-year carryforward for multifamily private activity bond volume from earlier, lower-demand years. **It is important to watch the rate at which a state utilizes its private activity bond volume versus the state's annual allocation. Once the rate of utilization exceeds the annual volume allocation for a state, it is probably only a matter of one to several years before the state's three-year carryforward balance will be exhausted and a rationing environment will emerge, as it has this year in most of the states listed above**. In 2019, if the demand for affordable rental housing continues to grow, a number of additional states may join this list of states with a multifamily housing bond volume shortage.

California provides a compelling example of where we may be headed. In 2017, California's issuance of $3.35 billion of private activity bonds for multifamily housing comprised 22% of the $15 billion multifamily issuance nationwide. The recent trend in California mirrors that of Colorado and a number of high growth states. In 2015, CDLAC allocated almost $2.9 billion to multifamily, up from $1.5 billion in 2014 – an increase of almost 100%! – and up from $1.2 billion in 2013. Moreover, the 2015 allocation for single family housing revenue bonds increased almost $1.5 billion from $225 million in 2014 to $1.7 billion in 2016. In other words, with a 2016 utilization rate of $4.6 billion versus an annual allocation of $3.8 billion, California used $800 million of its carryforward in 2016 alone. While total private activity bond issuance in California fell back to about $4.1 billion in 2017 against a $3.9 billion annual allocation and will probably be less in 2018, a resurgence of issuance could cause California to join the list of volume starved states. Nationwide, in a slowly growing number of states we appear to be quickly heading back to the 1990's, when the demand for multifamily housing bond volume substantially exceeded the supply.

Actions to Maximize Private Activity Bond Volume and Optimize Its Use

This is a wake-up call! The development community in states where the availability of bond volume is now or may soon become scarce need to take action on multiple fronts.

Maximizing the Percentage of Private Activity Bond Volume Allocated to Multifamily. The **first** action developers should take are **steps which will maximize the percentage of the state's private activity bond volume available for multifamily** residential rental projects versus other uses. Developers should work with the state bond volume allocator to allocate, to the extent possible given competing demands, a higher percentage of the state's total private activity bond volume to multifamily projects for 2019 and beyond. As shown in the chart above, multifamily grew from 54% of total private activity bond issuance in 2015 to 70% in 2016 but then fell back to 64% of total issuance in 2017. As the above data show, the main competition for multifamily housing bond volume in many states is the single family mortgage volume bond programs operated by most state housing finance agencies and a few local issuers. While these programs serve the laudable goal of lowering mortgage rates by first time homeowners, **the use of private activity bond volume not only lowers multifamily mortgage rates and thus rents, but as stated above, multifamily rental housing is the ONLY use which triggers an additional huge federal subsidy equal to 25-45% of total development cost for much needed affordable housing in the state.**

Developing an Effective Carry Forward Program. Developers should also work with the volume allocator and the issuers active in multifamily housing bond finance to **reallocate any unused private activity bond volume among issuers to those who will make the federal filings to preserve this** increasingly scarce, valuable private activity **bond volume** resource **for use on affordable multifamily projects** in future years. The logical issuers to consolidate unused bond volume and to carry volume forward would include state housing finance agencies and larger local housing finance agencies who have a sufficient repetitive demand for tax exempt multifamily housing bond financing to effectively use the volume carried forward for multifamily without a significant likelihood of it simply expiring unused. Note, the purpose for which the volume will be used (e.g., multifamily rental housing, pollution control, industrial development), must be specified in IRS Form 8328 at the time the volume is carried forward at the end of a calendar year.

Rationing New and Carryforward Volume to Maximize 4% LIHTC. The next step in dealing with this shortage involves actions which issuers and borrowers can use to stretch the available tax exempt private activity bond volume available for multifamily to maximize amount of affordable housing this limited new and carryforward volume will produce. Many issuers in volume-constrained states will **allocate new or carryforward multifamily housing bond volume** to a given project **only in the amount necessary (usually 52-55% of aggregate basis in land and buildings) to assure that the 50% Rule is satisfied,** so that the project is eligible for the vital 4% LIHTC without which most affordable housing project would not be feasible. This means that more projects and more units of affordable rental housing can be produced with a given amount of new and carryforward private activity bond volume.

Forward Commitment of Multifamily Housing Bond Volume from Future Years. In some instances, a Borrower will need a larger amount of private activity bond volume to start construction and assure compliance with the 50% Rule than can be made available in the current year. This may be especially true for larger projects in urban areas in states where volume is a scarce resource. For over 15 years in New York, and more recently in other states including Massachusetts, New Jersey and Arizona, **the state bond volume allocator may give assurances to the issuer and developer that it will assign to a proposed project not only a certain amount of private activity bond volume from the current year, but also an additional installment from the next year's allocation and possibly from the state's allocation in the next following year**. This sometimes comes in the form of three roughly equal installments of a three-year period. This may give the borrower, the credit enhancer of the tax exempt bonds or the tax exempt debt purchaser, as well as the 4% LIHTC investor, sufficient confidence that the required bond volume will be available when needed to fund tax exempt loan draws so that the financing can be closed and acquisition/rehab or construction can be commenced in year one, even though remaining volume required to cover costs and satisfy the 50% Rule will not come in until, when needed, in years two and three. If the financing is a draw down private placement, the terms of the financing can almost always be locked in at initial closing, even though draws may occur over the next two to three years. A transaction may also be structured under which **taxable** bonds will be issued in year one but will be exchanged upon the issuance of a like amount of tax exempt private activity bonds at an agreed upon interest rate at a future time (a so-called "Cinderella Bond" issuance). Of course, in such a situation, one needs to have strong assurance of the availability of private activity bond volume for the project and a forward purchase commitment for the tax exempt debt, if and when issued. If some or all of the required tax exempt debt will come from publicly-offered bonds, it may be difficult to lock in pricing before the subsequent installments of bonds can be issued and paid for. In the absence of an effective interest rate hedge, this can introduce substantial uncertainty and make such an approach more difficult or unavailable.

Generating Additional Sources of Tax Exempt and Taxable Financing

To the extent a project needs debt side financing greater than that available from the sources other than new or carryforward tax exempt bond volume, it must come from other sources, including those discussed below.

<u>Private Activity Bond Recycling – Additional Tax Exempt Leverage.</u> Active multifamily housing bond issuers such as the ones described above in states where volume is or may soon become limited should also implement a **private activity bond volume recycling program** of the type the major issuers in New York (the New York State Housing Finance Agency and the New York City HDC) have had in place for some time and which has recently been quite successfully implemented by the Washington State Housing Finance Commission. These recycling programs allow such issuers to **recapture tax exempt bond volume from prepayments, redemptions and other retirements of private activity bonds** issued in the last four years and **allocate it,** within 6 months of the retirement, **to another qualified residential rental housing project.** The final maturity of the reallocated bonds may not exceed 34 years from the date of issuance of the original bonds, a new TEFRA hearing will typically be required and other requirements may apply. **Such volume will not count towards satisfying the 50% Rule,** but it may serve to provide additional tax exempt leverage for projects that need the advantage of a greater amount of tax exempt leverage during the permanent phase.

There are at least **two major sources of such recycled tax exempt multifamily housing bond volume.** First, many projects in high-cost urban areas require multiple permanent phase financing sources (HOME, CBDG, Housing Trust Fund monies and other subordinate loans), which result in a **pay down at "Conversion"** from the construction phase to the permanent phase of the loan, **of a substantial portion of the tax exempt private activity bonds which were initially issued for the project** in order to provide bridge funding to pay costs during construction and rent-up and to satisfy the 50% Rule. A second major source may be the **redemption or payment at maturity of short-term cash-backed tax exempt bonds** which are issued in today's market to satisfy the 50% Rule for projects using FHA-insured loans, rural development loans and other loan programs where a lower loan rate can be achieved through a taxable securities sale than would be the case if the project were financed with the long-term municipal bonds backed by those credits.

Do You Remember "Taxable Tails?" Like the Gremlins in the Spielberg film, the "Taxable Tail" is back! If all of the above steps are not sufficient to provide the amount of long-term debt financing the project requires through the issuance of tax exempt bonds, in many cases **a portion of the issue (often 5-10%) can simply be segregated as a separate series of taxable bonds – a so-called "taxable tail."** This technique was widely used in the 1990's, when private activity bond volume was oversubscribed in many states. These bonds are typically equally and ratably secured with the tax exempt bonds, but simply bear a separate CUSIP number and typically the word "taxable" in the bond caption. **Most bond counsel firms will allow these taxable tail bonds to be amortized** (through serial maturities or mandatory sinking fund payments) **before the tax exempt bonds are retired**. This lowers the coupons associated with these bonds, thus limiting any adverse impact on the overall borrowing rate (often to an increase of only 5 or 10 basis points). In the alternative, in some cases, the tax exempt debt purchaser or credit enhancer may simply extend an additional taxable loan on the project without structuring it as taxable municipal debt.

Return to the 1990's? The Time to Act is Now!!!

If the economy stays strong,[*] increased demand for private activity bond financing which we have seen in many states in the past several years continues unabated, bond volume may become oversubscribed in even a larger number of states in the years ahead. We may be headed back towards the conditions which existed in many states in the 1990's, where scarcity of private activity bond volume was a **major limiting factor in affordable multifamily rental housing finance**. It is important for developers active in affordable housing financings to carefully assess the present and prospective availability of private activity bond volume for affordable multifamily rental housing in the states when their projects are located. In a volume starved state, unless private activity bond financing for the project can be reasonably assured, the project may be repositioned and redesigned as conventional multifamily rental housing or for some other use. If a shortage of private activity bond volume for multifamily housing already exists or will soon emerge in a state, affordable rental housing developers should **immediately and proactively take the steps outlined above to maximize the amount of affordable housing which can be produced from tax exempt multifamily housing bonds and the huge, vital federal subsidy provided by the 4% LIHTC.**

[*] Recessions dampen the demand for rental housing and for all types of financing, including tax exempt multifamily housing bonds.