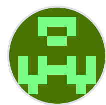
Strategies for Navigating Related Party Issues in Tax-Exempt Bond Transactions



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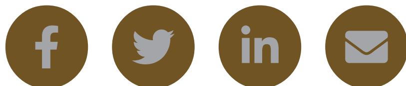

Background

In the current affordable housing development environment, multifamily projects that are not awarded competitive nine percent Low Income Housing Tax Credits are frequently exploring the four percent credit available for transactions in which, at least, 50 percent of the aggregate basis in the project is financed with proceeds of tax-exempt bonds or loans ("bonds") issued by state and local housing agencies and certain municipalities using private activity bond volume cap (the "50 percent test").

Since the four percent tax credit rate was locked at the end of 2020, demand for bonds in many jurisdictions has grown considerably, and, due to a variety of associated benefits, including those stemming from Community Reinvestment Act requirements, it is becoming increasingly common for banks and other lenders that purchase such bonds to invest in four percent LIHTCs. This dual-role approach tends to result in better tax credit pricing and a more streamlined execution but can lead to the application of certain tax rules that may significantly impact the structure of these transactions.

Specifically, two federal tax implications must be noted when contemplating a deal in which the same group is expected to hold the bonds and invest in four percent LIHTCs via an ownership interest in the partnership in excess of 50 percent, whether as a direct limited partner or through a syndicator. The first is the "substantial user" restriction, pursuant to which interest on the bonds, which would otherwise be exempt from federal income taxation, will be taxable to the holder thereof if the holder is a "substantial user" of the project (e.g., the borrower partnership that owns and operates the facility) or a "related person" of the substantial user.

This means that a bondholder that is also serving as the tax credit investor would be treated as a related person of the borrower, and, thus, interest received on the bonds would not be exempt from federal income taxation. To address this consideration, many lenders will charge interest at a higher rate in this scenario.

The second, and potentially more complicated, tax consequence arises out of the provisions related to restrictions on the fees that an issuer may charge in connection with a bond issue. Under the "program investment" rules set forth in the Treasury regulations, if a party "related" to the borrower—such as an investor in the tax credit partnership with an interest greater than 50 percent—also owns the bonds, the fee collected by the issuer (both up-front and on an ongoing basis) is not permitted to exceed 0.125 percent annually (blended for the term of the bonds). This can present a challenge for many deals across the country, as a number of state housing agencies and other conduit issuers charge fees well in excess of the prescribed limit; accordingly, additional planning is often needed to enable an organization to serve in both the debt and equity capacities in transactions with the fact pattern described above.

Despite constraints imposed by the program investment requirements, several strategies have been developed to permit an equity investor and also provide construction financing for a project, including negotiations with issuers on fee modifications and, where such adjustments are not feasible, structuring techniques that allow for the parties to achieve their intended economic objectives.

Reduction or Deferral of Issuer Fees

Because the program investment rule restricts the fees an issuer may charge, it is important to determine whether an issuer that ordinarily charges fees in excess of 0.125 percent on an annual basis is willing to (i) reduce its fees so that they no longer exceed this limit, or (ii) defer a portion of its fees until the conversion of the transaction to the permanent phase, at which point the construction

lender would relinquish ownership of the bonds to a third-party permanent lender and the bonds would cease to be held by a related person. If an issuer can reduce or defer its fees in this manner, a transaction is generally able to proceed with the same party serving in both roles as initially contemplated.

Disconnecting the Bondholder and the Borrower

If an issuer is unable to modify its fees, the focus turns to methods for eliminating the relationship between the borrower and the bondholder, such that the fee limitation does not apply. The more common approach for achieving this result is for a third party to purchase the bonds, with the construction lender making a construction loan that would either (i) collateralize the bonds, as in the "Cash-Backed Forward" structure, or (ii) be used to build the project directly, as in the "$51,000 Initial Draw" structure. Interest on such a construction loan would be taxable to the construction lender, which would also be the case if the construction lender were buying the bonds (given its role as equity investor). The less common approach is for the construction lender to hold the bonds and take a reduced equity position prior to conversion. Each is discussed below, along with its potential benefits and drawbacks.

Cash-Backed Forward Structure

Under the Cash-Backed Forward structure, an underwriter (usually, an investment bank) sells rated bonds to the public, and the proceeds of the bonds are deposited at closing into a project fund with the bond trustee.

Over time, the construction lender delivers to the trustee advances of its construction loan for deposit into a collateral fund to enable the trustee to disburse bond proceeds to pay qualified costs of the project. Amounts held by the trustee are invested in U.S. treasuries, the earnings from which partly or fully cover the interest cost on the bonds. Once the project is ready to convert, the bonds are tendered by the public holders and delivered to a permanent lender. Because the bonds would never be owned by the construction lender, such party can serve as the equity investor without triggering the 0.125 percent issuer fee restriction.

While this structure involves certain costs—including fees of the underwriter, the underwriter's counsel and the rating agency—the interest on the cash-collateralized bonds typically generates additional eligible basis and, accordingly, increased tax credit equity proceeds, which are typically more than sufficient to offset any such added expenses.

$51,000 Initial Draw Structure

Under the $51,000 Initial Draw structure, a third party—generally, the permanent lender—would purchase $51,000 of the bonds at closing to satisfy the tax rules for bond issuance. The construction lender again makes a construction loan; instead of collateralizing bonds. However, the construction loan proceeds are used to pay qualified project costs directly. Upon conversion, the third-party bondholder buys the remaining bonds, and those proceeds are used to repay the construction lender. For tax purposes, this constitutes a reimbursement allocation, such that the bonds are treated as having been spent on the project costs initially paid for with construction loan proceeds. As in the Cash-Backed Forward structure, the construction lender never holds the bonds, so the issuer's fee is not restricted to 0.125 percent.

Because the tax rules provide for a maximum three-year period (from the date of the original expenditure) during which bonds may be used to reimburse prior costs, this structure can potentially jeopardize the project's ability to meet the 50 percent test: if due to construction delays, the project is not ready to convert to the permanent phase within three years, the remaining bond proceeds (not delivered until conversion) are not allocable to previously incurred costs. Furthermore, the project is not eligible for four percent LIHTCs until the bonds are funded in full at conversion, a timing item that must be taken into account when assessing this structure's financial impact.

Reducing Equity Position

Instead of involving a third-party bond purchaser, the construction lender can buy the bonds but hold a beneficial interest in the tax credit partnership equal to or less than 50 percent prior to conversion (the remainder is held by a syndicator or participant), and as a result, it would not be treated as a related person of the borrower. While this strategy does address the program investment rule concern, it can also adversely affect the economics of a transaction given the adjustment to the equity investor's ownership of the tax credits, so it is typically employed only when other methods are unavailable.

Conclusion

A case-specific analysis is needed to determine whether the approaches discussed above, and others created to address the issues raised by the related party rules are appropriate for a given transaction. Developers considering four percent LIHTC deals should contact their lenders, equity investors and counsel experienced in this area to discuss options for navigating these challenges.

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