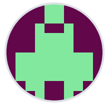
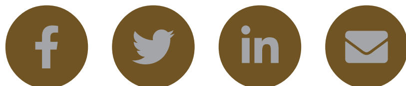
Legally Speaking: Exploring the Tax-Exempt Muni Market in 2023



By Lauren M. Marcus / Issue: February 2023

SHARE:



The nationwide shortage of affordable housing continues to make headlines. For low-income individuals seeking affordable housing, waitlists are hundreds—in some cases, thousands—of names long. For developers looking to meet this demand, the process from groundbreaking to ribbon cutting continues to grow in complexity. As we continue to adjust to a post-COVID world, developers are still faced with supply chain issues, cost overruns and project delays that impact overall budgets. The Federal Reserve Board's seven interest rate hikes since Q1 of 2022 have drastically increased the costs of project financing, making the need for gap financing a regular occurrence around the country. Those factors, coupled with the growing scarcity of private activity bond volume caps, have created an environment that requires a high level of creativity and collaboration to get to closing.

As an attorney in the affordable housing industry, nothing keeps me up at night as much as volume cap scarcity. Multifamily projects utilizing four percent Low Income Housing Tax Credits are required to finance their projects using a private activity bond volume cap. Compared to the ultra-competitive nine percent LIHTC, four percent LIHTCs were once considered a viable backup plan for projects that missed out on nine percent LIHTC funding. When using private activity bonds with the four percent LIHTC, at least 50 percent of the aggregate basis in the project must be financed with bond proceeds. In recent years, more and more states have seen their allocation of volume cap become oversubscribed, making access to four percent LIHTCs and accompanying volume cap increasingly competitive. Across the country, states are grappling with this growing scarcity of resources in many ways. Some states are addressing this issue by limiting volume cap allocations to 51 to 55 percent of a project's aggregate basis. In practice, this means that developers are highly motivated to value engineering and contain cost overruns, as a failure to meet the "50 percent test" will jeopardize the LIHTCs for the entire project. The District of Columbia, which will receive a bond volume cap allocation of around $358,000,000 in 2023, has determined that limiting project allocations to a total of $67 million will allow it to continue to finance the most significant number of affordable housing projects possible as it continues to work towards the robust goal of delivering 12,000 new units of affordable housing by 2025. Once an award of volume cap occurs, a countdown clock begins, with the requirement that the project reach bond closing in a prescribed number of days. Failure to meet this goal, even if due to factors beyond a developer's control, requires the volume cap to revert to the bond issuer. These practices, while somewhat harsh, allow bond issuers to prioritize shovel-ready projects that plan to deliver much-needed units in the shortest amount of time.

If your project is lucky enough to secure volume cap, the next step is getting to the (virtual) closing table while interest rates remain in your favor. Today's interest rate environment looks drastically different compared to the more favorable environment that existed during the last five-plus years. With interest rates on construction and permanent financing hovering near 5.75 percent, many deals that applied for bond financing in 2022 may no longer be viable. Now, more than ever, it's imperative for developers to work with their financing partners to create efficiencies that maximize every dollar.

To mitigate today's interest rate environment, use a financing structure that harnesses the power of the market's inverted yield curve and favorable short-term taxable rates. Using this "cash-backed forward" structure, short-term bonds are sold to a public investor for a prescribed period and then later converted to tax-exempt debt to be purchased by a lender upon project conversion. As a result of the initial bond sale to public holders, the affordable housing project receives bond proceeds that are used to purchase a taxable

investment (often U.S. Treasuries or State and Local Government Securities). In today's market, this taxable investment generates proceeds in an amount greater than the interest cost on tax-exempt bonds, a phenomenon known as "positive arbitrage." This results in zero percent net bond interest cost to the developer—a silver lining despite rising interest rates.

The cash-backed forward offers cost savings in multiple ways. Subject to approval by a developer's accounting firm, many developers utilizing this structure can make an election under Section 266 of the Internal Revenue Code. Such election allows both gross interest costs on the tax-exempt bonds (despite being offset by investment earnings treated as income to the partnership) and the interest on the taxable construction loan to be included in a project's eligible basis, thereby generating additional LIHTC proceeds, which can then be used to reduce the need for additional debt and gap financing or help to reduce a deferred developer fee. This execution should be added to the arsenal of any developer that has traditionally preferred the relatively short timeline of a bank private placement transaction (including the Freddie Mac TEL). In contrast, when utilizing a private placement, only interest related to the construction loan can be factored into eligible basis. So, pivoting to the cash-backed forward, which only builds one to two additional weeks into the closing timeline, could result in six-figure savings to a project.

Finally, the cash-backed forward structure allows affordable housing transactions to avoid having to navigate several bond-related tax considerations, including the "substantial user" and "program investment" issues. In connection with requirements under the Community Reinvestment Act (CRA), an increasing number of banks that offer construction financing are also looking to serve as purchasers of LIHTCs. Because the cash-backed forward structure utilizes a public offering of bonds that will be held by third-party investors, the LIHTC purchaser is permitted to own greater than 50 percent of the borrower entity without giving rise to some of the aforementioned tax implications, including taxability of interest on the bonds to such related-party holder or limitation on the fees a bond issuer can charge. The cash-backed forward structure allows CRA-motivated banks to serve as LIHTC investors and provide construction financing on the same transaction.

In combination with rising interest rates, volume cap constraints continue to apply pressure on those looking to address the nation's affordable housing crisis. Though it is difficult to predict how the affordable housing industry will continue to change over the coming years, one thing remains certain: creativity is key. Developers in this space should collaborate with their counsel and lending partners early and often in order to ensure the best possible execution and outcomes for their affordable housing transactions.

SPONSOR

TCA Digital Edition Access

In order to access Tax Credit Advisor Digital Edition and Articles, please login above. Once you have selected the issue you want to read, click on cover image to access digital edition.

NOTE: May not be compatible with Mozilla Firefox web browser. Google Chrome or Internet Explorer recommended.

GET WEEKLY UPDATES FROM NH&RA

Sign Up For Our Free Newsletter

NATIONAL HOUSING & REHABILITATION ASSOCIATION
1400 16th Street NW, Suite 420
Washington, DC 20036

P: (202) 939-1750
F: (202) 265-4435
E: info@housingonline.com

© 2023 NH&RA ® All rights reserved Privacy Notice