

As 2026 Approaches, State Agencies Prepare for New Bond Rules

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As 2026 comes to a close, states have taken various approaches to maximize new bond volume made possible by the 25 percent test. Courtesy DafneCholet/Flickr

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On January 1, 2026, the amount of tax-exempt Private Activity Bonds (PABs) required to qualify for the four percent Low Income Housing Tax Credit (LIHTC) will be lowered from 50 to 25 percent of a project's aggregate basis (the "25 percent test"). Nationwide, state agencies have been busy gearing up for this rule change, which experts say may have profound effects on affordable multifamily housing production.

Already, states are developing industry-recommended allocation policies and turning to creative auxiliary strategies such as bond recycling to maximize program efficiency.

Advocates hope this change will significantly increase the number of units produced via the LIHTC program, as many states currently issue their maximum allowable PABs (which is known in the industry as being "oversubscribed"). According to some estimates, roughly half of the states in the country are currently oversubscribed.

A New Wave of Bond Capacity

The new 25 percent test will free up the availability of "new money" bond volume cap (i.e., the type of volume cap needed to qualify a project for four percent LIHTCs, as distinct from "recycled" volume cap, discussed below) in oversubscribed states, theoretically allowing more deals to qualify for four percent LIHTCs.

The long-advocated-for lowering of the 50 percent bond test was codified in the One Big Beautiful Bill Act (H.R. 1), signed into law in July of this year. The new reduced threshold will apply to deals placed in service after Jan. 1, 2026.

Some states have already adopted regulations outlining specific requirements around the change, while others are still crafting policies and regulations.

These new policies are critical, as they will dictate how states strike the delicate balance between effectively utilizing available bond cap and continuing to provide projects with viable funding sources. Although the lowering of the PAB threshold is expected to free up more new money volume cap for affordable projects in oversubscribed states, the change also could increase the cost of some projects, since PABs provide lower-cost capital to a project in the form of tax-exempt debt.

If a project receives an allocation of new money bond volume cap below the amount of permanent debt the project can support, developers may need to turn to costlier, taxable sources of funding to fill out a capital stack.

Despite this concern, there is hope that the lowering of the threshold is expected to free up more bond capacity for more affordable housing projects, helping to alleviate the nation's crippling affordable housing crisis.



Mark Shelburne

"This is one of the most important changes our industry has benefited from in the 25 years that I have been doing this work," says Mark Shelburne, a housing policy consultant with Novogradac. "It's right up there with the minimum four percent rate that we got a few years ago that we now kind of take for granted, but we really shouldn't, because it made a dramatic difference in project feasibility. And this is going to make a dramatic difference in program outcomes once we get past the growing pains and get it implemented."

Many factors — from the turbulent availability of soft funding and federal subsidy to unpredictable tax credit pricing — will dictate just how impactful this change will be for affordable housing production. Despite these unknowns, there still is excitement among developers about the lowering of the threshold, especially in states where sufficient volume cap was not previously available for their shovel-ready projects.

"Developers in states where they had shovel-ready projects that couldn't get financed because there wasn't volume cap available are excited now that there should be volume cap in 2026 to fund their developments," says Dirk Wallace, partner at Novogradac. "These are developments that were ready in 2025 and couldn't get funded."



Dirk Wallace

Finding the Sweet Spot

The primary strategy that states have been employing to maximize the new bond threshold's potential impact has been to find a sweet spot between funding as many deals as possible and funding those deals with adequate PAB allocations.

Although past rules called for a minimum of 50 percent of a project's aggregate basis to be allocated, in practice, states typically issued a cushion (anywhere from 2.5 to five percent) to guard against rising project costs between allocation and project completion.

Industry leaders expect that cushion to remain, meaning that the typical allocated minimum will likely be between 27.5 to 30 percent of aggregate basis. Still, this may not be enough, as maximum permanent supportable debt on a project tends to fall in the 35 to 45 percent range, leaving deals with gaps that must be closed with capital that is harder to find or more costly than tax-exempt PAB proceeds.

Thus, some industry leaders have called on state agencies to issue the greater of 30 percent of aggregate basis or the full amount of PABs that could fund a project's maximum permanent supportable debt. Others, like the Affordable Housing Tax Credit Coalition (AHTCC) in their 25 percent test best practices guide, published in September, urge states to cap allocations between 27.5 and 30 percent of aggregate basis. Any additional allocations would be a discretionary allowance.

When Tax Credit Advisor last reported on this in August, only a few states had announced rules governing PAB allocations under the 25 percent test. In the months since, National Housing & Rehabilitation Association (NH&RA) has been tracking new state rules. According to NH&RA, as of Dec. 1, 15 states have adopted final rules, with rules forthcoming from an additional 18 states plus the District of Columbia. Additionally, Maryland announced its final rule on Dec. 3 and Texas announced its final rule on Dec. 4, bringing the total number of states (plus D.C.) with announced or forthcoming 25 percent test policies to 35.

Of those states, seven have adopted and two have drafted policies that set an initial allocation amount at between 27.5 and 30 percent, with discretionary additional allocation to meet a project's maximum permanent supportable debt. Other states, such as Tennessee, Washington and Maryland, allow allocations beyond the minimum threshold, but still set hard caps for maximum allocations allowed.

Some States Lead the Way, While Others Wait and See

In particularly oversubscribed states, allocating agencies have become strikingly creative in their new bond allocation rules in order to maximize the number of units built.

For example, Wallace and Shelburne point to California, which was one of the first states to come out with a 25 percent test policy, addressing new projects for 2026 and projects currently in the pipeline in 2025 that penciled out using the former 50 percent test.

"It's remarkably progressive and comprehensive in what it does," Shelburne says. The regulation lets developers who have deals in the pipeline in 2025 make a "strategic, logical choice" to reduce the amount of bond volume they have for existing, underway projects, giving them other incentives to do so, such as increases in developer fees.

"It creates an ability for the developer to look at their particular circumstances and decide what makes the most sense," Shelburne adds. "It's like they had it ready, almost waiting for the law to pass."

Wallace posits that the preparedness may be derived from the state's particularly urgent position. "Because they're so oversubscribed, California looked to see if there was something they could do in 2025," he says.

For the few remaining states without proposed or adopted policies, developers may need to check in with the allocating agencies to see if any changes are in the works. Kent Neumann, founding member at law firm Tiber Hudson LLC, says that some states may not make any changes to what they already have in place.

"For states that have not yet made any changes to their programs, some will continue to accept applications for as much volume cap as the deal can support in the form of permanent debt and others may end up looking at it on a case-by-case basis," Neumann told TCA over email. "It's important to note that the 25 percent test is just the minimum, but there is no maximum amount that can be allocated to a deal, subject to compliance with the general tax-exempt bond rules and expenditures."

Kent Neumann

For states that usually do not have bond volume cap constraints and are "undersubscribed," this lack of a formal policy may not create as many issues. "If it's Wyoming, for example, a deal can get 60 percent tax-exempt bonds and it doesn't hurt anything because they have so few deals," Shelburne says.

Neumann believes that some issuing agencies may loosen their allocation process if excess volume cap is available toward the end of the year, or constrain it if little volume cap remains at such time.

Despite the evolving patchwork of state-by-state regulation, the number of deals using PABs is expected to increase, since more tax-exempt bonds will be available with the lowering of the threshold. Novogradac's Shelburne says he does not expect states or allocating agencies to significantly increase staff to meet the higher demand for bond deals. Instead, they may take longer to process applications.

"Or they may transfer or reassign people," Shelburne says. "They may do a little bit of hiring."

Wallace says that oversubscribed states (currently over half of the country) will see the largest jump in application volume, and that those are the likeliest agencies to hire additional staff to process new bond applications in 2026.

Embracing Bond Recycling

Even with the reduced allocation threshold, some states (and some developers) still will need to be creative in order to allocate bonds most efficiently. One way that state agencies and/or developers can help get their deals to pencil deals under the new threshold is to fold "recycled" tax-exempt bonds into the capital stack.

Recycled bonds are those that initially were issued — in connection with an allocation of new money volume cap, to an affordable housing project — and are redeemed within four years of such initial issuance. The volume cap associated with such bonds, once they are redeemed, can be recycled into a new multifamily deal to allow for the issuance of new tax-exempt, "recycled" bonds.

Although these recycled bonds do not count toward the minimum bond financing threshold — and therefore, do not generate additional four percent LIHTCs — they can still serve as low-cost capital for projects already receiving a state allocation of new money volume cap that is not sufficient to obtain fully tax-exempt permanent supportable debt.

Timing is critical when using recycled bonds, because the new deal using the recycled bonds must close around the same time as the prior bonds are scheduled for redemption. Additionally, the volume cap being recycled must be allocated to the new project no later than four years after the prior tax-exempt debt was issued, and the recycled bonds must mature no later than 34 years after the original bonds were issued.

The practice of bond recycling is more common in several oversubscribed states. Neumann says just over a handful of states — including California, New York, Washington, Massachusetts, Colorado, and Illinois — have been actively encouraging the use of recycled bonds for several years, with several "way ahead of the curve."

However, a common misconception is that recycled bonds can not be used unless a particular issuer has a "program." To the contrary, Neumann says that his firm Tiber Hudson have been working with developers looking to use recycled bonds, and have already closed many in a states that don't have any official bond recycling program. With a little advance planning, Neumann says they are able to track down previously issued bonds that are coming up for redemption and which can be recycled into a new or upcoming affordable housing transaction.

"If developers, with help from us or a few others, can track down previously issued bonds, from either their own deals or other deals in the state, that are scheduled for redemption around the time they're trying to close their new deal, they don't need for the issuer to have a recycling program," says Neumann. "But it requires doing some homework and working on the timing — and obviously getting some help — to pull it all together."

Neumann still encourages issuers to consider creating a "program" (which typically involves a taxable loan facility that can help extend the life of bonds being redeemed by up to six months) to allow for as many options as possible to maximize this dwindling resource. Based on Neumann's estimates, absent any changes to the current tax rules, the amount of projected bonds available for recycling will decrease by about 85 to 90 percent in approximately three to 3.5 years. This is due to the primary source of tax-exempt bond redemptions scheduled within four years of issuance under the 50 percent test no longer being as prevalent under the 25 percent test.

Lisa Vatske, director of multifamily housing and community facilities for the Washington State Housing Finance Commission, says Washington started a bond cap recycling program in 2018, because it was "burning through our cap and not using it for long-term debt, just the construction phase."

Lisa Vatske

Washington has adopted regulations for the use of recycled debt and the lowering of the bond threshold to 25 percent, and is one of the few states explicitly to fold bond recycling into allocation policy. Under the state's 2026 four percent policy guidance, projects are to receive either 30 percent of aggregate basis plus land, or can be granted a higher percentage — up to 40 percent — if the developer is unable otherwise to obtain recycled bonds. Though this novel policy bakes inherent bond allocation efficiency into the process, Vatske stresses the importance of planning and coordination.

"It's very time sensitive," says Vatske. "Lining up the conversion dates with closing dates can be a little tricky."

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