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Financing Affordable Housing with Qualified 501(c)(3) Bonds in Washington State

Introduction

In an increasing number of states, demand for private activity bonds to finance affordable housing projects is skyrocketing. The maximum amount of private activity bonds that may be issued within a state is governed by Section 146 of the Internal Revenue Code of 1986, as amended (the "Code") and is often referred to as "volume cap" or the "state ceiling." In 2022, the Internal Revenue Service ("IRS") has capped this amount at the greater of $110 per capita or $335,115,000.[1] In Washington State, volume cap allocation "rounds" are often four and five times oversubscribed, and each year many worthy projects fail to secure an allocation of this scarce federal resource. Ironically, this funding logjam is worsening at the same time that local governments in Washington are accessing new funding sources for affordable housing, including the 1/10th of 1% sales and use tax authorized in 2019[2] and made councilmanic in 2020[3] and the lodging tax.[4] These new sources, coupled with the well-established Washington State Housing Trust Fund and many local housing levies, are providing strong levels of available "gap" financing from the public sector. In addition, private sector philanthropic participation has surged, with significant commitments from Microsoft, Amazon and the newly launched Evergreen Impact Housing Fund, managed by The Seattle Foundation. As demand for volume cap increases, the development community has begun to look for alternative ways to finance affordable multifamily housing projects.

There are three basic types of tax-exempt bonds that can be issued to finance affordable multifamily housing projects:

1. Governmental bonds for multifamily projects to be owned by governmental entities;
2. Section 142(d) bonds for multifamily projects to be owned in whole or in part by private developers, usually combined with low-income housing tax credits ("LIHTC"); and
3. Qualified 501(c)(3) bonds for multifamily projects to be owned by 501(c)(3) organizations.

Governmental bonds are typically issued by Washington cities, counties, housing authorities and public development authorities for projects that the bond issuer intends to own and operate.

Section 142(d) bonds, on the other hand, are generally issued for a combination of for-profit, nonprofit and joint nonprofit and for-profit development entities using an allocation of volume cap, as described above. Housing projects financed with volume cap and meeting certain requirements also may qualify for the "four percent" LIHTC program, which has driven demand for this allocation.

Qualified 501(c)(3) Bonds

"Qualified 501(c)(3) bonds" are an alternative method of financing multifamily projects that do not require volume cap and thus are not resource constrained. Under Section 145 of the Code, tax-exempt qualified

[1] IRS Rev. Proc. 2021-45, Sec. 3.20.
[2] HB 1406.
[3] HB 1590.
[4] ESSB 5835, 2011, but redirecting a portion of lodging taxes commencing in 2021.

501(c)(3) bonds may be issued for the benefit of an organization described in Section 501(c)(3) of the Code.[5] The construction and ownership of the multifamily project financed with bond proceeds must further the organization's exempt purposes. Status as a state nonprofit corporation is not sufficient.

Generally, the borrower must have received a determination letter from the IRS stating that it is an exempt organization described in Section 501(c)(3), and the borrower must be prepared to maintain its 501(c)(3) tax-exempt status while the bonds are outstanding. In most cases, the relevant charitable purpose for providing low-income housing is relieving the poor and distressed.

Significantly, multifamily projects financed with 501(c)(3) bonds are not eligible for the LIHTC program and thus would need to find additional funding sources to replace the tax credit equity.

Project Ownership

A 501(c)(3) bond-financed multifamily project must be 100% owned by the borrower, a state or local government or another 501(c)(3) organization. The borrower should expect to own the multifamily project for at least the life of the bonds.

Revenue Procedure 96-32 – Safe Harbor

Most multifamily projects financed with 501(c)(3) bonds will need to meet the requirements of Revenue Procedure 96-32, which establishes a safe harbor for low-income housing organizations to determine whether they meet the charitable requirement of relieving the poor and distressed. This requirement applies across a 501(c)(3) borrower's portfolio, and not only to a multifamily project financed with 501(c)(3) bonds.

The safe harbor is met if, for each project:

1. At least 75% of the units are occupied by families that qualify as low-income (defined under Department of Housing and Urban Development ("HUD") guidelines as family income of no more than 80% of the median family gross income of the area, adjusted for family size), and either (a) at least 20% of the units are occupied by residents that are very low-income (defined under HUD guidelines as family income of no more than 50% of the median family gross income of the area, adjusted for family size), or (b) at least 40% of the units are occupied by residents whose incomes do not exceed 120% of the area's very low-income limit (or as it is more commonly described, 60% of the median family gross income of the area, adjusted for family size);
2. The project is actually occupied by poor and distressed residents; and
3. The housing is affordable to the charitable beneficiaries (for example, under government-imposed rent restrictions).

Bond counsel will require a 501(c)(3) opinion from borrower's counsel regarding the organization's 501(c)(3) status and use of the facility. For this reason, borrower's counsel will be the party responsible for determining whether the safe harbor requirements of Revenue Procedure 96-32 are met.

[5] However, the 501(c)(3) corporation may form a single-member limited liability company (LLC) that is disregarded for federal tax purposes to act as the borrower and owner. State or local government entities may also serve as 501(c)(3) borrowers.

Donnelly Amendment – Bond Requirements

Under Section 145(d)(2) of the Code, also known as the "Donnelly Amendment," qualified 501(c)(3) bonds that are used to provide residential rental housing for family units must meet one of the following requirements:

1. the "first use" of the residential rental property is pursuant to the bond financing (i.e., new construction);
2. the property meets the set-aside requirements of Section 142(d), relating to qualified residential rental projects (i.e., 20% of the units are restricted to households earning up to 50% of area median income ("AMI"), or 40% of the units are restricted to households earning up to 60% of AMI); or
3. the property is substantially rehabilitated in a rehabilitation beginning within a two-year period ending one year after the date of acquisition of the property.[6]

For borrowers acquiring an existing project who will rely on the second prong of the Donnelly Amendment, a regulatory agreement will be recorded against the property, and the 501(c)(3) borrower will need to be in full compliance with the regulatory agreement within 12 months of closing or the bonds will become taxable.[7] While the Revenue Procedure 96-32 safe harbor is more extensive than the Section 142(d) set-aside requirements, and the requirements of the Donnelly Amendment will generally be met for multifamily projects designed to relieve the poor and distressed under the Revenue Procedure, the 12-month hard deadline for meeting the Donnelly Amendment requirements with respect to the bonds frequently proves the more challenging requirement when acquiring an existing property.

Allowable Expenditures

Proceeds of qualified 501(c)(3) bonds are generally expended for capital costs of an approved project. A capital expenditure is a cost of a type that is properly chargeable to a capital account (or would be so chargeable with a proper election) under general federal income tax principles. Costs incurred to acquire, construct, or improve land and buildings, expenditures for furniture, fixtures and equipment, and certain carrying costs are capital expenditures. While Section 142(d) bonds are limited to multifamily projects (including functionally related and subordinate facilities), qualified 501(c)(3) bonds can be issued for a variety of capital projects, as long as they are within the scope of the borrower's exempt purposes. This flexibility may allow a 501(c)(3) borrower to finance a more expansive project, of which housing is one portion, where the rest of the financed facilities also further the borrower's exempt purposes.

Bond proceeds may also be used to finance costs of issuance of the bonds, such as legal fees, issuer fees and underwriter's discount; however, not more than 2% of the bond proceeds can be used to finance issuance costs. In addition, up to 5% of the bond proceeds may be expended on working capital expenditures that are directly related to the bond-financed capital project.

Any payments to related parties or affiliates of the borrower will face additional scrutiny.

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[6] The rehabilitation requirement for 501(c)(3) bonds is the greater of $5,000 or an amount equal to the adjusted basis of the building and its structural components. In contrast, the rehabilitation requirement for qualified multifamily housing bonds under IRC § 142(d) is 15% of the portion of the cost of acquiring the building (and equipment) financed with the net proceeds of issue (and 100% for structures other than buildings).

[7] See IRS Revenue Procedure 2004-39.

Private Business Use

No more than 5% of the qualified 501(c)(3) bond proceeds may be used to pay for private business use, as measured annually, and then averaged over a "Measurement Period" for a tax-exempt bond issue. Private business use is use of 501(c)(3) bond-financed property in a trade or business carried on by a person other than a state or local government entity for governmental purposes or the borrower in furtherance of its exempt purposes ("qualified users"). Private business use can arise from a lease, management contract, or any other arrangement that gives anyone, other than a qualified user, special legal entitlements with respect to the use of the multifamily project. Note that use by the federal government and use by the borrower in a trade or business that is unrelated to the borrower's exempt purposes (as one example, in activities that generate unrelated taxable business income) generally constitute private business use.

Categories of unlimited ("good") use of a 501(c)(3) bond-financed project include:

- Use by the borrower in furtherance of its exempt purposes;
- Use by a state or local government or another 501(c)(3) organization in a manner that furthers the exempt purposes of the borrower;
- Use by the general public under a safe harbor; and
- Use pursuant to a qualified management contract.

Any costs of issuance (which may include underwriter's discount, legal fees, issuer fees, etc.) paid from bond proceeds are treated as private business use.[8]

Working with Private Developers

Private for-profit developers can provide helpful expertise and resources to 501(c)(3) organizations that want to develop or operate affordable multifamily projects; however, for multifamily projects financed with qualified 501(c)(3) bonds, the role of the private developer must be limited. The private developer cannot have an ownership interest in the multifamily project and generally cannot be a partner or member of an ownership LLC or partnership. The multifamily project is not a joint venture between the developer and the 501(c)(3) organization. The 501(c)(3) organization is ultimately responsible for the debt service on the bonds, for the operation of the multifamily project, and for complying with the requirements of the Code.

Any fees paid to a private developer, whether for development, management or other services, must be reasonable and should not exceed fair market value. The payments to the developer and the relationship between the parties cannot result in private inurement or private benefit and, if the developer will have an ongoing management role, must meet the safe harbor requirements for management contracts in IRS Revenue Procedure 2017-13. Additional scrutiny is generally required if the 501(c)(3) organization and the private developer are affiliated or have overlapping ownership or management interests.

[8] Thus, for example, a borrower that finances the maximum allowable 2% of costs of issuance with bond proceeds may use no more than an additional 3% of bond proceeds to pay for other private business use.

The above is an abbreviated summary of the rules applicable to 501(c)(3) bonds. If you have additional questions about using qualified 501(c)(3) bonds to finance your multifamily housing project, please contact any of our housing bond attorneys, listed below.

If you have any questions regarding this information, please contact:

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