



The Low-Income Housing Tax Credit and Tax-Exempt Bonds Issue

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Developers, States Finding Creative Ways to Stretch Private Activity Bond Use for Housing

JIM CAMPBELL, SOMERSET DEVELOPMENT COMPANY LLC

As so many cities and regions in the United States face extreme and increasing shortages of affordable housing, federal, state and local governments have stepped up with a variety of funding programs and other initiatives to incentivize the development of low- and moderate-income housing.

These incentives—including the American Rescue Plan Act (ARPA) in 2021, large-scale bond issuances for affordable housing in California, Oregon and elsewhere, often prompted by voter initiatives (the Portland, Oregon, metropolitan area alone floated a \$600 million bond for affordable housing), and increases in direct state and local appropriations such as in Washington, D.C.—provided the gap funding necessary to make financially feasible many affordable housing developments funded with tax-exempt bonds and 4% low-income housing tax credit (LIHTC) equity.

This substantial infusion of gap funding, along with the 4% “fix” in 2021, has been effective in generating increased supply of affordable housing and in significantly increasing the demand for tax-exempt private activity bonds. In fact, the demand has overwhelmed many states, resulting in a large increase in the number of states that have hit their bond cap. The Internal Revenue Service (IRS) imposes a per-capita limit on the dollar amount of private activity bonds that a state can issue each year. In 2024 that limit was \$125 per capita, with a floor total amount for small states and the District of Columbia of \$378,230,000. States allocate those bond amounts for multifamily housing, single-family housing, industrial and other private development uses.

In the years before the COVID-19 pandemic, around seven or eight states hit their bond cap or multifamily allocation. Today, according to Kent Neumann with

Tiber Hudson, one of the premier bond underwriter and purchasers counsel in the U.S., there are at least 20 states plus Washington, D.C., that are oversubscribed for multifamily tax exempt bonds with an additional 11 states at parity. Many of the oversubscribed states, including D.C., have forward-committed future year bond cap to projects in their pipeline, effectively putting on hold or killing all new affordable housing developments that would be relying on the 4% LIHTCs generated by properties financed with tax-exempt bonds. In the District of Columbia, it is anticipated that tax-exempt bond authority will not be available for new affordable housing developments until 2026 or more likely 2027. And, like D.C., many oversubscribed states have instituted new competitive processes for selecting developments to receive a bond allocation.

So, what are states and developers doing to try address this bond capacity constraint and enable additional affordable housing developments to move forward?

States Emphasizing Multifamily Rental Housing

Some states, such as Pennsylvania, are increasing their allocation to multifamily rental housing. According to Dirk Wallace of Novogradac, Tennessee and other states are exploring increasing their multifamily bond allocation by using recycled bonds for single-family housing programs. They would allocate bond capacity for short-term multifamily bonds and then recycle

those bonds rather than have the bonds redeemed. The recycled bonds could be used for single-family programs or other uses. A recycled bond does not come with tax credits, which single-family programs do not need, and is not counted against the state's bond cap. The result is that states can increase allocations of tax-exempt bond authority for multifamily, while maintaining bond capacity for single-family programs.

Many states are working to make their bond capacity go further within their multifamily allocation. Steps being taken include adjusting underwriting requirements for new projects whereby the amount of tax-exempt bonds awarded to a project is limited to 51% to 53% of eligible aggregate tax-exempt basis. The law requires that the bond amount be at least 50% of eligible aggregate basis. Previously states might approve 55% or more, in order to provide a larger margin of safety. In addition, some states and developers are seeking to combine 9% credits with 4% bond deals, or to supplement the tax-exempt bonds with taxable bonds. These steps reduce the amount of bond authority needed for a project, thus making multifamily bond allocation available for more developments.

Getting Creative With Capacity

Other creative attempts to expand bond capacity, according to Neumann, include using short-term cash-backed bonds with taxable permanent financing. The earnings received by the developer on the bond proceeds can be added to the bond amount for meeting the 50% test. In essence, the amount of the earnings increases the numerator in that calculation, allowing the state to slightly reduce the bond allocation for a development; hence making more bond allocations available for others. Related to this, developers can take a 266 election, which can generate additional tax credit equity by including bond and construction loan interest in eligible tax credit basis. While this adds to the denominator in the 50% test, there is still a net benefit when combined with the inclusion of the earnings on the bond proceeds.

Fortunately, it does not appear that the substantial increase in the supply of 4% LIHTCs has had a significant negative impact on pricing of LIHTC equity, according to Steve Napolitano with Boston Financial Investment

Management. What slight softening there may be in the equity market, particularly among economic investors as opposed to Community Reinvestment Act-motivated investors, is more related to competition from the clean energy tax credits under the Inflation Reduction Act. Investor yields and credit timeframes under the energy credits are much more advantageous to the economically motivated investor than under LIHTCs.

There appear to be some signs that the bulge of developments using 4% bonds and driving the oversubscription of volume cap is beginning to plateau or even lessen. Phil Porter, senior vice president and head of acquisitions for Enterprise Communities, observed that many of the deals moving through state pipelines the past two years were underwritten when interest rates were historically low and/or benefited from the huge expansion of gap subsidy available. As they have worked their way through the bond process, newer deals are facing diminished gap subsidy and higher interest rates, resulting in reduced demand for bonds. Some states, such as Texas, Maryland and California, have experienced givebacks of bond and 9% awards as increased interest rates and construction costs have made once viable projects no longer financially feasible. Demand for bonds in California has slowed as the state has used up its excess soft funds.

Potential Solutions

The shortage of affordable housing opportunities throughout the nation can be chipped away at with expanded multifamily allocations of tax-exempt bond authority within the cap and with more efficient use of that bond authority with the creative approaches discussed above. Greater impact can be made if the Tax Relief for American Families and Workers Act of 2024, which passed the U.S. House of Representatives in February, were to pass the Senate this year, perhaps during a lame-duck sessions after the coming election. This legislation would reduce the 50% test to 30%, effectively increasing tax-exempt bond volume by 40%. It would also increase the state allocations for 9% credits. ◆

Jim Campbell is co-founding principal of Somerset Development Company.

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teresa.garcia@novoco.com

925.949.4232

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christianna.cohen@novoco.com

925.949.4216

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