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Introduction to Tax-Exempt Multifamily Housing Bonds

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I. BACKGROUND.

A. The purpose of this memorandum is to provide a general introduction to tax- exempt multifamily housing bonds issued to provide rental housing. The memorandum discusses the different types of issues and basic legal requirements (Section I.), the identity of the financing participants, the general timetable and the principal documents typically involved in such financings (Sections II., III. and IV.), the principal tax and securities law requirements applicable to such issues (Sections V. and VI.) and the alternative financing structures frequently used in these financings (Section VII).[1] Appendix A provides an analysis of a hypothetical new money private activity bond financing under Section 142(d) of the Code (discussed in V.A.1 below) using 4% housing tax credits. Appendix B sets forth the structure of several alternative hypothetical Section 501(c)(3) bond financings under Section 145 of the Code (discussed in V.A.2 below), where 4% tax credit equity is unavailable.

B. Why use tax-exempt bonds?

1. **Low Interest Rates on Borrowing:** Today, interest rates for long term "AAA" rated fixed-rate housing bonds are generally 5.80% or below; 7-day floating rates for AAA/A-1+ rated tax-exempt bonds are in the neighborhood of 1.0% to 1.5% (not greater than 7.5% for last 10 to 12 years). Debt financing often funds anywhere from 50% to 90% or more of total project costs for multifamily housing projects. Using tax-exempt bonds can often reduce the "all-in" borrowing rate by 1% (i.e., 100 "basis points") or more versus taxable financing rates. In addition, use of tax-exempt financing may permit longer loan amortization periods. This lower borrowing cost can often increase available

[1] By its nature, any memorandum of this nature provides only a general description of the material covered. The description of legal standards and financial structures set forth herein are intended to represent only general guidelines which may or may not apply in certain situations or which may vary depending upon the facts and circumstances of a particular financing. Persons contemplating a tax-exempt multifamily housing bond financing should confer with their attorneys and advisors as to the applicability of these and other requirements to a particular financing.

loan proceeds by 10% to 15% or more versus those available through a taxable loan.

2. **Additional Equity Proceeds from 4% Low Income Housing Tax Credits.** In addition, privately owned projects financed with tax-exempt new money "private activity bonds" having a volume allocation under Section 146 of the Code (discussed in V.A.1 below) are generally eligible to receive "4%" low income housing tax credits on the low or moderate income set-aside units, which can make available substantial additional proceeds (often as much as 25-30% or more of project costs).

C. Three general sets of legal requirements must be satisfied to issue tax-exempt multifamily housing bonds:

1. **State law: Public purpose and other requirements.** In order for interest on any bond to be tax-exempt, the bond must be an "obligation of" a state, county, city, state or local housing finance agency, redevelopment agency, housing authority, industrial or economic development board or other political subdivision or an instrumentality of a state or local government. Almost all states have various laws which authorize such public bodies to issue bonds, the proceeds of which will be used to provide financing for multifamily rental apartment projects. Some state laws require a certain percentage of the units to be occupied by persons of lower income, and a few impose upper limits on rents for such units.[2]

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[2] Revenue Ruling 63-20 Corporation Issues. There may be circumstances where a public body which wants to facilitate the financing of housing through the issuance of tax-exempt bonds is subject to certain restrictions under state law (interest rate limitations, competitive bidding requirements or other restrictions) which make it impractical for the public body to issue its own debt for this purpose. In other circumstances, the public body may be able to issue its debt for this purpose, but due to political or other circumstances, may be reluctant to do so. At the same time, nonprofit corporations organized under the general state nonprofit corporations code may be subject to no such legal restrictions when issuing their debt, and issuing debt through such a controlled nonprofit subsidiary of the public body may be less controversial. In these circumstances, under Revenue Ruling 63-20, the public body may set up a separate nonprofit corporation **issuer**, which can act on the alter ego of the public body to issue tax-exempt debt for the financing of the project.

The Bond issued by such a "Section 63-20 corporation" are treated as issued on behalf of the controlling political subdivision for purposes of Section 103 of the Code. Under the principles of Rev. Ruling 63-20, such nonprofit corporation issues must meet each of the following tests in order to achieve "on behalf of" issuer status:

(1) the corporation must engage in activities which are essentially public in nature;

(2) the corporation must be one which is not organized for profit (except to the extent of retiring indebtedness;

(3) the corporate income must not inure to any private person;

(4) the state or a political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding and it must obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and

(5) the corporation must have been approved by the state or a political subdivision thereof, either of which must also have approved the specific obligations issued by the corporation.

2. **Federal tax law requirements.** Sections 103, 142(d) and 145 of the Internal Revenue Code provide that interest on certain types of bonds for multifamily rental housing will be excluded from gross income for federal income tax purposes if they meet the requirements of the Code provisions applicable to several different types of multifamily housing bonds (discussed under I.D.1 and V. below).

3. **Securities law requirements.** While municipal bonds are generally exempt from registration under federal and state securities laws, the antifraud provisions of both federal and state securities laws impose an obligation on all participants to properly disclose the material facts surrounding offerings of multifamily housing bonds. In addition, Rule 15c2-12 of by the Securities and Exchange Commission ("SEC"), imposes on underwriters of municipal bonds the obligation to assure they have received and reviewed a "complete" preliminary official statement before bidding for, purchasing, offering or selling bonds in connection with the initial offering of most tax-exempt housing bonds. Furthermore, Rule 15c2-12 also requires that underwriters impose on the issuer and/or the owner "continuing disclosure" obligations to provide annual updates of certain financial information included in the original official statement on offerings covered by the Rule and to report certain specified significant events which may affect the security for the Bonds. These requirements are briefly discussed in VI. below.

D. Two basic types of multifamily housing bond issues:

1. **"New Money" Issues.** Proceeds are used to finance the construction or acquisition and, in some cases, rehabilitation of a multifamily rental housing project. Within "new money" issues, there are three categories of transactions, depending on the nature of the **borrower**, each with its own very different set of rules:

   a. **Private Activity Bond issues under Section 142(d)** (discussed in V.A.1 below), where bond proceeds are loaned to a **profit motivated owner** to build or acquire and rehabilitate qualified residential housing facilities.

   b. **"Section 501(c)(3)" Bond issues under Section 145 of the Code** (discussed in V.A.2 below), where bond proceeds are loaned to a **charitable organization** having a designation under Section 501(c)(3) of the Code to build or acquire facilities for its mission of

      (i) providing **affordable housing** for persons of lower income,

      (ii) providing appropriate housing for the **elderly or handicapped**,

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Because of these requirements, Revenue Ruling 63-20 issuers are most often used on "essential function" or "governmental purpose" financings described I V.A.3 below, where the **owner of the project** will also be a public body or controlled instrumentality thereof.

(iii) providing **student housing** to assist a public or private nonprofit college or university in its educational mission; or

(iv) assisting a community by "relieving the burdens of government," most often in the context of certain **mobile home park** financings.

c. **"Essential Function" or "Governmental Purpose" Bond issues under Section 103 of the Code** (discussed in V.A.3 below), where bond proceeds are used by a state, city, county, redevelopment agency, housing authority or other public governmental entity, or by an instrumentality of such a **public governmental body**, to provide **facilities to be owned by the public body** in the pursuit of its public functions.

2. **"Refunding" Issues.** Proceeds are used to pay off bonds previously issued to finance a multifamily rental housing project, generally to achieve significant savings in interest rates. Cannot be issued more than 90 days before old bonds are retired (unless the project is owned by a Section 501(c)(3) corporation or a public body, as discussed in V.B.5 below).

II. FINANCING TEAM. The financing team in a tax-exempt multifamily housing bond financing will consist of the players described below. These should be identified, with the help of the underwriter, as early as possible in the financing.

A. **The Issuer.** The Issuer is a key participant. Only public entities of the type listed in I.C.1 above are authorized under state and federal law to issue tax-exempt bonds for multifamily rental housing projects. It is vital to identify the particular issuer or issuers who have authority to issue the bonds for the type of project, given its location. One must establish the requirements of state law applicable to that issuer or those issuers and their policies for issuing the type of bonds in question. Issuers who are involved in these types of bond financings typically have a number of common goals. These include providing rental housing where supplies are tight, and providing rental housing for persons of moderate, low or very low income. Issuers often must earn income from u-front fees or ongoing fees to maintain their existence and/or their multifamily housing activities. If the financing is a new money private activity bond financing under Section 142(d) (discussed under V.A.1 below), the availability of private activity bond volume allocation for that issuer is critical. Issuers generally serve as "conduits" in these financings -- that is, they generally don't put their own credit behind the bonds (unless the issuer owns the project). State housing finance agencies are sometimes an exception to this rule.

B. **Bond Counsel.** Bond Counsel passes on the validity of the Bonds under state law and the tax-exempt status of the Bonds under federal and state law and drafts the main financing documents such as the Indenture, Loan Agreement and Regulatory Agreement, and the closing papers.

C. **Issuer's Counsel/Consultant.** There may also be a separate Issuer's Counsel and/or an Issuer's Financial Consultant to advise the issuer on various matters relating to the financing.

D. **Underwriter.** Structures the bond issue, assists the project owner (the "Owner") in assessing availability of private activity bond volume, if applicable; choosing optimal financing structure, including credit enhancement, if any; coordinates financing participants; obtains rating; sells bonds.

E. **Underwriter's Counsel.** Assists Underwriter in above matters; drafts Official Statement to be used in sale of Bonds and prepares Bond Purchase Agreement, Remarketing Agreement (if any), and Continuing Disclosure Agreement (if any); reviews and comments on Bond documents and closing papers for Underwriter; clears sale of bonds under various state securities or "Blue Sky" laws.

F. **Owner.** Develops, builds, owns and often manages the project. In some cases, may be a Section 501(c)(3) corporation, the Issuer itself or another public body. (See V.A.2 and V.A.3 below.)

G. **Owner's Counsel.** Passes on legal matters for the Owner. Should be experienced in real estate matters and in Bond financings.

H. **Owner's Financial Consultant.** Some owners may engage their own financial consultant to advise them on matters relating to interest rates, alternative financial structures, issuer requirements, credit enhancements and other aspects of the tax-exempt financing.

I. **Credit Enhancer.** Most multifamily bond issues are secured by some form of credit enhancement which will assure repayment of Bonds if project revenues are insufficient. This is what gives most Bond issues their AA or AAA rating, which results in the lowest interest rates and often achieves lowest borrowing costs for the Owner. Typical Credit Enhancers include FHA, Ginnie Mae, Fannie Mae, Freddie Mac, Bond insurers (e.g., MBIA, FSA, Ambac, American Capital Access); larger domestic and foreign banks (through letters of credit), and others. The Credit Enhancer, like the Issuer, is a key participant. Its requirements, together with those of the Issuer, will generally determine the basic terms of the financing and the form and content of most of the financing documents.

J. **Credit Enhancer's Counsel.** Drafts credit enhancement documents and passes on legal matters for Credit Enhancer. Reviews and comments on Bond documents and closing papers for Credit Enhancer.

K. **Construction Phase Credit Enhancer and Counsel.** Some highly competitive long-term credit enhancers (such as Fannie Mae, Freddie Mac and most bond insurers) generally will not accept the risk of default during construction or rehabilitation and rent-up. (Most banks and FHA **will** accept this risk.) Where such a credit enhancer is chosen, a construction phase credit enhancer (most often the Owner's bank) will provide a credit facility (often a letter of credit or cash deposit) which the top tier credit enhancer for the bonds can draw upon if a default occurs before stabilized occupancy (e.g., 90 days' operation at 1.25% or greater debt service coverage) and other permanent loan "conversion" requirements are met. Such construction phase credit enhancers, when present, are almost always represented by outside counsel and are also key players in the financing.

L. **Rating Agency.** Rates the Bonds. Most credit-enhanced bonds are rated "AAA" or "AA" (Standard & Poor's) or "Aaa" or "Aa" (Moody's) (the top 2 categories, which produce lowest interest rates for an issue of a given maturity).

M. **Trustee and Trustee's Counsel.** Administers trust indenture; makes payments to Bondholders. Where the Trustee will be represented by counsel, it is important to involve them at an early stage. Also serves as dissemination agent under the Continuing Disclosure Agreement on most fixed-rate financings.

III. FINANCING TIMETABLE.

A. General.

As a general rule, one should allow as much as four to six months from the very outset to the closing of a new money tax-exempt multifamily bond issue, although many bond issues, especially refundings using the same credit enhancement, may be completed in less time. A credit enhancer will usually require a **minimum** of 45 to 60 days to provide a commitment for credit enhancement, and in many instances this process alone may take 90 to 120 days or more. While the Issuer should pass an "official action" or "reimbursement" resolution on a "new money" issue early in the financing process (as is discussed in V.A.1.h below), a credit enhancement commitment or other substantial evidence of credit enhancement will generally be required before a private activity bond volume allocation for a private activity "new money" issue will be awarded (or may even applied for) in most jurisdictions (see V.A.1.d). Moreover, since many financing participants are often compensated on a contingent fee basis in tax-exempt bond financings, and since the form of credit enhancement will have a major impact on the financing structure and documentation, most financing teams will not commence significant documentation work on a bond issue until reasonable evidence is available that credit enhancement is or soon will be made available. Generally, the Underwriters will not price the Bond issue until the credit enhancement commitment has been delivered and the Issuer has passed a Bond resolution approving the financing, although the pricing normally occurs within several days to a week after these steps have been taken. Generally, the transaction is closed within 7 to 15 days after pricing.

The chart below gives a sample timetable for a tax-exempt multifamily housing bond issue. Of course, depending upon the particular type of issue (as further discussed below) and depending on various circumstances surrounding the particular financing, the steps required to complete a transaction and the amount of time required to accomplish each step can vary significantly from financing to financing.

<u>Week</u>	
1	Owner selects Underwriter and works with Underwriter to identify appropriate Issuer, availability of private activity bond volume allocation, if applicable, optimal financing structure and possible forms of credit enhancement, if applicable, and other aspects of the basic structure and terms of the financing and the identity of various other financing participants.
2-6	Owner and Underwriter finalize proposed financing structure and team; Application filed with credit enhancer, which begins loan underwriting process; "official action" or "reimbursement" resolution passed by Issuer (for "new money" private activity Bond

	issue); Owner applies for private activity Bond volume allocation (on private activity Section 142(d) new money financing).
8[3]	Obtain private activity Bond volume allocation -- key event on new money private activity deal. Underwriter prepares and circulates initial financing participants list, rough financing timetable and basic term sheet. "All hands" organization meeting or conference call to review financing structure, discuss major substantive issues raised by the financing and finalize financing participants list and timetable.
9-10	Bond Counsel circulates draft of Bond Documents (e.g., Indenture, Loan or Financing Agreement, Regulatory Agreement); Credit Enhancer's Counsel and Construction Phase Credit Enhancer's Counsel (if any) circulate(s) initial draft of credit enhancement commitment(s) and documents; Underwriter's Counsel prepares and distributes initial drafts of Preliminary Official Statement, Bond Purchase Agreement, Rule 15c2-12 Continuing Disclosure Agreement, if any (see VI.D. below) and Remarketing Agreement, if any (variable rate transactions).
11-12	"All Hands" meeting or conference call to obtain comments on initial draft documents; draft persons prepare revised drafts reflecting first round comments; Underwriter submits documentation and cash flows to Rating Agency. Notice published (minimum 14 days) for TEFRA hearing by the Issuer (see V.A.1.i below).
13-14	Initial comments received from Rating Agency; documents in "substantially final form" submitted to Issuer.
14-15	TEFRA hearing held; Issuer passes Bond Resolution and approves TEFRA hearing; credit enhancement commitment (both permanent and, if applicable, construction) received; rating received from Rating Agency; Preliminary Official Statement finalized, "deemed final" by the Issuer and/or Owner for SEC Rule 15c2-12 purposes (see VI.C. below) and mailed.
15-16	Underwriter prices and sells Bonds; Bond Purchase Agreement executed; parties commence preparation of final documents including pricing information; Bond Counsel circulates Closing Papers.
16-17	Conference call to discuss comments on final Closing Papers and Documents prior to Closing; final Official Statement printed and mailed.
17-18	Transaction preclosed one day and closed and funded on the following day or the second following day.

[3] This activity could commence later on new money private activity issues, depending upon the lag between the private activity bond volume application deadline and the award. For example, in California this gap may be roughly three months, which would imply that receipt of a private activity bond volume allocation might occur around week 16, with subsequent weeks pushed back accordingly. This would imply a total financing schedule of about 6 months, as compared to the roughly 4-month schedule reflected above.

IV. PRINCIPAL DOCUMENTS USED IN TAX-EXEMPT MULTIFAMILY HOUSING BOND FINANCINGS

The following is a summary of the principal documents which are utilized in most tax-exempt multifamily housing bond financings. These documents will, of course, vary greatly depending upon a number of factors. These include whether the bond issue is credit-enhanced or noncredit-enhanced, whether it is fixed or variable rate, whether the financing structure involves a loan of bond proceeds to the borrower (most typical structure), or a lease, installment sale, or other arrangement, and other factors.

A. **Trust Indenture.** The basic terms of the Bonds are typically set forth in a Trust Indenture between the Issuer and a commercial bank serving as Bond Trustee,

1. Sets forth the basic financial terms of the Bonds, including their maturities, interest rates (or methodology for determining interest rates, in the case of a variable rate issue), redemption provisions, mandatory tender provisions, if any (on certain variable rate transactions), and other such basic financial terms.

2. Also sets forth the basic security for the Bonds and pledges to the Bondholders.

3. Sets forth various funds and accounts, specifies how Bond proceeds and other monies will initially be deposited into those funds and accounts and provides a "waterfall of funds" directing how revenues coming into the Indenture will be disbursed to pay debt service on the Bonds, to cover other administrative expenses of the issue, and for other purposes.

4. Sets forth certain events of default and remedies and provisions governing the role of the Trustee, supplemental indentures and certain other matters.

5. Typically prepared by Bond Counsel.

B. **Loan or Financing Agreement.**

1. Agreement between Issuer and Borrower and possibly the Trustee or another Lender, typically prepared by Bond Counsel, pursuant to which Bond proceeds are loaned to the Borrower to provide for the construction or acquisition and rehabilitation of the Project.

2. Sets forth obligations of the Borrower to repay the loan of Bond proceeds to the Lender or to the Trustee on behalf of the Issuer and other basic terms of the loan.

3. Will often contain various other representations, warranties and covenants by the Borrower which are generally designed to ensure the property is operated and maintained in such a manner as to enable the Borrower to make the payments due on the loan and to preserve the tax-exempt status of the Bonds.

   Contains specified events of defaults and remedies and embodies various other provisions relating to the Project.

4. Typically prepared by Bond Counsel.

C. **Mortgage or Deed of Trust.**

1. Document under which Borrower grants a real estate security interest in the Project and related fixtures to the Bond Trustee and typically to any Credit-Enhancer of the Bonds to secure obligation of the Borrower to repay the loan of Bond proceeds under the Loan Agreement.

2. A Security Agreement may be embodied in the Deed of Trust or separately prepared to create a security interest in equipment relating to the Project in personal property in favor of the Trustee and/or Credit-Enhancer.

3. Will contain typical real estate security provisions, and will vary from state-to-state.

4. May be prepared by Bond Counsel, Lender's Counsel or Borrower's Counsel or by Counsel to the Credit-Enhancer.

D. **Regulatory Agreement or Declaration of Restrictive Covenants.**

1. Agreement between Borrower and Issuer and/or Trustee in which the Borrower agrees to comply with the provisions of Section 142(d) of the Internal Revenue Code (in the case of private activity bonds for profit-motivated sponsors), Section 145 of the Code (in the case of certain financings for charitable organizations under Section 501(c)(3) of the Code) and/or other provisions of the Code and regulations applicable to tax-exempt multifamily housing bonds (see V. below).

2. Typically executed and delivered at closing and recorded at closing or at least before Bond proceeds are disbursed, and will "run with the land" on the property.

3. Typically prepared by Bond Counsel.

E. **Credit Enhancement Facility.**

1. Provides assurance of timely payment of debt service on Bonds, or senior most Series of the Bonds, in the event net cash flow from the Project is insufficient.

2. May consist of a Credit Enhancement Agreement (e.g., a Fannie Mae for Freddie Mac credit-enhanced financing), a letter of credit (in the case of bank credit enhanced financing), a Bond Insurance Policy (MBIA, Ambac, FSA and other bond insurers), a Mortgage Insurance Policy (in FHA-insured financings), or Government Guaranteed Pass-Through Security (Ginnie Mae-backed financings), or similar device.

3. Prepared by Credit Enhancer or its Counsel.

F. **Reimbursement Agreement.**

1. Agreement between the Borrower and Credit Enhancement Provider under which Borrower agrees to reimburse credit enhancement provider for any draws on the Credit Facility.

2. Contains numerous and elaborate default and remedial provisions, and typically gives the Credit Enhancer tremendous control, particularly following any default in the Borrower's obligations on the transaction.

3. Secured by shared interest in Mortgage or Deed of Trust, or by separate Deed of Trust on Project.

4. Typically prepared by Counsel to the Credit Enhancer.

G. **Intercreditor Agreement.**

1. Governs the respective rights of the Trustee on behalf of the Issuer, on the one hand, and the Credit Enhancer on the other, to real estate security for the Bonds and to direct control of proceedings in the event the Borrower defaults on any of its obligations on the transaction.

2. Typically gives principal control and enforcement rights to the Credit Enhancer following a loan default, so long as the Credit Enhancer is performing its obligations under the credit enhancement facility, and otherwise to the Trustee on behalf of the Issuer and the Bondholders.

3. Typically prepared by Bond Counsel (since the Issuer is typically a party).

H. **Official Statement.**

1. Disclosure document similar to a stock prospectus used by the Underwriter to sell the Bonds, signed by Issuer and/or Borrower.

2. Generally contains a description of the terms of the Bond issue, the Credit Enhancement (if any) and the Credit Enhancer, the Issuer of the Bonds, the Borrower and other private participants and the Project, and the expected sources and uses of Bonds for the financing.

3. Typically contains summaries of the principal legal documents (Indenture, Loan or Financing Agreement, Regulatory Agreement and possibly other principal financing documents) description of tax-exemption on the Bonds.

4. Form of the Bond Counsel Opinion relating to the validity and tax-exempt status of the Bonds as well as the form of the Continuing Disclosure Agreement of the Borrower (on fixed-rate financings) may be attached as Exhibits.

5. Generally prepared by Underwriter's Counsel on multi-family housing bond transactions.

I. **Bond Purchase Agreement.**

1. Agreement executed and delivered by the Issuer, the Underwriter and the Borrower, at the time the Bonds are sold to the public, under which the Issuer will agree to issue the Bonds on a day specified for closing, typically several weeks (on a fixed-rate deal) to several days (on a variable rate deal) following the

pricing of the Bonds and the execution and delivery of the Bond Purchase Agreement.

2. Underwriter agrees to purchase the Bonds upon satisfaction of conditions set forth therein and the Borrower agrees to borrow the Bond proceeds pursuant to the Bond documents.

3. Specifies the terms of the purchase of Bonds, including the agreed underwriting fee or discount, sets forth specific documents, certificates and opinions which must be delivered (often attaching forms of the certificates and opinions as exhibits or specifying their content in the body of the document) in order for the Underwriter to be obligated to close and accept delivery of the Bonds.

4. May contain indemnification provisions in favor of the Issuer and/or the Underwriter, and may set forth the other fees and expenses of the financing and the party or parties responsible for paying them.

5. Typically prepared by Underwriter's Counsel.

J. **Continuing Disclosure Agreement.**

1. Required in most fixed-rate financings under SEC Rule 15c2-12.

2. Agreement in which Borrower agrees to provide to the Trustee, acting in the capacity of a "Dissemination Agent" information regarding certain material events which may occur during the life of the financing, copies of its annual financial statements, and certain other continuing disclosure information required by Rule 16c2-12.

3. Typically prepared by Underwriter's Counsel and sometimes by Bond Counsel.

K. **Remarketing Agreement.**

1. Used in variable rate bond issues or in fixed rate issues, where the interest rate on the Bonds is not fixed to the final maturity at Bond closing.

2. Agreement between the Borrower and the Underwriter, serving in the capacity of Remarketing Agent, under which the Remarketing Agent agrees to remarket any Bonds tendered when the interest rate on the Bonds is reset to a new rate.

3. Specifies the procedure for the remarketing of Bonds, the method of payment and the ongoing fees of the Remarketing Agent.

4. Typically prepared by Underwriter's Counsel.

L. **Other Agreements, Certificates and Opinions.** There are numerous other agreements which may be involved in many bond financings. In the event more than one series of Bonds are involved, there may be separate versions of each of some of the above agreements (e.g., Indenture, Loan Agreement) with respect to each series of Bonds and there may be various subordination agreements specifying the respective rights between or among the various series of Bonds or vis-à-vis other non-bond debt. Assuming the structure involves a separate construction credit facility, there may be an entire separate set of documents relating to the construction loan aspect of the financing. The foregoing is by no means an exhaustive list of the documents, opinions and certificates delivered in a typical tax-exempt multifamily housing bond transaction. A typical closing transcript on such a financing will include at least 40 or 50 and sometimes over 100 items and may consume two or three volumes of materials in especially complex financings.

V. FEDERAL TAX LAW REQUIREMENTS APPLICABLE TO MULTIFAMILY HOUSING BOND FINANCINGS.

General. As noted above, the requirements for a "new money" multifamily housing bond issue are substantially different from a "refunding" issue under federal tax laws.

A. **New Money Financings --** three different types: (i)"private activity bond financing" under Section 142(d), where the project is owned by a partnership or other profit motivated sponsor, (ii)"Section 501(c)(3)" financings under Section 145, where the project is owned by a nonprofit corporation which has received a Section 501(c)(3) determination letter from the IRS, and (iii)"essential function bond" or "governmental purpose" financings, where the project is owned by public body (such as the city, county or housing authority).

1. **Private Activity Bond Financings under Section 142(d).** Section 142(d) of the Code permits the issuance of tax-exempt bonds to finance the construction or acquisition and rehabilitation of multifamily housing projects to be owned by **profit motivated sponsors** if a number of requirements are met.

a. The project must be a residential **rental** housing facility. Tenants must rent, not own, the units. Condos are not permitted; they must be financed under a separate section of the Code. The facilities must also consist of **complete living units**, each containing a separate bathroom and basic kitchen facilities (including at least a refrigerator and some type of oven) (e.g., single room occupancy or "SRO" facilities generally don't qualify). The units may not be rented on a transient basis (e.g., no hotels, rooming houses, etc.). The facility must also serve and be available on a regular basis to the **general public**, or as part of a facility so used, as contrasted with facilities constructed for the exclusive use of a limited number of non-exempt persons in their trade or business (e.g., exclusive company housing). "Functionality rated and subordinate facilities" (e.g., club houses, pools, playgrounds, laundry rooms, parking areas, maintenance and management units, etc.) may also be financed from tax-exempt bond proceeds. A residential rental housing facility may be located in a structure with other uses (e.g., retail, office, parking) – costs must be allocated using the various facilities.

b. **"Low Income Occupancy"** or so-called **"Targeting"** requirements.

(1) **20/50 or 40/60 test.** Requires an election by the owner at time of issuance of the bonds to either (a) set aside 20% of the units for persons whose income does not exceed 50% of area median income or (b) set aside 40% of the units for persons whose income does not exceed 60% of area median income.

(2) **Adjustment for family size.** The above percentages of area median income (50% or 60%) are for a family of four. The applicable percentage (depending on the test chosen) is adjusted up or down by roughly five percentage points on 20/50 test or roughly six percentage points on the 40/60 test for family sizes above or below four. For example, under the 20/50 test, the applicable income limit on a set-aside unit occupied by one person is roughly 35% of area median. This is a much tougher targeting requirement than under pre-1986 law (Section 103(b)(4)(A) of the 1954 Code), which required that only 20 percent of the units be set aside for persons whose income did not exceed **80%** of area median, with **no** adjustment for family size.

(3) Note that the foregoing test is a **limit on the income** of the occupant(s) of the set-aside unit; **not a limit on the rent** which can be charged on those units. Section 142(d) of the Code does not limit the rent per unit on set-aside units, though Section 42 relating to 4% low income housing tax credits and some state laws impose such limits on some or all of the set-aside units (e.g., not more than 30% of 60% of area median income) and some issuers impose such limits on set-aside unit rents as a matter of policy.

(4) **Annual Recertification.** If income of a tenant in a set-aside unit rises above 140% of the applicable income level on a targeted unit, the next unit of equal or smaller size must be held available for a qualifying tenant.

c. **Qualified Project Period.** The above **rental** test is required to be met so long as any Bonds remain outstanding. Low or moderate income **occupancy** or targeting tests applies during the "Qualified Project Period." The Qualified Project Period

(1) **begins** at 10% occupancy; and

(2) **ends** on the **latter** of (i) 15 years after 50% occupancy, (ii) first day when no bonds remain outstanding or (iii) date on which any project-based Section 8 subsidy ends.

d. **Volume Allocation.** May be the killer requirement. As discussed further below, in legislation passed in December, 2000, Congress increased the private activity bond volume allocation for the first time since 1986. For the 15 years prior to enactment of that legislation, the Code imposed a private activity bond volume ceiling for each state equal to the greater of $150 million or $50 per capita. Thus, in a state of roughly 34 million population, like California, the volume cap limit was approximately $1.7 billion. "Private activity bonds" cover a wide range of different types of financings where tax-exempt bonds are issued for profit motivated owners. This includes pollution control bonds, privately owned water and power supplies, single family mortgage revenue bonds, student loan bonds, multifamily housing revenue bonds, industrial development bonds and others. States allocate the volume directly and/or through local agencies to different types of uses and projects. The Owner usually is required to pay a fee (in California, for example, equal to 1%) to get an allocation, and one generally has a specified period of time (generally from 90 to 120 days) to use the volume allocation (i.e., to close the bond issue) or both the fee and the allocation are lost and the allocation goes back to the original pool. (Most of this fee is generally refunded or applied to other closing costs if the transaction is closed.) It is important that Owners who want to use tax-exempt financing work with an Underwriter early to obtain Issuer cooperation and line up credit enhancement **before** an allocation is requested in order to assure that the financing transaction can be completed before the volume allocation expires.

In the last five years, due to the passage of H.R. 4577 discussed below, private activity bond volume has become increasingly available for multifamily housing bonds, even in high growth states such as California, Arizona, Texas and Florida. Over the past eight years, almost all states have gradually and substantially increased their allocation to multifamily housing bonds. In **1995,** only **7%** of the country's total private activity bond volume was allocated to multifamily housing. In **2002,** approximately $6.5 billion or approximately **30%** of the country's total private activity bond volume was allocated to multifamily.

The different states vary widely in the percentage of private activity bond volume allocated to multifamily housing. In 2002, only 6 states did not allocate any private activity bond volume to multifamily housing. (This was down from 25 states which made no allocation to multifamily in 1998.) On the other hand, other jurisdictions allocated as much as 50% to multifamily, with 20% to 35% being the norm for states which allocated some bond volume to multifamily.

Some jurisdictions, such as California, Georgia, Florida and Texas allocate a very substantial percentage of their tax-exempt private activity bond volume in the multifamily housing. In 2002 California allocated $1.4 billion or 56% of its total allocation to multifamily. In 2002, Georgia allocated $452 million or 72% of its $629 million of private activity bond volume to multifamily. Florida allocated $404 million or 33% of its $1.3 billion 2002 allocation to multifamily. Texas allocated $404 million or 25% of its $1.6 billion of private activity bond volume to multifamily in 2002.

The passage of the Consolidated Appropriations Act of 2000 (H.R. 4577) in December, 2000 finally provided significant relief from the almost 40% erosion in the real value of private activity bond volume wrought by inflation since 1986. Under that legislation, the private activity bond cap in each state rose by a total of 50% in 2001 and 2002. The cap rose to $75.00 per capita, subject to a minimum of $225.0 million, in 2002. The cap has also been indexed for inflation after 2002. Many states have already allocated at least a pro rata share of this increase to multifamily. For example, California has increased its multifamily allocation from $900 million in 2000 to $1.434 billion in 2003.

Notwithstanding these increases, due to the tremendous demand for tax-exempt bonds and 4% low income housing tax credits in most jurisdictions, it is imperative for a developer proposing to use tax-exempt private activity bonds to work with its investment banker and the appropriate issuer at the very outset of the transaction to determine the likelihood of obtaining a private activity bond volume allocation for its project and to discuss the procedures and timing of the allocation process.

e. **15% Rehab Requirement on Acquisition Financings.** Requires that one spend an amount equal to 15% of the portion of the depreciable cost of the building and fixtures financed from bond proceeds for the purpose of rehabilitation of the Project within 24 months following the issuance of the Bonds. For example, assume a project is being acquired for $10.0 million and $2.0 million represents the value of the land, with $8.0 million being allocated to the building and fixtures. Assume $6.0 million of Bonds are issued, with the remainder of the financing coming from equity. If $4.8 million of bond proceeds are used for the building and fixtures and $1.2 million are allocated to land, an amount equal to 15% of $4.8 million, or $720,000 would be required to be spent for rehabilitation of the project with 24 months. Subject to the rules described in subparagraph h. below, the source of these rehabilitation funds may be Bond proceeds, equity funds or other moneys. The 15% rehab requirement often limits the use of tax-exempt bonds for the acquisition of recently built projects, which need little renovation.

f. **Prohibition of Tax-Exempt Refinancings for Existing Owners.** Note that the Code prohibits the use of tax-exempt bonds to provide refinancing of debt or equity for an existing private owner where there is no change of ownership for tax purposes (i.e., at least a 50% change in ownership), except in the case of certain tax-exempt refundings of prior tax-exempt debt described under V.B. below.

g. **Alternative Minimum Tax.** New money private activity bonds are subject to the alternative minimum tax or "AMT." This raises the interest rates on the bonds 15 to 25 basis points or so.

h. **Official Action; "Good Costs/Bad Costs" Test; 2% Costs of Issuance Limitation.** Under the so-called "good costs/bad costs" test, at least 95% of bond proceeds (net of allowed debt service reserve funds) must be used to pay or reimburse "good costs" of the project which were paid or incurred no earlier than 60 days (or, under certain circumstances, 12 or 18 months) before the issuer took "official action" by passing a resolution or ordinance evidencing its intent to issue bonds to provide financing for the facility. "Good costs" are costs (i) which represent land or costs which the Owner may or is required to treat as depreciable for federal income tax purposes (i.e., capital or "brick and sticks" types of items (including construction period interest); working capital, post-construction period interest and various other "soft" costs are excluded) and (ii) which are paid or incurred **after** the date not earlier than 60 days before the "official action" or "inducement" resolution. No more than 5% of net Bond proceeds can be used to fund "bad costs" (i.e., costs other than good costs). Moreover, on private activity bond financings (including Section 501(c)(3) financings, discussed below) no more than 2% of Bond proceeds can be used to pay costs of issuance of the Bonds (which include underwriting discount, attorneys fees relating to the issuance of the bonds, rating agency charges, initial trustee, issuer and other issuance fees, but excluding credit enhancement fees). "Bad costs" in excess of 5% and costs of issuance in excess of 2% may be paid from equity, taxable bond proceeds (see VII.B. below) or other sources other than tax-exempt Bond proceeds.

The foregoing requirements make it imperative that Owners obtain passage of an "official action" or "reimbursement" resolution early in the planning stages of a project to be financed with tax-exempt bonds. Failure to do so can result in a requirement that a substantial portion of project costs be financed from moneys other than tax-exempt bond proceeds.

Note that the cost of acquiring the project site (in a new construction financing) or the site and building (in an acquisition/rehab financing) may be deemed to have been "incurred" within the meaning of the above rules when a binding contract to acquire is entered into, but an Owner generally will not be deemed to have crossed this threshold if the Owner merely has an option to acquire or the purchase contract is subject to substantial closing contingencies.

i. **Public approval or "TEFRA" requirement.** The Code now requires a public approval for all "new money" private activity bonds (including Section 501(c)(3) bonds discussed in V.A.2 below) and, if the bond maturity is extended, on "refunding" private activity issues (discussed in V.B. below). This requirement was added to the Code to permit citizens living in areas where bond financed projects are located to have input into the Issuer's decision to provide tax-exempt bond financing before final action on the issue is taken. The process generally requires that the issue be approved by an **elected representative** (e.g., city council, mayor) of the governmental unit which issued the bond and (if different) a governmental unit in which the project is located **after** a public hearing following reasonable (generally 14 days') public notice. While in most cases these requirements are easily satisfied, they may present a major obstacle to a project which faces substantial community opposition in the area in which the project is located or is proposed to be built. Financing team members should determine if any such opposition is likely at the very outset of a financing before substantial efforts are expended on the tax-exempt bond financing.

2. **Section 501(c)(3) Financings.**

a. **General Requirements.** Within the context of residential rental housing, Section 145 of the Code provides an exemption from federal income taxation of interest paid on bonds issued to finance residential rental housing projects owned by charitable organizations which have received a determination letter under Section 501(c)(3) of the Code for one of four charitable purposes: (i) "providing relief for the poor and distressed" through the provision of **affordable housing for persons of lower income,** (ii) providing appropriate housing to meet the needs of the **elderly and/or the handicapped,** (iii) providing **student housing** to assist a public or private nonprofit college or university having a charitable determination under Section 501(c)(3) in fulfilling its educational mission, or (iv) "lessening the burden of government," often seen in the context of certain **mobile home park** financings. Each of these charitable purposes is discussed in further detail in V.A.2.c.f. below.

b. **"Good News" -- "Bad News": Requirements Under Section 145 Less Onerous than Section 142(d) – But Low Income Housing Tax Credits Unavailable. "Good News":** Assuming the participants have identified a Section 501(c)(3) borrower for which a project is within its charitable purpose, as further described below, the requirements for a Section 501(c)(3) financing under

Section 145 of the Code are less onerous in certain important respects than those applicable to private activity bond financings under Section 142(d).

(1) **No private activity bond volume allocation is needed.**

(2) **The 15% rehab requirement is not applicable.**

(3) **No separate targeting requirement,** if new construction or substantial rehabilitation, **although** Section 142(d) targeting is required under the **"Donnelly"** provisions of the Code if bond proceeds are being used to **acquire a project** without substantial rehabilitation, as further discussed below.

(4) **Interest on Bonds not subject to AMT.**

"Bad News": Section 42 of the Code only provides the 4% low income housing credit for projects financed with the proceeds of tax-exempt bonds which have received a volume cap allocation. Since **all** of the ownership of the facility must reside in the Section 501(c)(3) organization to be eligible for tax-exempt financing under Section 145, **no volume cap allocation is used, and,** unlike private activity bonds issued for profit-motivated sponsors under Section 142(d), **the project will not qualify for 4% low income housing tax credits.** Since almost no credit enhancers or investors will provide financing for 100% of value or cost, this often requires Section 501(c)(3) borrowers to structure subordinate bonds, obtain other subordinated loans or devise other methods for "closing the equity gap" in these financings. The same problem may confront public entity borrowers in "essential function" or "governmental purpose" financings described under V.A.3 below. Appendix B discusses some of the techniques which have been used by such Section 501(c)(3) or public entity borrowers to close this "equity gap" in these financings.

(5) **Other Possible Advantages of Section 501(c)(3) Financings.** Although they can't claim 4% tax credits, Section 501(c)(3) financings may enjoy a number of other important benefits, including the following:

(a) Some states and counties exempt Section 501(c)(3) owners from payment of real estate taxes which can be 1% or more of appraisal value per year, and thus can be a significant component of annual operating costs. (This benefit may also be available to profit-motivated sponsors using private activity bond financing under Section 142(d) in some jurisdictions, such as California, if the managing general partner or managing member of the borrower is a nonprofit corporation)

(b) Some jurisdictions provide relief from sales taxes on materials and/or prevailing wage requirements for projects owned by nonprofit organizations such as Section 501(c)(3) corporations.

(3) In some jurisdictions, low or moderate income set-aside funds (e.g., California) or other public funds may be available to subsidize up-front costs and/or ongoing operations of projects owned by non-profit corporations.

(4) HOME funds or other federal funds may be more readily available to Section 501(c)(3) borrowers than to profit-motivated entities.

c. **Affordable Housing for Persons of Lower Income.** The charitable purpose most often served by organizations which qualify for Section 501(c)(3) financing is that they **"provide relief for the poor and distressed."** Merely providing rental housing for persons of **low or moderate** income will generally **not** be deemed to serve this purpose sufficiently to qualify an organization for Section 501(c)(3) status. Providing rental housing exclusively for persons of **low** income at affordable rates generally **will** be considered to constitute providing relief for the poor and distressed under Section 501(c)(3).

(1) **Rev. Proc. 96-32 Safe Harbor Guidelines.** Whether an organization will be recognized as a Section 501(c)(3) organization depends on all the facts and circumstances. In 1996, the IRS published **Revenue Procedure (96-32)** which provided **safe harbor guidelines** for organizations seeking 501(c)(3) status (i.e., organizations who do not have an existing determination letter, as further discussed below) based on their providing housing for the "relief of the poor and distressed." An organization will qualify if it satisfies the following requirements:

(a) The organization establishes that for its project (i) at least **75% of the units** are made available to persons of "low income" under HUD guidelines (i.e., **persons whose incomes do not exceed 80% of area median** income, adjusted for family size) and (ii) **either** at least **20%** of the units in the Project are occupied by persons who also meet the very low income limit **(50% of area median income,** adjusted for family size) or **40%** of the units in the project are occupied by persons whose incomes do not exceed 120% of the area's very low income limit (i.e., **60% of area median** income). If a qualifying resident's income for purposes of one of the above tests **rises to a level above 140%** of the applicable income level, the safe harbor will still be met if the Owner rents the next comparable non-qualifying unit to a tenant who meets the applicable income test. **Up to 25% of the units can be rented at market rates to persons with incomes in excess of these limits.**

(b) The project is **actually occupied by poor and distressed residents.** A transition period of one-year or possibly longer to actual occupancy by such persons is allowed in acquisitions. This is to be contrasted to the "Donnelly Rules," discussed in V.A.2.b.(2) below, which, if applicable, apply fully from the date of issuance of the bonds with no transition period.

(c) The housing must be **affordable** to the charitable beneficiaries, as evidenced by the rents on the low and very low income units being set at levels not in excess of government imposed restrictions (e.g., 30% of 50% or 60%, as applicable, and 30% of 80% of area median) and by other policies providing relief for the poor and distressed.

(d) If a project consists of multiple buildings and each building does not separately meet the requirements set forth in (a), (b) and (c) above, the buildings must share the same grounds, except for certain scattered site projects exclusively for low income families.

If an organization does not meet all of these tests, IRS Revenue Procedure 96-32 provides a **number of other factors** which may be considered to demonstrate "facts and circumstances" indicating that the organization qualifies for Section 501(c)(3) status by meeting the needs of the poor and distressed. These facts and circumstances may include, but are not limited to: (a) a substantially greater percentage of residents than required by the safe harbor with incomes up to 120% of the area's very low income limit; (b) limited degree of deviation from the safe harbor percentages; (c) limitation of a resident's portion of rent to ensure that the housing is affordable to low-income and very low-income residents; (d) participation in a government affordable housing program; (e) operation through a community-based board of directors; (f) provision of additional social services affordable to the poor residents; (g) relationship with an existing 501(c)(3) organization active in low-income housing for at least five years if the existing organization demonstrates control; (h) acceptance of residents with unusual burdens such as high medical costs which cause them to be in a condition similar to persons with qualifying income limits; (i) participation in affordable home ownership programs; (j) existence of affordability covenants or restrictions running with the property.

(2) **Separate Low or Moderate Income Occupancy Requirements under the "Donnelly Rules."** In 1988, Section 145 of the Code was amended in legislation introduced by Representative Brian Donnelly of Massachusetts to add a new Section 145(d) imposing Section 142(d)-type 20/50 or 40/60 low or moderate income targeting (as discussed in Section V.A.1.b. above) on bonds issued under Section 145 of the Code to provide financing for Section 501(c)(3) organizations, where the facilities, by their nature, constitute "residential rental housing facilities" within the meaning of Section 142(d), irrespective of the Section 501(c)(3) charitable purpose served by the borrower organization. These amendments have come to be referred to as the "Donnelly Rules." There are three general exceptions to the Donnelly Rules: (i) where the proposed financing plan involves **new** construction, (ii) where the financing plan involves **very substantial rehabilitation** (i.e., rehabilitation where the amount of the rehab work exceeds the adjusted

basis of the building acquired, together with its structural components)[4] , and (iii) where the bonds being issued are **general obligations** of the issuer (i.e., the issuer is putting its credit behind the bonds and not simply issuing as a “conduit”). In addition, several other exceptions may apply as discussed below. As a result, under most circumstances where bonds are proposed to be issued under Section 145 of the Code to provide financing for the **acquisition** of an existing housing facility by a Section 501(c)(3) organization, the Donnelly Rules will apply and the project will be subject to the same type of 20/50 or 40/60 targeting as would be the case had the bonds been issued for a profit-motivated sponsor under Section 142(d) of the Code. If applicable, the Donnelly Rules apply from and after the date of issuance of the bonds without any transition period such as that available under Rev. Proc. 96-32 described above.

There are other circumstances, other than the general exceptions outlined above, where targeting imposed by the Donnelly Rules may not apply. The first is the case where the nature of the facility’s design is such that one can avoid the conclusion that the project constitutes a “residential rental housing facility” within the meaning of Section 142(d). One way this definition can be avoided is if the facility is designed in such a way that the **units do not constitute “complete living units”** within the meaning of those provisions. For example, if the facility is an SRO (Single Room Occupancy) facility where the units share a common bath, it will not meet the definition of “residential rental housing facility” under Section 142(d). Similarly, if the units do not contain at least a minimal kitchen (i.e., basic facilities for cooking and cleaning, including at least a microwave or other type of oven and some type of refrigerator), residential rental housing facility status can be avoided. As a result, units could contain a small refrigerator and no microwave or cooking facilities, or a microwave but no refrigerator, and bond counsel will in most instances take the position that the facilities do not constitute residential rental housing facilities under Section 142(d), and thus the Donnelly Rules would not apply.

Another basis upon which some **facilities designed primarily for the elderly** can avoid “residential rental housing facility” status and thus the Donnelly Rules being triggered, is if the nature of the facility and services provided includes the provision of **continual, or frequent nursing, medical or psychiatric services.** In IRS Revenue Ruling 98-47 (discussed in detail in Section V.A.2.c(3) below, the Service ruled that the provision of continual or frequent nursing, medical or psychiatric services, in addition to common dining and other services, in a phase of a facility designed for the elderly would cause that phase of the facility to be treated as a nursing home rather than as “residential rental housing” under Section 142(d). This was distinguished from two other phases of the facility where, in one case, only basic shelter and common dining were involved and, in the other case, additional services such as

[4] Aside from avoiding the impact of the Donnelly Rules, there is no 15% or other rehab requirement on Section 501(c)(3) acquisition bond financings under Section 145 of the Code, unlike the “15% rehab requirement” discussed under Section V.A.1.e. above for private activity acquisition bond financings for profit-motivated sponsors under Section 142(d).

medication management assistance, nurse consultation and assistance in dressing, bathing and similar activities were provided, but not continual or frequent nursing, medical or psychiatric services. The first two phases were treated as "residential rental housing facilities" within the meaning of Section 142(d). As a result, the first two phases could be financed with tax-exempt bonds under Section 142(d) if a volume allocation were obtained and the other requirements of that Section were met, but if these two phases were financed by a Section 501(c)(3) owner with bonds issued under Section 145 of the Code, they would be subject to the Donnelly targeting requirements (unless one of the exceptions to the Donnelly Rules discussed in this V.A.2.c.(2) applies). On the other hand, the facilities described in the third phase would be ineligible for private activity bond financing under Section 142(d), since they did not constitute "residential rental housing facilities" under Section 142(d); however, those facilities could be financed for a Section 501(c)(3) owner through the issuance of bonds under Section 145 of the Code, without compliance with the Donnelly targeting requirements, even on an acquisition financing when no rehabilitation or general obligation credit is involved.

The final area in which the Donnelly Rules may be deemed not to apply to an acquisition financing by a Section 501(c)(3) borrower, even though the units in the facility constitute complete living units within the meaning of Section 142(d), is in the area of **student housing** discussed in V.A.2.e. below. In this case, the legislative history of the Donnelly Rules strongly suggests that Congress did not intend to impose these requirements on bonds issued under Section 145 of the Code to provide what is traditionally viewed as student housing.

It should be emphasized that, aside from the foregoing exceptions, the Donnelly Rules are generally viewed as applying in a very mechanical way. Thus, even if the charitable purpose of the Section 501(c)(3) organization which will own the facility is something other than "providing relief for the poor and distressed," such as combating community deterioration, eliminating discrimination and prejudice, lessening neighborhood dislocation, relieving distress of the elderly and physically handicapped and lessening the burdens of government, the Donnelly Rules will apply if the proposed financing involves the issuance of revenue (not GO) bonds to provide for the acquisition of an existing facility by the Section 501(c)(3) organization (without very major rehabilitation), and the nature of the facilities is such that they constitute "complete living units" and otherwise constitute "residential rental housing facilities" within the meaning of Section 142(d). This means that Donnelly applies to acquisition deals for the elderly and handicapped, as well as acquisition deals for one or more of the other charitable purposes outlined above, unless one of the exceptions described in this Section V.A.2.e.(3) is available.

(3) **Revenue Ruling 98-47; Continuing Care Facilities as "Residential Rental Property."** In Revenue Ruling 98-47, the IRS was called upon to rule whether a retirement facility providing certain services in addition

to housing was "residential rental property" within the meaning of Section 142(d) and Section 145(d) of the Code. Such a determination would have entitled the project to bond financing under Section 142(d), but would have subjected the facility to the Donnelly Rules discussed under Section V.A.2.c.(3) above imposing on the project the 20/50 or 40/60 income targeting requirement described under V.A.1.b. above. On the other hand, a determination that the project fell outside that definition would enable the Section 501(c)(3) non-profit borrower to obtain tax-exempt financing under Section 145 of the Code free of those restrictions.

The facility in question was comprised of three buildings – elegantly referred to in revenue ruling jargon as "Buildings X, Y and Z." All units in the facility had separate and complete facilities for living, sleeping, eating, working and sanitation. The cooking and eating area in each unit contained a small refrigerator, a sink, a pull-down table, and a two-burner stove with an oven. Each unit was designed so that the stove could be replaced with a full-sized microwave oven if the physical or mental frailties of the resident made it imprudent to provide a functioning cooking stove. Thus, the units were "complete living units" under the residential rental property definition of Sections 142(d) and 145(d).

Each resident entered into a lease arrangement, with the amount of the monthly payment varying according to the level of care provided, with Building Z (described below) commanding the largest payment and Building X the smallest payment. The monthly payment was made in exchange for use of an individual unit, basic services and, with respect to Buildings Y and Z, other services. Under a lifetime lease payment option, residents could also pay a fixed monthly amount for the time they resided in the complex. The lifetime lease option guaranteed a resident the right to move to a unit in Buildings Y or Z if the resident required additional care.

In Building X only housing services were provided. These included laundry, housekeeping, regular meals in common dining areas, 24-hur monitored emergency call services, planned social activities and scheduled transportation services. Building Y residents were provided with these services and were additionally provided medication, management assistance, nurse-consultation, assistance by non-medically certified aides in dressing, bathing and similar activities, and routine checks on general well-being. In Building Z, residents were provided with the foregoing services, plus registered nurses for 12 hours per day, licensed practical nursing services available 24 hours per day, and other services providing for the residents' medical and psychiatric needs.

In its ruling, the Service concluded that, based on the presence of **continual or frequent nursing, medical or psychiatric services** for residents of Building Z, that building would not be a residential rental property under Section 142(d) or 145(d), but that the absence of such services in Buildings X and Y would result in those facilities being treated as residential rental property under those sections. As a result, the Section 501(c)(3) borrower was able to finance Building Z, but not Buildings X or Y, using tax-exempt bonds under Section 145 of the Code, free from the targeting requirements imposed by Section 142(d) of the Code by the Donnelly Rules. Buildings X and Y could have been financed with tax-exempt bonds under Section 145, but could have been subject to Donnelly (absent an exception as described under V.A.2.c.(2) above. Of course, **if the Borrower had been a profit-motivated sponsor** and had not been a Section 501(c)(3) organization eligible for tax-exempt financing under Section 145 of the Code, the ruling would have permitted the Borrower to finance Buildings X and Y with tax-exempt bonds issued under Section 142(d) if a volume allocation were available and the other requirements of Section 142(d) were satisfied, but the ruling would have precluded the use of any tax-exempt bond financing for Building Z.

c. **Relieving Distress of the Elderly and/or the Handicapped.** Another charitable mission which may be served through the issuance of tax-exempt bonds for Section 501(c)(3) corporations is "relieving distress of the elderly and/or the handicapped." For this purpose, elderly is generally defined to be 62 years of age and older. The IRS guidelines in this area suggest that merely providing shelter for the elderly and the handicapped will be insufficient to establish a charitable purpose under this criterion. Absent the applicability of the "Donnelly Rules" discussed in V.A.2.c.(2) above, there are no specific income guidelines applicable to tenants in facilities owned and operated by such Section 501(c)(3) organizations. However, there must be some demonstration that the units in the project are generally affordable to the residents, and some provision must generally be made for the housing and other needs of persons who, due to health, financial or other reasons, may encounter difficulties in continuing to afford the rents normally charged by the facility. In addition, there must be some evidence that the facility is appropriately designed for the intended class of charitable beneficiaries and that services required by the intended residents are generally available within the facility on reasonable terms to make the facility suitable for the targeted charitable class. Compared to the guidance given with respect to low income housing in Revenue Procedure 96-32, IRS guidance in this area is limited and not very specific.

d. **Student Housing for Nonprofit or Public Colleges or Universities.** Growing demand for student housing across the country has seen the evolution and increasing use of financing models which involve the issuance of tax-exempt bonds under Section 145 of the Code to finance the ownership of student housing facilities by a separate Section 501(c)(3) nonprofit corporation, the charitable mission of which involves the assistance of a public or private nonprofit college or university in the achievement of its educational mission. The principal advantage of these financings is that they provide low-rate, tax-exempt, long-term bond financing, while minimizing the increased cost and delays and the adverse balance sheet impact that might result if the colleges or universities were to undertake these financings separately. On the other hand, this is an evolving area that has attracted IRS scrutiny. As a result, it is important that transactions of this type, as well as other Section 501(c)(3) financings, be carefully structured.

(1) **Finding of Need; Cooperation Agreement; Rental Exclusively to Students; Location and Design.** One of the principal requirements in these financings is a formal finding by the college or university that it ha substantial unmet housing needs and that the ownership and operation of the proposed facility by the Section 501(c)(3) organization will be of material assistance to the college or university in meeting those needs. Internal Revenue Service guidelines also typically require arrangements to assure that the units be rented exclusively to students. These facilities are generally located on or immediately adjacent to the college or university campus or, if such a site is not available, a short distance away at a location which is readily accessible to the campus by public transportation. The facilities also must be designed for students, and there must be a close connection, both physically and programmatically, between the operation of the facility and the college's or university's educational mission.

(2) **Eligible Section 501(c)(3) Ownership Entities; Relationship to College/University; Independence from Developer.** The legal theory behind this financing model is that the Section 501(c)(3) entity, by owning the student housing facility, is assisting the college or university in the college's or university's charitable mission – education. This charitable mission should not be confused with that of other Section 501(c)(3)'s, which may provide affordable housing as described in V.A.2.c. above. As a result, student housing facilities are not required to comply with "20/50" or "40/60" targeting or other affordable housing guidelines under Section 42 or Section 142(d) of the code, nor would most of these facilities be able to do so, since in order to qualify as a lower income housing tenant under affordable housing guidelines, students must be married and filing a joint return. On the other hand, in order to satisfy IRS guidelines, the rents on tax-exempt bond financed student housing facilities must generally be set somewhat below market rates and must be affordable to students. The Service may also require the rents on units generally be set no higher than is necessary to pay operating expenses and to cover debt service by a margin sufficient to cover applicable rating agency and/or credit enhancer requirements. IRS guidelines typically require that the substantial majority (e.g., 75% or more) of any operating surplus be distributed to the college or university, with only a minor portion being retained by the Section 501(c)(3) for its purposes.

Internal Revenue Service rulings and pronouncements also require that the Section 501(c)(3) entity either be established and/or controlled by the college or university and/or the community in which it is located or otherwise have a close relationship with the college or university and/or community. Those guidelines also prohibit any significant control of the Section 501(c)(3) entity by a developer or other private party involved in the student housing project, as is further discussed below.

Many colleges or universities have a separate Section 501(c)(3) operation or foundation which is authorized, among other things, to enter into transactions to assist the college or university in financing its activities. Since the rating agencies and most credit enhancers prefer that the project be owned by a "bankruptcy remote" special purpose entity, in many instances this financing foundation might set up a separate Section 501(c)(3) corporation, the sole purpose of which would be ownership and operation of the proposed student housing facility. That subsidiary entity might also set up a nonprofit partnership or limited liability company, although in some jurisdictions (such as California), ownership of the property by a limited liability company may jeopardize a real estate tax-exemption, which is often important to the financial feasibility of most of these financings. It should be noted that if the parent entity does not have a so-called "group exemption" (see V.A.2.j. below), it will be necessary to submit an application to the Internal Revenue Service to obtain a charitable designation under Section 501(c)(3) for the special purpose ownership entity.

In any event, it is important that the college or university have substantial involvement in and control over the Section 501(c)(3) ownership entity, perhaps together with members of the local community. This is to be contrasted to a fact pattern of "roving" developer-controlled Section 501(c)(3)'s, which was attacked by the Service in a training publication released in fall 2000. Those facts involved the ownership of tax-exempt bond financed student housing facilities by Section 501(c)(3) corporations having a nationwide or other multi-jurisdictional purpose to assist colleges and universities generally in meeting their educational needs. In many instances, the officers and directions of the Section 501(c)(3) corporation had no significant relationship to each other, to the college or university served by the proposed student housing bond facility or to the community in which the student housing was to be located. In some instances, these Section 501(c)(3) corporations had been organized by and/or received initial funding from the developer and other private parties who were active in the development of the student housing facilities to be owned by the charitable corporation. The development firm or other private parties might also have had one or more persons on the board of directors and, in a number of instances, the same developer and group of other private participants would participate in multiple financings for facilities at different colleges and universities.

In its publication, the Service challenged the tax-exempt status of this type of nonprofit corporation under Section 501(c)(3) and, potentially, the tax-exempt status of any bonds issued to finance the facilities owned by such a corporation. Subsequent to that publication, the Service brought at least one investigative proceeding involving a series of student housing bond financings by a Section 501(c)(3) organization which embodied some of these characteristics. As a result of these developments, almost all bond and Section 501(c)(3) counsel involved in these financings immediately began to require that the Section 501(c)(3) entity be organized by or substantially controlled by the college or university where the project is located and/or representatives of the local community, as compared to various persons who may have expertise in real estate, education or financing, but who have no clear connection with the college or university or community in question or to each other.

Since the date of that publication, most law firms have refused to render clean opinions where there has been any significant evidence of developer control or involvement in the governance and affairs of the Section 501(c)(3) entity, and they have insisted that any contracts between the Section 501(c)(3) entity and developers or other private participants have competitive terms and not have the overall effect of giving a developer or another private party significant control over the Section 501(c)(3)'s governance or activities.

Subsequent private letter rulings issued in late 2002 removed the threat to the charitable status of the organization under which had been placed under review in 2000 and to the tax-exempt status of the bond issues in which they had been involved, after they had amended their articles and by-laws to assure that the local college or university and the local community controlled the board of directors of the Section 501(c)(3) Corporation which owned the project and that there could be no presence on the board of persons affiliated with profit-motivated participants in the financing.

(3) **Financing Structure; Roles and Compensation of Developer and Other Private Parties.** In a typical structure, a university may actually own the land on which the project will be built. In many instances, the university will lease this land to the Section 501(c)(3) entity under a long-term lease, the terms of which will cause the land and any improvements to revert to the university at the end of a 30 or 35-year term after the bonds have been repaid. In some instances, this arrangement may instead be structured so that the college or university has an option to acquire the facility for a nominal price (e.g., $10) at that time or whenever sufficient funds are on hand to retire the outstanding debt. In some instances, the Section 501(c)(3) organization will enter into a development agreement with the developer to pay the developer a competitive fee in return for its development services relating to the facility. In other cases, the developer may develop and build the facility with its own funds or the proceeds of a taxable construction loan on a "turnkey" basis and then sell the facility to the Section 501(c)(3) corporation at a price not exceeding its appraised fair market value, with the 501(c)(3) corporation using the proceeds of the tax-exempt bonds to finance that purchase.

In a number of instances, the developer may have an affiliated contractor, who will build the facility and may also be affiliated with a management company which may manage the facility on behalf of the university through a qualifying management contract meeting Internal Revenue Service guidelines. In some instances the 501(c)(3) entity will enter into some type of operational agreement with the college or university to operate the facility in accordance with the university's policies. In some cases, the management company retained by the Section 501(c)(3) entity will lease units to students; in others, the management company may take care of physical maintenance but the renting of units is handled by the college or university. In other instances, the Section 501(c)(3) entity may lease the facility back to the college or university, which will retain control over the rental and/or physical management functions. In many of these financings, particularly those involving a management or operating agreement rather than a lease-back to the university, the university's credit will not be pledged to repayment of bonds; instead, the bonds will be supported by the pledge of the net operating income derived from the operation of the facility and a first deed of trust on the property, as further described below.

Of course, all of the foregoing arrangements with private parties for development, construction, management and other services must pass customary requirements applicable in all Section 501(c)(32) bond financings that the fees paid to private entities be reasonable and competitive as compared to the prices which would be paid for such services in transactions not involving Section 501(c)(3) organizations and/or tax-exempt bond financings under Section 145 of the Code. Failure to satisfy these tests could result in a finding of impermissible "private benefit," which could jeopardize both the Section 501(c)(3) status of the ownership entity and the tax-exempt status of any bonds issued to finance the facility. See V.A.2.k.(2) below. However, the IRS has indicated that excess private benefit may be present even if all compensation arrangements are at fair market value, particularly if a private party controls the 501(c)(3) borrower.

f. **"Relieving the Burden of Government."** A Section 501(c)(3) corporation may receive a favorable determination from the Service on the grounds that its mission will "relieve the burden of government." In the context of residential rental housing financings, this is the charitable purpose sometimes seen for nonprofit corporations, the principal mission of which is to acquire ownership of the infrastructure and "pads" in mobile home communities which might otherwise be converted to private ownership. Especially where there is strong evidence that the community in which the facility is located deems nonprofit ownership of this type of facility to be vital to the community's well being and is willing to support that ownership financially and otherwise, and where the residents are persons such as the elderly or persons of lower income, who the city or other governmental entity would be otherwise required to support, this charitable mission may be the basis for a favorable determination under Section 501(c)(3), and the acquisition of such facilities has in a number of instances been financed with the proceeds of tax-exempt bonds under Section 145 of the Code.

g. **Charitable Missions Not Additive.** Strictly speaking, charitable missions are not additive. In other words, one cannot obtain a favorable determination under Section 501(c)(3) by satisfying **some** of the requirements of one charitable mission (e.g., providing affordable housing for some persons of moderate, but not low income) and some elements of another charitable mission, such as lessening some burdens of government. Nonetheless, where a strong showing is made that the activities of a given nonprofit corporation satisfy most, if not all, of the requirements for one charitable purpose, the presence in the activities of the Section 501(c)(3) of elements of other charitable activities may help the nonprofit corporation to obtain a favorable determination under Section 501(c)(3).

h. **Other Charitable Purposes.** In addition to achieving Section 501(c)(3) status by serving the purposes set forth above, organizations may qualify for Section 501(c)(3) status by combating community deterioration, eliminating discrimination and prejudice and lessening neighborhood dislocation, as these concepts have been developed in various IRS Revenue Rulings and other pronouncements. However, these charitable purposes have not been as widely used in tax-exempt housing bond financings as those described above.

i. **Section 501(c)(3) as Borrower; Not Issuer.** Note that to qualify for tax-exempt bond financing under Section 145 of the Code, the project must be **owned by** the Section 501(c)(3) organization (even though the tax-exempt bonds issued under Section 145 of the Code are often referred to as "Section 501(c)(3) Bonds"). In other words, the Section 501(c)(3) entity is the **borrower.** In either case, the Section 501(c)(3) (or other nonprofit corporation) **is not the issuer** of the bonds; the issuer must still be a public governmental body of the type described in I.C.1 above, just as it is in a "private activity bond" financing described in IVA.1 above. In a few cases, the **issuer** of tax-exempt multifamily housing bonds may be a nonprofit corporation set up under Revenue Ruling 63-20 as an alter ego of such a public body as described in I.C.1 above, but this is very rare. It is also possible to set up a nonprofit corporation (with or without a Section 501(c)(3) determination) as an instrumentality of a governmental unit, and then have it serve as the borrower in tax-exempt "essential function" or "governmental purpose" bonds (see V.A.3 below). Of course, many nonprofit corporations, including those who have received a charitable designation under Section 501(c)(3), are empowered under their state statutes and articles of incorporation to issue their own bonds to finance their activities. Moreover, in some instances, these bonds might receive an exemption from SEC registration under Section 3(a)(4) of the Securities Act of 1933. However, interest on these bonds, **if issued by** the typical nonprofit corporation, as compared to a political subdivision or instrumentality thereof on behalf of the nonprofit corporation, would be taxable for federal income tax purposes (as well as for state income tax purposes in most states).

As further discussed below, ownership interests in the Project cannot be given to entities other than the Borrower through contractual arrangements. Management and other contracts between a 501(c)(3) organization and for-profit entities must be scrutinized to make sure they are not structured in a way that would amount to a transfer of tax ownership of the project to a for-profit entity, which would now allow use of Section 501(c)(3) bonds. In Revenue Procedure 97-13, the IRS provided safe harbor guidance for management contracts between for-profit entities and governmental units or Section 501(c)(3) corporations. These guidelines are discussed in further detail in Section V.A.2.k.(2)(d) below.

j. **"Grandfathered" Section 501(c)(3)'s versus "New Approval" Section 501(c)(3)'s.** The easiest path to pursuing a Section 501(c)(3) financing is where the borrower is a well-established existing Section 501(c)(3) corporation; where the organization's Section 501(c)(3) determination letter from the IRS includes the provision of low or moderate income housing within the nonprofit's charitable purpose and where the Section 501(c)(3)'s governing instruments specifically authorize to use of the exempt bonds. While every organization is subject to a "facts and circumstances" test as to whether it fulfills a permitted charitable mission under Section 501(c)(3) (as is discussed further below), well established Section 501(c)(3) corporations acting within the historical scope of their charitable mission are generally less likely to be subject to rigorous scrutiny by the Service than will be the case with newly established entities. Where a proposed financing involves such an established Section 501(c)(3) borrower, bonds can generally be issued under Section 145 of the Code to finance the 501(c)(3)'s borrower's projects without prior review or approval by the IRS.

Of course, the need for use of a single-purpose entity to own a debt-financed real estate project may give use to a need to get a new determination letter for the new entity, or the entity may elect to create as the ownership entity a limited liability company of which the Section 501(c)(3) corporation is the sole member. Some established Section 501(c)(3) corporations have a "group exemption" which allows them to establish special purpose subsidiaries without prior IRS review. Where this is not the case, or where the borrower is a newly-established nonprofit corporation applying for Section 501(c)(3) status for the first time, one must add to the financing timetable a period for prior IRS review of the nonprofit corporation's status under Section 501(c)(3) and the proposed financing plan. Such prior IRS review and approval can require an additional six to eight weeks (if expedited processing is requested and obtained) or may take as long as three or four months for a new Section 501(c)(3) corporation with a complex financing plan. The amount of time required may be on the longer end of this range to the extent factors indicative of abusive transactions, as discussed in Section V.A.2.k.(2)(e) below, are present. Such prior IRS review can, of course, also result in more conservative financing requirements than those which might be imposed by Bond Counsel where separate IRS review is not required.

k. **Roles for Private Developers and Permitted Compensation.** For-profit developers may play various roles in Section 501(c)(3) financings, and be compensated for doing so, so long as the arrangements do not give rise to an abusive transaction as described above or otherwise cause any significant degree of tax ownership to be transferred to a for-profit entity.

(1) **Potential Roles for Profit-Motivated Parties.** The roles of a for-profit entity may include:

(a) Development role.

(b) Construction of the project through construction affiliate.

(c) Management – under a qualified management contract, as described below.

(d) Loan servicing.

(e) Other functions. The for-profit entity may be paid reasonable fees – up-front and ongoing. Various creative financing structures have been utilized, including sellers taking back tax-exempt bonds as a part of the purchase price (though this may be one factor which the IRS will review on audit, as described below).

(2) **Compensation.** Bond Counsel will generally impose several tests when private parties perform substantial roles in tax-exempt Section 501(c)(3) financings. As discussed above, scrutiny may be heightened where the Section 501(c)(3) entity has little housing experience.

(a) **Reasonableness of Compensation; Avoiding "Private Inurement" or "Excess Private Benefit."** Most Bond Counsel will examine each element of compensation proposed to be paid to private parties performing the above roles in Section 501(c)(3) financings and will require some demonstration that the compensation paid to such private participants is reasonable in light of the services performed and/or the risk incurred. Generally, evidence of what such parties charge for performing these roles and/or incurring these risks in transactions non involving tax-exempt Section 501(c)(3) financings will be helpful in establishing the "reasonableness" of proposed compensation to private parties. In a Section 501(c)(3) acquisition financing, Bond Counsel will also generally require the proponents to provide an appraisal or some other evidence that the purchase price being paid by the Section 501(c)(3) purchaser is a reasonable price which has not been inflated by the presence of tax-exempt bond financing. Some counsel will take the position that the purchase price paid by a Section 501(c)(3) borrower acquiring a project from the proceeds of tax-exempt bonds should not reflect any increase in appraised value attributable to the low rate financing made available by the tax-exempt bonds or the value of real estate tax relief which may be available. Notwithstanding this, some credit enhancers and bond purchasers may take such value into account in determining whether they will credit enhance or purchase the tax-exempt bonds.

Payment of excessive compensation or inflated purchase price may cause the IRS to conclude that the transaction involves prohibited "private inurement" (if to officers, directors or employees of the Section 501(c)(3) or "excess private benefit" (if paid to other private participants) or that significant ownership of the project resides with a non-exempt entity, which would jeopardize the tax-exempt status of the bonds and trigger other adverse tax consequences. The IRS has indicated that it plans to be diligent on these issues on audit. In addition to jeopardizing the tax-exempt status after the borrower issues the bonds, this may expose officers and directors of Section 501(c)(3) organizations to potential liability under the "intermediate sanction" regulations promulgated by the IRS in 1998.

(b) **Other "Excess Private Benefit."** Moreover, the Service has recently taken the position that even in the absence of any private inurement or excess private benefit due to payment of excessive compensation or inflated prices, the Section 501(c)(3) structure of the ownership entity and the tax-exempt status of related bonds may be jeopardized if benefits to one or more private parties are determined, when taken as a whole, to be excessive when examined in relation to the charitable purpose serviced by the Section 501(c)(3) entity and the related bond financing. In these cases, private parties generally stand to benefit from the transaction through control of various aspects of the 501(c)(3) organization's activities in ways that are more than incidental, both qualitatively and quantitatively. For an incidental benefit to be **qualitatively** incidental, benefits must flow generally to the public or other benefited class, and the private benefit should be a mere by-product or direct result of the public benefit. For a private benefit to be **quantitatively** incidental, it should be relatively insubstantial in amount. Thus, for example, in the case of a student housing bond financing, if a project is located far from campus, maintains rents very close to market, and does not appear to serve a critical college or university housing need, but benefits numerous private participants involved in the financing in numerous and substantial ways, the Service may determine that an "excess private benefit" is involved, even though all private participant fees and/or prices paid are reasonable and competitive and there is no finding of "private inurement."

(c) **Establishing Section 501(c)(3) as True Owner.** In order for Bonds to be exempt under Section 145 of the Code, the legal ownership and virtually all of the economic ownership of the Project must reside in the Section 501(c)(3) organization and non-Section 501(c)(3) participants may **not** have any significant **ownership** role. Thus, Bond Counsel will generally require the proponents of the financing to provide cash flow projections or other analyses demonstrating that the cash flow projected from the project (based on reasonable and customary assumptions regarding increases in rents, operating expenses and other factors) will be sufficient to cover operating expenses and reserves and to pay, when due, debt service on the tax-exempt bonds proposed to be issued and other debt which will be borne by the Project, while still leaving some projected material residual cash flow and/or residual sales or refinancing proceeds available to the Section 501(c)(3) owner entity. In addition, management contracts will be scrutinized under the safe harbor guidelines discussed below. Absence of such cash flow and residual for the Section 501(c)(3) owner or the presence of non-conforming management arrangements might allow the IRS to re-characterize the Bonds as not being Section 501(c)(3) bonds.

(d) **Safe Harbor Management Contract Guidelines.** In 1997, the IRS published Revenue Procedure 97-13, providing a revised set of safe harbor guidelines under which profit-motivated entities can provide management or other services to Section 501(c)(3) organizations without such activities resulting in a "private business use" under Section 141(b) of the Code, which could threaten the exempt status of the organization and the tax-exempt status of the related bonds.

In general, to fall within these safe harbor guidelines, a management contract must provide for reasonable compensation for services rendered with **no compensation based,** in whole or in part, **on a share of net profits** from the operation of the facility.

Arrangements that generally not treated as net profits arrangements, include compensation based on:

(1) A percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses of a facility, but not both (a **"Periodic Fee");**

(2) A **Capitalization Fee** (i.e., a fixed period amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed service for a specified period so long as the quantity and type of services actually provided to cover persons varies substantially); or

(3) A **Per-Unit Fee.**

The guidelines provide that the **maximum permitted term** for a management contract (including all renewal options) will vary depending on the nature of the fee arrangements:

Type of Contract	Maximum Term
95% Periodic Fixed Fee	Lesser of 80% of reasonably expected economic life of project or **15 years**
80% Periodic Fixed Fee	Lesser of 80% of reasonably expected economic life or **10 years**
50% Periodic Fixed Fee; 100% Capitation, or Combination Of Per-Unit and Periodic Fixed Fee	**5 Years** (terminable after 3 years) **3 Years** (terminable after 2 years)
Certain Third Party or Start-Up Contracts with fees based on 100% Percentage (of Revenues or Expenses) Or Combination of Percentage (of Revenues or Expenses) and Per-Unit Fees	**2 Years** (terminable after 1 year)

Under the management contract guidelines, **the service provider must not have any role or relationship** with the qualified user (i.e., the Section 501(c)(3) owner) **that,** in effect, **substantially limits the qualified user's ability to exercise its rights, including cancellation rights,** under the contract, based on all the facts and circumstances. This requirement is deemed to be satisfied if –

(1) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

(2) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and

(3) The qualified user and the service provider under the contract are not related parties (as defined in the regulations).

(e) **Applying the "Facts and Circumstances" Test – Avoiding Abusive Transactions.** In 1999, the IRS published a chapter of its audit training materials entitled "Identifying Abusive Transactions Involving Section 501(c)(3) Organizations and Tax-Exempt Bonds," written by Gerald Sack and Clifford Garnett of the IRS. This publication provides an excellent basic explanation of the application "facts and circumstances" test to a newly formed Section 501(c)(3) corporation which purports to be formed for the purpose of providing housing for the poor and distressed.

In this article, the authors indicate that agents should examine at a minimum several general factors in determining whether a transaction constitutes an abusive transaction which would result in a loss of the organization's tax-exempt status and the conclusion that interest paid on bonds issued to finance the organization's project would be taxable to the bondholder. These factors include: (i) the composition of the board of directors; (ii) the relationships of the parties to the arrangement; (iii) the organization's relationship with other exempt organizations, governmental entities, and banks or guarantors; and (iv) the facts surrounding the management of the facility.

According to the article:

"Factors indicating that an organization's bond financed project does not adversely affect the organization's status under IRS 501(c)(3) may include, among other items, the following:

a. The governing board of the organization is comprised of local, independent, civic leaders that broadly represents the community in which the bond financed facility is located.

b. The organization is controlled by an established IRS 501(c)(3) organization whose exempt purposes are also furthered by the bond financed project. For example, a charity plans to bond finance the construction of an elderly home on the campus of a university. The fact that the university acts as the charity's parent would be a significant fact weighing in the organization's favor.

c. The organization was created by a local governmental entity to be the lessor in a lease-back transaction in which the lessor issues bonds or certificates of participation.

d. None of the for-profit parties involved in the bond financed project (sellers, developers, contractors, managers, etc.) or individuals connected with them were instrumental in the creation of the organization or exercise substantial influence over the affairs of the organization.

e. Prior to selecting the bond financed project, the organization had made a good faith effort to find a suitable project.

f. A feasibility study reflects a projected rate of occupancy that is similar to the actual occupancy rate of the facility being acquired and indicates that the organization will be able to operate the facility in a charitable manner.

g. An appraisal of the bond financed facility uses the income method, market method, and cost method of valuation to estimate the facility's current business enterprise value.

h. The organization plans to manage the bond financed facility itself, hire a related exempt organization that has experience managing similar facilities to manage the facility, or selects a manager through competitive bidding."

In the article, the authors identified the equivalent of George Carlin's "seven dirty words" of newly formed Section 501(c)(3) financings. These seven warning factors or red flags were described by the authors as follows: "Factors indicating that an organization's bond financed project may adversely affect the organization's status under IRS 501(c)(3) may include, among other items, the following:

a. Members of the governing board of the organization are located throughout the country and have no discernable connection with each other or the community in which the bond financed facility is located.

b. A for-profit developer, manager or other party engaged in bond financed projects throughout the country created and controls the organization.

c. A for-profit entity involved in the bond financed project loaned the organization funds or paid various costs incurred in the process of organizing the organization and pursuing tax-exempt financing. Such costs might include incorporation fees, application fees, and fees for feasibility studies, appraisals, and engineering and environmental studies.

d. The for-profit entity selling the bond financed facility to the organization recently purchased the facility and is making a substantial profit on the sale.

e. The for-profit seller has provided a portion of the financing for the project by purchasing a series of subordinate bonds.

f. A bank lender or third party guarantor, such as a bond insurer or a letter of credit bank, has final authority over the organization's budget and fees and has required the organization to maintain an unreasonable amount of cash on hand.

g. The organization has entered into a management contract with a for-profit manager to operate the bond financed facility which provides for the sharing of net profits or provides for penalties if the applicant terminates the contract."

According to the handbook, applicable IRS regulations "…clearly place the burden of proof upon the organization to establish an application for exemption that it is not organized and operated for the benefit of private interests." Notwithstanding this language in the handbook, a number of major bond counsel firms have approved financing plans, notwithstanding the presence of one or more of these "warning factors," where the other elements of the financing plan made it clear that the Section 501(c)(3) corporation was the true owner of the facility and that the financing and compensation arrangements did not involve prohibited "private inurement" or other abusive elements.

3. **Essential Function or Governmental Purpose Bonds.**

a. Very few rules apply, other than usual arbitrage restrictions and similar rules.

b. However, the facility must be owned by and for the benefit of a public governmental body, such as a city, county or housing authority, to fall within this category. Ownership by an alter ego Revenue Ruling 63-20 nonprofit corporation may also qualify for financing in this category, but not ownership by other types of Section 501(c)(3) or other nonprofit corporations.

B. **Refundings** – Primary Rationale: Reduction in interest rates; expiration of prior credit enhancement.

1. **Background.** A tremendous volume of tax-exempt multifamily housing bonds were issued in 1980-1985 at interest rates as high as 9% - 12% or more. Most of these issues were open to optional call 10 years after their issuance. Moreover, many of those bonds were subject to mandatory tender upon expiration of the original credit enhancement facilities at the end of 10-12 years. Many of those credit enhancers were no longer in existence in the early 1990's (e.g., many S&L's), or had left the business of credit enhancing tax-exempt housing bonds (e.g., many banks and insurance companies), and thus a refunding with a new credit enhancement was both necessary, as well as being desirable in terms of interest rate savings. As a result, a large number of these bond issues were refunded in the early 1990's, often at rates of 7.5% to 8.5% or so. Like the original bonds they refunded, these refunding bonds were closed to optional call for 8 to 10 years when issued since almost all of these refundings were issued as fixed rate bonds. In addition, the early 1990's saw a resurgence of "new money" bond issues, as the growing demand for affordable apartments overcame the over-supply problems of the late 1980's, and developers began to combine new money private activity bond issues under Section 142(d) with 4% tax credits. These bond issues in the early 1990's also bore rates of interest in the 7.5% to 8.5% range, and when issued as fixed rate bonds, were also generally closed to optional call for 8-10 years.

   Today, interest rates are approaching the lowest levels seen in the market place in over 20 years. Many of these early 1990's refunding issues as well as "new money" issues are now, or soon will be, eligible to be refunded at today's even lower rates, often providing interest rate savings of 100 to 200 basis points or more.

2. **More Liberal Rules than "New Money" Deals.** Federal rules relating to refundings are much more liberal rules than those applicable to new money financings, including:

   a. No volume allocation; but "issue price" of tax-exempt refunding cannot exceed outstanding balance of prior bond issue (any excess will generally be structured as taxable bonds).

   b. "Old" targeting requirements – i.e., 80/20 with no adjustment for family size (if the original bonds were issued before 1986).

   c. No 15% rehabilitation requirement.

   d. Not subject to AMT (if the original bonds were issued before 1986).

3. **Issuer Requirements.** Note that the issuer may impose certain requirements as a condition for issuing refunding bonds – it may want some extension of the Qualified Project Period (e.g., for an addition 5-10 years). It is desirable to avoid an issuer's imposing deeper targeting requirements where the refinancing involves a default refunding or work-out refunding of a distressed project, although such "work-out" refundings are relatively rare in the current market place.

4. **Optional Call Versus "Default" Refundings.**

   a. Optional call refundings. Bonds called after first optional call date at par or small premium. Easiest type of refunding.

   b. Default refundings. Bonds called under extraordinary mandatory redemption (usually at par) before optional call dates. Project is in distress, thus a successful refunding is usually more difficult to structure. Loss of yield to original investor raises due diligence requirements and indemnification issues not present in optional call refundings.

5 **"Current" versus "Advance" Refundings; "Rerefundings."** "Current" refundings are tax-exempt refundings where the Bond proceeds are used within 90 days following the issuance of the refunding bonds to retire the prior tax-exempt issue. "Advance" refundings are tax-exempt refundings where the proceeds of the refunding bonds are placed in an "escrow" (and generally invested in U.S. Treasury Securities and used to pay debt service on the prior tax-exempt bonds) until a retirement date more than 90 days after the issuance of the refunding bonds.

   a. **Advance Refundings.** Advance refunding bonds may only be issued on a **tax-exempt** basis where the prior bonds are Section 501(c)(3) bonds or essential function bonds (i.e., where the facility is owned by a Section 501(c)(3) organization or a governmental body). Generally speaking, where tax-exempt advance refundings are permitted, there can be only one such transaction (i.e., a tax-exempt advance refunding of a prior tax-exempt advance refunding issue is prohibited). Advance refunding bonds issued to refund private activity bonds (i.e., where the facility is owned by a profit-motivated sponsor) may only be issued on a **taxable** basis.

   b. **Current Refundings; "Rerefundings."** The law permits "current" refunding bonds to be issued on a tax-exempt basis to refund all three types of prior tax-exempt issues, and also permits an unlimited number of current refundings (i.e., where one tax-exempt current refunding issue retires a prior (generally higher rate) current refunding). As indicated above, such "rerefundings" have begun to emerge within the past several years, where a second tax-exempt issue of current refunding bonds is issued (at, for example, rates of around 5.5%) to retire earlier tax-exempt current refunding bonds issued in the early 1990's at interest rates of 7.50% to 8.5%, and which are now subject to optional redemption. As noted above, many of the early 1990's new money bond issues can now be currently refunded at such savings as well. Generally, when long-term rates have fallen by 150 basis points or more after bonds have been issued and where the prior tax-exempt bonds have become currently callable, the savings produced by another refunding will more than offset the call premium and transaction costs, resulting in increased cash flow to the project owner, greater project affordability and/or moneys being made available for needed project repairs or improvements.

6. **"Six month" rule.** Treasury Regulations cause refunding bonds to be treated as new money acquisition bonds (requiring a private activity bond volume allocation and subject to the much more rigorous requirements described under V.A. above) if issued within six months before or after change in ownership of the project. Usually, this result would be a "deal killer," and the refinancing must be carefully coordinated with any change of ownership to avoid applicability of the rule.

C. Use of Tax-Exempt "New Money" Bonds with 4% Low Income Housing Tax Credit.

1. Restricted to private activity bonds issued under Section 142(d) of the Code (described under V.A.1. above). Use of the tax credit is not possible where bonds issued under Section 145 of the Code ("Section 501(c)(3)" issues) or with essential function bonds, since under those sections the project must be entirely owned for tax purposes by the Section 501(c)(3) nonprofit corporation or the public body. On the other hand, a nonprofit corporation can be a partner or joint venturer in an owner of a project financed under Section 142(d), if a private activity bond volume allocation is obtained and the other requirements for such a financing are met. Even though tax-exempt private activity bond volume is increasingly scarce (see V.A.1.d. above), projects applying for the low income housing tax credit often compete very effectively for limited bond volume, since often all or most of the units are targeted toward lower income tenants, as compared to only 20% or 40% for most other private activity issues.

2. Where private activity "new money" bonds under Section 142(d) are combined with the 4% low income housing tax credit, there is:

   a. Good News: No separate allocation of low income housing tax credit is required, as is the case with 9% tax credits. This has recently become a major reason for using tax-exempt bonds under Section 142(d) where the allocation of 9% low income housing tax credit is scarce but private activity bond volume is available. Unfortunately, there is also…

   b. Bad News: The use of tax-exempt bonds reduces the credit from 9% to 4% on the low income units.

3. Section 42 Requirements. Section 42 of the Code imposes numerous additional requirements on the Project in addition to those imposed by Section 142(d) of the Code. Among other things, to obtain 4% low-income housing tax credits under Section 42 not only is the project subject to the same type of 20/50 or 40/60 targeted occupancy as is required under Section 142(d) (**but on a building-by-building basis under Section 42**), but also project **rents are restricted** to 30% of the income restriction chosen. In addition, acquisition credits are available only for existing buildings which satisfy a 10-year holding period and have not

had a qualifying rehabilitation in the last 10 years. Receipt of 4% low-income housing credits based on bond financing without competing in the separate competitive tax credit pool is also dependent upon at least 50% of the aggregate basis of the building and land being financed with the proceeds of the tax-exempt private activity bonds. In some instances, borrowers have successfully structured unrated, privately placed subordinated tax-exempt bonds secured by tax credit equity pay-ins, which, when added to a senior series of rated, credit-enhanced bonds, enables the borrower to pass the 50% test. These bonds are often structured to mature on or immediately after the first day after the project is placed in service.

4. Example of Private Activity Bond/Tax Credit Financing. Appendix A sets forth an example of a hypothetical project financing combining tax-exempt "new money" private activity bonds and 4% low income housing tax credits.

D. **Recent IRS Enforcement Activities Affecting Tax-Exempt Multifamily Housing Bonds**

1. **Random and Targeted Audits.** In late 2001, the IRS announced the commencement of two types of enhanced enforcement activities in the area of tax-exempt multifamily housing bonds: (1) "random audits" of up to 30 multifamily housing bond financings and (2) "targeted audits" when the Service had reason to suspect bond financings may have been closed which do not satisfy one or more tax law requirements.

   a. **Random Audits.** Since early 2000, the Service has begun to notify certain issues of "random" audits of tax-exempt multifamily housing bond issues. In these cases, the Service will check to determine whether various tax law requirements have been satisfied, including whether the borrower is complying with low or moderate income targeting requirements, whether arbitrage restrictions on investment of funds have been satisfied and so forth. Most counsel have taken the position that the Issuer or Borrower is not obligated to file a "material events notice" under Rule 15c2-12 or otherwise advise bondholders of a receipt of a notice of a random audit, unless the notice or subsequent developments indicated a belief on the part of the Service that one or more tax law requirements may not have been satisfied.

   b. **Target Audits – Blind Pools.** Since late 2001, the Service has also announced its intention to audit a number of tax-exempt multifamily housing bond issues when it believes one or more tax law requirements have not been satisfied. Perhaps the ripest area for Service inquiry of this type has been on so-called Section 501(c)(3) "Blind Pool" financings. In these financings, an issuer issues bonds to finance directly or indirectly loans to a number of potential projects which may be potential borrowers of the bond proceeds, but where the specific borrowers are not identified or committed to borrow bond proceeds at the time the bonds are issued. While such pooled financings, in theory, can significantly reduce borrowing costs, especially for small loans, there are at least two tax law requirements which the Service has asserted have not been met in as many as 18 recent blind pool financings for hospitals, multifamily housing projects and other facilities.

(1) **Reasonable Expectations.** First, as a general matter, the Code requires that the issuer have a reasonable expectation at the time the bonds were issued, that the bond proceeds will be expanded for the purpose of the financing within a three-year period beginning when the bonds are issued. Often, such issues are supported by "demand studies" generally indicating it is reasonable to expect this requirement will be met. On several financings of $50 million to $100 million or more challenged by the Service, large bond issues have resulted in only a small percentage of originations during the required three-year period (e.g., 10% to 15%). However, in one instance, the Service has challenged the reasonableness of an issuer's expectations where $66.8 million or 75% of a $87.9 Section 501(c)(3) hospital blind pool financing were disbursed, with only the remaining 25% of bond proceeds being redeemed.

(2) **TEFRA's Requirements.** TEFRA approvals are required, prior to bond issuance, for projects financed with 501(c)(3) bonds, which makes truly "blind" pools difficult. The Service has asserted that a number of these financings utilized so-called "telephone book" TEFRA approvals which, in the view of the Service, do not meet the public notice and hearing requirements set forth in Section 147(a) of the Code (see V.A.1.i. above). In the case of one $100 million Section 501(c)(3) multifamily housing blind pool financing in 2000, for example, the TEFRA notice listed 338 different apartment developments within the jurisdiction of the bond issuer which might be financed with bond proceeds. While there is a significant difference of views among bond counsel firms regarding how specifically the expected use of bond proceeds must be tied to a specific project or projects, the Service has asserted that such notices do not satisfy the public notice and hearing requirements of Section 147(a) of the Code, and, in January of 2003 the Service indicated that it had sent preliminary adverse determination letters to issuers in connection with five large blind pool financings which the Service asserted did not meet these requirements.

Not surprisingly, since these announcements by the Service commenced in late 2001 and 2002, the issuance of blind pool bond issues of these types have been sharply curtailed.

(3) **Section 6700 Audit.** In November, 2002, the Service announced what it believed to be the first Section 6700 audit of a municipal bond financing of what is believed to be a blind pool financing involving facts which the Service considered to be particularly egregious. Section 6700 was developed to allow the Service to impose monetary penalties up to the lesser of 100% of gross income derived or $1,000 per activity on the promoters of

abusive tax shelters. In 1989, Congress amended Section 6700 to make it clear that it could be applied to abusive municipal bond issues. Traditionally, the Service's principal enforcement device has been to force an issuer to enter into a settlement agreement to avoid its bond issue being declared taxable, and issuers have sometimes obtained contributions to such settlements from other participants to avoid potential civil liability following such an event. While the Service has indicated they intend to reserve this enforcement device for only the most egregious cases, and only one such audit has been pursued at this point, this device may give the Service a significant new device to force disgorgement of profits in especially abusive transactions.

V. SECURITIES LAW REQUIREMENTS APPLICABLE TO MULTIFAMILY HOUSING BOND FINANCINGS.

A. **Registration Exemptions.** As a general rule, municipal bonds, including tax-exempt multifamily housing bonds, are exempt from the registration requirements which apply to the issuance of other types of securities under the federal and state securities laws. Thus, a new issuance of tax-exempt and multifamily housing bonds generally is not required to undergo the time-consuming and costly review and registration process with the SEC which is required for most new issues of securities under the federal Securities Act of 1933 (the "1933 Act") and a similar registration process required under the securities (or so-called "Blue Sky") laws of most states before securities can be issued and sold to the public. Of course, the presence of certain types of credit enhancement devises can result in a separate "registerable security" being present in some financings, in which case the bonds are generally sold in a so-called "private placement" or other specific type of transaction which is exempt from these registration requirements due to the limited nature of the offering.

B. **Anti-fraud Provisions.** Notwithstanding the general exempts from registration requirements described above, municipal bonds are subject to the antifraud provisions of Rule 10b-5 ("Rule 10b-5") under the federal Securities and Exchange Act of 1934, as amended (the "1934 Act"), as well as similar antifraud provisions of most states' securities laws.

1. **Rule 10b-5.** Rule 10b-5 states that:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. to employ any device, scheme, or artifice to defraud,

b. to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

c. to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The existence of this provision, as well as similar antifraud provisions of many state securities laws and common law fraud provisions, places on the participants in any offering of municipal securities, including tax-exempt multifamily housing bonds, a responsibility to assure that material aspects of the offering are disclosed in a way that satisfies these requirements.

2. **Materiality.** Under U.S. Supreme Court rulings, a fact is generally considered to be material if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding whether to purchase the security being offered. Stated differently, a fact may be considered material if it would assume actual significance in the deliberations of a reasonable investor or if disclosure of the fact would be viewed by a reasonable investor as significantly altering the "total mix" of information made available with respect to the investment.

3. **Remedies.** As a result of the foregoing antifraud requirements, the Issuer, the Owner, the Credit Enhancer and the other parties involved in a municipal financing, as well as the Underwriter of the bonds, have a significant interest in assuring that the Official Statement or other selling document satisfies these disclosure requirements. The securities laws provide the SEC and state securities commissioners with significant enforcement remedies vis-à-vis Issuers, Owners and the other parties and professionals involved in offerings which violate these antifraud provisions, in addition to imposing significant potential private civil liability on the participants, in the event bondholders suffer losses as a result of offerings which are found to violate these rules.

4. **Disclosure Documents.** The principal disclosures relating to an offering of municipal bonds, including tax-exempt multifamily housing bonds, are usually made principally through on Official Statement, Offering Circular or other document which is usually prepared by the Underwriter and its counsel and is usually signed by the Issuer and/or the Owner for use in the offering of the Bonds. The Official Statement generally provides information on the Issuer, the Owner, the Credit Enhancer and other significant financing participants, on the terms of the Bonds, on the basic security for the Bonds (including any credit enhancement), on the project being financed, on the principal documents (such as the Indenture, Loan or Financing Agreement, Regulatory Agreement, Note and Mortgage or similar documents), as well as the legal opinion, the rating or ratings and other significant aspects of the Bonds. The Underwriters use a "preliminary" form of this document called the Preliminary Official Statement or "POS" in the actual marketing of the bonds. This POS must be deemed "final" by an "issuer," which may be the developer and/or the issuer of the bonds, except for "pricing" information, as further discussed in VI.C. below. After the Bonds are priced, a "final" Official Statement is prepared, which includes the interest rates on the Bonds and other pricing information and which is required to be delivered to Bondholders who purchase the Bonds.

5. **Opinions and Certificates.** As a result of the potential liabilities under the antifraud provisions, the different parties to these financings who supply

information for the Official Statement will normally be asked to give comfort to the Underwriters and other parties that the sections of the Official Statement for which they are responsible satisfy these requirements. This comfort normally takes the form of certificates and/or legal opinions, the forms of which are normally attached to or described in the Bond Purchase Agreement which is signed by the Issuer, the Underwriter and sometimes the Owner immediately following the marketing of the Bonds.

6. **Effect of Credit Enhancement.** Many tax-exempt multifamily housing bond issues are credit-enhanced (as is further discussed in VI. Below), and on such issues bondholders look primarily to the credit-enhancement as the source for repayment of their bonds. As a result, for a number of years, many in the industry felt that little information was required to be included in the Official Statement on the project or the Owner. In recent years, the SEC has stated its view that, notwithstanding the presence of credit-enhancement, all parties have an obligation to assure that disclosures be made of all material aspects of the financing, including the project and its Owner. As a result, almost all Official Statements on tax-exempt multifamily housing bond offerings will now include at least a basic description of the Owner, its principals (e.g., its principal officers, directors, partners or principals of the Owner) and their prior experience in the development, construction, ownership and/or management of multifamily housing. Similar descriptions will typically be included for the Project's managing agent and, in the case of new construction or acquisition/rehabilitation financings, for the architect(s) and the contractor. Background information is also generally given for the lender or servicer, if any, and for the bond trustee. In addition, almost all such Official Statements will include a brief physical description of the project (including location, age (if existing), number and type of units and related amenities (e.g., parking, pools, laundry facilities) as well as three or more years summary of historical operating data for the project (to the extent available for existing projects). In offerings involving more than two or three projects, much more limited data is often provided on the owners (and related private participants) and on the projects.

C. **Rule 15c2-12 – Primary Offerings.** In 1989, the SEC expanded its regulation of municipal securities business through the adoption of Rule 15c2-12 under the 1934 Act. As originally adopted, Rule 15c2-12 imposed an obligation on any underwriter participating in a primary offering of municipal securities, before bidding for, purchasing, offering or selling the securities, to obtain and review an official statement that one or more "issuers" of the securities deemed "final" as of its date, except for various items dependent upon the pricing of the bond issue. The adoption of this Rule ended a frequent practice of underwriters' marketing bonds through the use of Preliminary Official Statements which contained numerous blanks when the bonds were offered for sale to the public or which were often substantially rewritten and revised before the Final Official Statement was prepared and delivered to buyers. In addition, Rule 15c2-12 requires the participating underwriter to contract with the issuer to receive a Final Official Statement within seven business days after signing a bond purchase agreement or other final agreement to purchaser, offer or sell the securities, to assure that final Official Statements will be available for timely delivery to Bond purchasers. The Rule also imposed obligations on the Underwriters to update information in the Official Statement for a certain period of time following an offering covered by the Rule. The primary exception to the Rule is an exemption for variable rate bonds which have a maturity of nine months or less or which are subject to being tendered by the issuer within nine months or less, and which are issued in large denominations of $100,000 or more (i.e., most variable rate tax-exempt multifamily housing bonds).

The adoption of Rule 15c2-12 went a long way to providing for reliable disclosure in Preliminary Official Statements used in initial offerings of securities in the municipal marketplace. However, as a result of the Rule, the Underwriter will generally ask various "issuers" of the obligations which secure the bond issue (i.e., the Issuer, the Owner and/or the Credit Enhancer), to "deem the Preliminary Official Statement final" within the meaning of Rule 15c2-12 before it is used for the offering of bonds to prospective investors. This is often done through so-called Rule 15c2-12 certificates, or in a bond resolution or ordinance passed by the issuer.

D. **Rule 15c2-12 – Continuing Disclosure.** While the foregoing provisions greatly improved the quality of disclosure in initial bond offerings, the SEC continued to be concerned that little information is available to investors when bonds are offered or sold in the secondary market after the initial offering was ended. To improve the information available for such secondary trades, Rule 15c2-12 was amended in 1995 to impose "continuing disclosure" obligations in connection with municipal bond issues covered by the Rule. The amendment to the Rule prohibits an Underwriter from purchasing or selling bonds unless the Underwriter has reasonably determined that the Issuer of the securities or another obligated person for whom financial operating data presented in the Final Official Statement (such as the Owner in the case of a conduit financing), has signed an agreement to provide to certain nationally recognized municipal securities information repositories ("NRMSIRs") and any designated state depository "…annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement." In most tax-exempt multifamily housing bond offerings, this will require the Owner to agree to provide annual updates on any financial information regarding the project or the Owner to be included in the final Official Statement and to provide copies of any annual financial statements (which need not be audited unless audited statements are otherwise available) to the NRMSIRs and state repositories.

In addition, the Owner will typically be required to provide in a timely manner to such repositories notice of any of the following events with respect to the securities being offered in the offering, if material:

(1) Principal and interest payment delinquency;

(2) Non-payment related defaults;

(3) Unscheduled withdrawals from debt service reserves reflecting financial difficulties;

(4) Unscheduled withdrawals from credit enhancements reflecting financial difficulties;

(5) Substitution of credit or liquidity providers or their failure to perform;

(6) Adverse tax opinions or events affecting the tax-exempt status of the securities;

(7) Modifications to rights of security holders;

(8) Bond calls;

(9) Defeasances;

(10) Release, substitution or sale of property securing repayment of the securities; and

(11) Rating changes.

In conduit financings, the obligation to supply this continuing information is generally imposed on the Owner through the form of a Continuing Disclosure Agreement which the Owner will be asked to enter into with the Issuer and/or the Trustee. Because of the limited nature of the information required, most Owners have concluded that these requirements do not impose major new burdens in connection with these types of financings; however, Owners must now assure that they have put in place mechanisms to assure these requirements will be satisfied on an ongoing basis, after the closing of a tax-exempt multifamily housing bond issue subject to the Rule.

VI. ALTERNATIVE FINANCING STRUCTURES.

A. **General.** Numerous financing structures are used in tax-exempt multifamily housing bond issues. Most have credit enhancement of some type (see II.H. above); however, some issues may have one or more series which are rated (usually "BBB" or "A;" the lowest two tiers of "investment grade"), based on project cash flows and/or loan-to-value. Noncredit-enhanced issues or series are also sometimes sold without a rating in large minimum denominations to sophisticated individual or institutional investors, where an issuer is willing to have its bonds placed on this basis. Often, a "senior/sub" structure is used in these situations where payment of debt service on one series (usually "Series A") is made in full before any debt service is paid on the subordinated series (usually "Series B" or "Series C").

B. **"Taxable Tails."** Federal tax law prohibits more than 2% of the proceeds of any tax-exempt multifamily issue (other than "essential function bonds") being used to pay underwriting discount and costs of issuance (such as fees and expenses of the financing participants described under II. Above, other than credit enhancement fees which are not subject to this limitation). Since these costs typically exceed 2%, a small portion of many issues is separately identified as a separate series (often "Series A-T" or "Series B"), and is sold on a taxable basis – i.e., a so-called "taxable tail." These bonds usually (but not always) are covered by any credit enhancement and may be retired before the tax-exempt bonds (causing one prominent tax lawyer to refer to this series as a "taxable nose"). Because the separate taxable series is so small, it has little adverse impact on the overall interest rate achieved by the financing.

C. **Fixed-Rate Versus Variable-Rate Financings.**

1. **General.** The tax-exempt yield curve almost always is significantly "upward sloping" – that is, interest rates are lower for shorter maturities than for longer maturities, especially for the first 10 years (after which the curve "flattens" substantially). As noted above, under recent conditions, rates for AAA rated multifamily housing bonds have ranged from as low as 1-2% for 7-day demand

"lower floater" bonds, which can be tendered by the holder back to the issuer on one week's notice, up to around 5.0% or slightly higher for 30-to-40 year tax-exempt multifamily housing bonds. In many markets in recent years, this differential between short and long-term tax-exempt rates has been 300 basis points to even 400 basis points or so.

2. **Variable Rate Financings.** Since the tax-exempt yield curve is almost always "upward sloping," some borrowers prefer to use short term variable rate financings to achieve the lowest financing rate over time. Of course, this carries with it the risk of interest rates rising above the level which project cash flow will support. For this reason, not all credit enhancers will provide credit enhancement for variable rate bonds, and many of those who do require the developer to purchase an interest rate "cap" or enter into "swap" for at least the first five to seven years of the financing, and that the borrower annually escrows a pro rata portion of the estimated cost of purchasing a successor cap or swap.

3. **Fixed-Rate Financings.** To avoid the risk of resetting interest rates, many developers and credit enhancers prefer a "fixed-rate" structure, where the interest rate or rates on the bonds are fixed for the entire life of the issue.

4. **Comparison; Blended Structures.** The most conservative financing structure, albeit the one which produces generally the highest rates, is a level amortizing fixed-rate financing with a final maturity of 30 to 40 years, such as much of FHA and Ginnie Mae and some Fannie Mae and Freddie Mac backed tax-exempt multifamily housing bond financings. The most aggressive, generally lowest rate financing structure is a seven-day or even daily floating rate financing, with no interest rate swap or cap. There are numerous alternatives in between, with the range being more or less as follows:

    a. Daily or seven-day demand lower floaters.

    b. "Put bonds," where the interest rate is set for a fixed number of years (e.g., one, five, seven or 10, after which, as noted above, the yield curve becomes rather "flat"), with a mandatory tender and remarketing of the bonds at the end of the initial fixed-rate marketing period. On some new money private activity bond issues under Section 142(d), the interest rate may be fixed to a mandatory tender date after the end of the 15-year tax credit compliance period under Section 42 (e.g., 18 to 21 years), with a remarketing of the Bonds to maturity contemplated at that time.

    c. Long term fixed-rate financings, with maturities of 10 to 15 years in the case of some refundings or from 25 up to 30 or 40 years, plus a construction period, in the case of most "new money" financings.

Some variable rate financings allow the Owner, with the consent of the credit enhancer, to shift among any number of these modes (e.g., seven-day floating, monthly, quarterly, yearly, reset (longer than one year but less than maturity) and fixed (remarketing to maturity).

Almost all variable rate financings have some form of "liquidity" built in, which provides the Bond Trustee with a source of cash to repurchase Bonds from tendering bondholders if the bonds cannot be remarketed by the remarketing agent at rates which the project can support. This liquidity may be provided by the credit enhancer, or may be a separate letter of credit or other facility provided by another bank or other institution. Liquidity providers charge separate fees (over and above credit enhancement), but these fees and the remarketing fees associated with variable rate financing are generally more than offset by the lower interest rates they produce under most market conditions in the recent past.

A major role of the Underwriter in a tax-exempt multifamily housing bond financing is to assist the Owner in selecting the financing structure and credit enhancement (if any) most appropriate for his project.

Appendix A

Sample Financing Combining "New Money" Tax-Exempt Private Activity Bond Financing Under Section 142(d) With "4%" Low Income Housing Tax Credits.

To demonstrate the potential appeal of using tax-exempt multifamily housing bond financing, let's assume a hypothetical financing combining the use of tax-exempt "new money" private activity bond financing under Section 142(d) of the Code with "4%" low income housing tax credits.[5] In our example, we are assuming that a developer has obtained control of a site and has developed general plans to construct a new 200-unit multifamily residential rental housing facility targeted to persons of lower income (i.e., not greater than 60% of area median income, adjusted for family size) at a total project cost of $75,000 per unit or $15 million. Of the total cost, $10 million represents construction costs, $3.5 million is the cost of the land and $1.5 million is the cost of development fees, financing fees and other "soft" costs.

Preliminary Steps; Major Participants

Before incurring substantial expenditures, the owner selects an investment banking firm experienced in tax-exempt multifamily housing bond finance. Together they identify the Issuer, determine the likely availability of a private activity bond volume allocation for that project through the Issuer, identify the Issuer's charges and any special Issuer regulatory requirements and obtain the passage by the Issuer of an "official action" resolution confirming the issuer's general intent to provide tax-exempt bond financing for the project.

At the same time, the investment banker works with the owner to identify the financing structure (fixed-rate or variable; level amortization or amortization to a "balloon" and so forth) and the credit enhancement program (e.g., FHA insurance with a GNMA "wrap," FNMA "DUS" or Freddie Mac "program plus" loan, bank letter of credit or municipal bond insurance) which fits the proposed project type, the project's projected operations and the owner's particular financial goals and objectives.

The owner also engages a firm specializing in providing tax credit equity financing to review the financial plan for the syndication of "4%" tax credits for all of the units in the project, since all units in our example (but not in all cases) will meet the eligibility requirements for such tax credits. Basically, these requirements are the same as the low or moderate income targeting requirements for new money private activity bonds described in Section IV.A.1. of the attached memo, but with an added cap on rents equal to 30% of 60% of area median income, adjusted for family size.

Finally, if the owner has selected a credit enhancer for the bonds which does not take construction and rent-up risk (FHA and most banks do; Fannie Mae, Freddie Mac, and most bond insurers generally do not), arrangements are made with a construction phase credit enhancer (often the owner's bank) which will provide a facility (often cash or a letter of credit) which the credit enhancer for the Bonds may draw upon if a project default occurs before the project reaches stabilized occupancy (e.g., 90 days at 1.25 debt service coverage) and other permanent financing (or "conversion") requirements imposed by the permanent lender and Bond credit enhancer.

[5] As is the case with the aspects of this memorandum describing the rules applicable to tax-exempt housing bond finance, the description of the low income housing tax credit program set forth herein is intended only to be the most general description of certain aspects of that program. Readers are referred to the many excellent materials and professionals dealing specifically with that program for a more accurate and comprehensive description of the program.

General Financing Plan

After detailed discussion with the foregoing parties, the owner develops the following financing plan:

Sources	
Tax-Exempt Bond Proceeds	$11,000,000
4% Tax Credit Equity	3,312,000
Subordinated Loan from City	500,000
Other Equity	188,000
Total:	**$15,000,000**

Uses	
Land	$ 3,500,000
Construction Costs	10,000,000
Financing Fees	500,000
Other "Soft" Costs	1,000,000
Total:	**$15,000,000**

Tax-Exempt Loan Underwriting

Almost all credit enhancers will determine the maximum loan on the Project they are willing to credit enhance by applying several underwriting tests. These tests typically include minimum debt service coverage ("DSC") test (e.g., debt service coverage of at least 1.25:1) and a maximum loan-to-value ("LTV") test and/or loan-to-cost ("LTC") test (e.g., a maximum loan-to-value ratio of 80%). "Value" in a loan-to-value test is often determined by an appraisal, which will often project the project's value based on analyses of (i) the project's cost, (ii) discounted projected project cash flow and residuals, and (iii) analysis of market "comparables" based on recent sales prices of other similar projects in the general market area. The credit enhancer will typically agree to credit enhance a loan no larger than the smallest loan produced by the different underwriting tests applied. Different types of credit enhancers differ on their requirements in this area, with FHA being generally more "lenient" in its requirements for projects meeting its program requirements (DSC as low as 1.12 to 1.15 and LTC as high as 90%+); Fannie Mae and Freddie Mac often being "in the middle" (with DSC's often in the neighborhood of at least 1.20 and LTV's no greater than 75% to 85%) and bond insurers being the most conservative (with DSC's of 1.35 to 1.40 or higher and LTV's no greater than 65% to 70%).

In our example, we will assume that the Bond credit enhancer has applied the debt service coverage ("DSC") test to underwrite the project loan as follows: The credit enhancer estimates annual monthly project revenues after achievement of stabilized occupancy at $2,097,600 ($950 per month x 200 units x 12 months x 92% occupancy) plus an additional 3% ($63,000) for laundry and other miscellaneous revenue, or total revenues of $2,160,600. A detailed analysis indicates that projected annual operating expenses will run approximately 40% of gross revenues or $864,240, which, together with a $50.00/unit/month deposit to a replacement reserve and other reserve accounts (i.e., $180,000 per year), will amount to an annual cash requirement, before financing costs, of $1,044,240, leaving $1,116,360 available to cover debt service (plus related ongoing fees and expenses) on the Bonds and any other Project debt as well as equity return to the Owner.

Let's now assume that the loan, like the Bonds issued to finance the Project, will be a level amortization obligation with interest only payable for a 30-month construction and rent-up period and level payments of principal and interest for 30 years (360 months) thereafter. Credit enhancement and loan servicing fees are 100 basis points per year and other ongoing fees (i.e., fees of the bond issuer, the trustee and dissemination agent, the rebate monitor and other such fees) total 25 basis points per year. The Underwriter estimates that the Bonds will need to bear a 5.75% coupon to achieve a "par" sale in the current market. Thus, the Project must bear an annual interest obligation of about 7.0%.

Let's now assume that the credit enhancer will not credit enhance a loan greater than that which will produce a debt service coverage of at least 1.25:1. Since we know that we have cash flow available to pay debt service of $1,116,360, at a 1.25:1 debt service coverage, we will calculate cash available to service the loan as follows:

C = Cash Available for loan debt service

$$\frac{1.25}{1} = \frac{1{,}116{,}360}{C}$$

1.25C = $1,116,360

C = $ 893,088

Using a calculator, we could then calculate the maximum loan size roughly as follows:

n	=	Number of months	=	360
i	=	7.00% / 12	=	.583333
Pmt	=	$893,088 / 12	=	$74,424
PV	=	$11,186,495; or about $11,000,000		

Assuming the credit enhancer's loan-to-value or loan-to-cost underwriting has produced a loan of $11,000,000 or greater, our assumed loan size will be $11,000,000. If those tests had produced a smaller loan size, the result, as noted above, would generally govern the maximum amount of the loan.

4% Tax Credit Equity

In our example, we assume the owner can raise $3,312,000 by selling limited partnership interests passing through "4%" low income housing tax credits to corporations who can offset future tax liability by the amount of the credit. In general terms, the tax credit partner(s) will be entitled to a tax credit equal to approximately 3.6% of the "tax credit basis" of the property (very generally, total costs less land) over a 10-year period. In our example, this is 3.6% x $11,500,000, or $414,000 per year for ten years, or $4,140,000. Note that this is a credit against tax, which is a dollar-for-dollar offset of tax liability, as compared to a tax deduction (the value of which is less and depends on the taxpayer's tax bracket and other factors). Taking into account the time value of money and compliance risk, as well as the magnitude and timing of passive activity losses allocated to the tax credit investor, we assume the tax credit partner will pay the owner about 80¢ per $1.00 (or $3,312,000) for these credits. Of course, in many low-income housing tax-credit transactions, the tax-credit limited partner may also be entitled to receive some percentage of projected cash flows and/or residuals, but these are generally allocated periodically to the general partner(s).

Subordinated Debt Financing

Subordinated debt financing may be available for projects financed with tax-exempt bonds, especially projects like many 4% tax credit transactions, which may be 100% "affordable." In many cases, cities or counties in which the project is located may have HUD moneys (enterprise zone funds, Hope VI funds or other moneys) or state funds (such as low or moderate income tax increment set-aside funds in California), which they will make available on a grant or subordinate loan basis to provide financing for this type of project. Terms of such financings generally provide for payment of no interest or a nominal (e.g., 3%) rate of interest and often no or low amortization of principal, especially during the early stage (e.g., first 5-10 years) of the financing. Prepayment of principal may be forgiven under some programs over time if low income occupancy and any applicable rent restriction and other requirements are maintained. Subordinated debt is either secured by a **subordinated** deed of trust on the property or no deed of trust. It may also be possible for the underwriter to structure and sell unrated subordinated bonds on a tax-exempt or taxable basis to provide additional project financing, although issuers will generally impose limitations on such debt to limit their exposure (e.g., $100,000 minimum denominations, sales only to sophisticated or institutional investors, limits on transferability). It is important to note that almost all credit enhancers will also place strict limits on subordinated debt, including some limitations on the enforcement remedies available to the holders of such debt while the credit-enhanced senior debt remains outstanding. Some credit enhancers also place limits on the percentage of cash flow after payments on the senior debt which can be pledged to repay subordinated debt (e.g., no more than 75% of such free cash flow), so as to leave the owner with at least some projected current cash flow as an incentive to continue to operate the project efficiently.

Other Equity

Finally, unlike the early to mid-1980's, when little or no non-tax oriented cash equity was put into many projects, many projects financed in the 1990's do have some degree of real cash equity provided by the sponsor. Many credit enhancers and/or tax credit syndicators require the presence of some "hard" cash equity as a condition to their participation in the project. The resurgence of REITs and other such vehicles for the raising of equity capital for real estate in the 1990's has resulted in an increased level of equity funding being available for many projects.

Appendix B

Sample Section 501(c)(3) and Essential Function Bond Financings – Closing the Equity Gap

Since 4% low income housing tax credit equity is not available in Section 501(c)(3) or "essential function" bond financings, these types of transactions may suffer significant disadvantages in generating sufficient proceeds to cover total project costs. Most credit enhancers will impose debt service coverage ("DSC") and loan-to-value ("LTV") tests which will effectively limit the amount of financing obtainable through the credit-enhanced tax-exempt bonds on the transaction to 80% or 90% of total project costs. In some cases, nonprofit or public borrowers may receive larger loans or other more lenient loan terms than profit-motivated borrowers receive. For example, under certain FHA insurance programs, a publicly controlled nonprofit mortgagor, as well as a Section 501(c)(3) corporation, may be entitled to mortgage loan financing which will cover as much as 98% of replacement cost. In addition, Fannie Mae may waive certain restrictions on subordinated debt where the mortgagor is a nonprofit or public borrower.

In both Section 501(c)(3) and essential function bond financings, creative strategies have been devised to provide other means of closing this equity financing gap,. These often involve the use of grants from HUD or other federal, state or local sources, or subordinated loans from such sources, which are much more likely to be available if the owner of the facility in question is a Section 501(c)(3) corporation or, in the case of an essential function or governmental purpose financing, a public body or controlled subsidiary. For example, in California, redevelopment agencies are required to set aside a certain percentage of their tax increment revenues to provide housing for persons of low or moderate income, or else lose those tax increment revenues to the state. While political and other considerations may bar the granting of these monies to profit-motivated sponsors or the lending of them to profit-motivated entities at below-market rates, such issues are much less likely to become major obstacles where the owner of the project being financed is a Section 501(c)(3) nonprofit corporation or a public body providing affordable housing for citizens of the community.

Finally, it is not unusual for investment bankers to structure one or more series of subordinated tax-exempt bonds which may be sold to cover the fees of various private participants involved in the financing, or which may be delivered to the seller of a property, or to participating private participants in lieu of cash consideration for the property provided or services rendered. In each of these cases, counsel will carefully test to see that the above guidelines of reasonableness of compensation and true ownership by the Section 501(c)(3) nonprofit or public entity owner have not been violated, but such devices are frequently used to close the financing gap which would otherwise apply to these deals.

Sample Financings Using Subordinated Bonds

Example 1

For simplicity, let's assume total costs of such a financing (hard costs and soft costs) are $10.0 million. A hypothetical source of funds on such a financing might be as follows:

Series A Credit-Enhanced, Rated Senior Tax-Exempt Bonds ($5,000 minimum denominations, publicly offered; first lien; 1.20:1 DSC; 80% LTV)	$ 7,500,000
Series B Noncredit-Enhanced, Unrated Subordinate Tax-Exempt Current Interest Bonds ($100,000 minimum denominations, institutionally placed; second lien; 1.10 to 1.15:1 DSC; 85-90% LTV)	$ 1,500,000
Series C Noncredit-Enhanced, Unrated Junior Subordinated Tax-Exempt Compound Interest Bonds ($250,000 minimum denominations or single bond, institutionally placed; third lien; 1.05:1 DSC; 95% or greater LTV) – ("Seller Take-back" or "Fee for Services" Bonds)	$ 600,000
State or City (Fourth lien) Loan or Grant	$ 400,000
Total	$10,000,000

Example 2

In recent years, selling fixed-rate subordinated bonds on Section 501(c)(3) or Essential Function Bonds has become very difficult. Whereas the Series B Bonds described in Example 1 may have been marketable at a coupon of 8% in early 2000, more recently such yields have often been insufficient for marketing these bonds, even if the project seller or developer were willing to take back Series C Bonds of the type described above at tax-exempt yields of 10-12%. In order to address this problem, some financings have incorporated variable rate financings on the Series A Bonds, combined with imbedding an "inverse floater" on the Series B Bonds to enhance their projected yield. An example of such a financing might be as follows:

Senior Series A Fannie Mae Credit-Enhanced, Rated Variable Rate Tax-Exempt Bonds; $100,000 minimum denominations; first lien, 1.25 DSC, 85% LTV[6]	$ 7,000,000
Junior Series B Nonrated Noncredited Tax-Exempt Bonds with embedded inverse floater (i.e., assume These bonds receive a 7.0% rate at which this project loan was underwritten as described below, plus the incremental coupon left over on the $7.0 million of Series A Bonds (the 200 basis points difference between the actual borrowing cost and the Fannie Mae Underwriting Rate) = $140,000 additional yield on $2.0 million of B Bonds = 7% extra yield = Total 14% Projected Yield at a 3.75% rate on the Series A Bonds.	$ 2,000,000

[6] If we assume that Fannie Mae is the credit enhancer on the Series A bonds, the underwriting rate would be established basically as follows:

3.75%	Floating Rate on Bonds (Estimated Current Rate)
0.85	Credit Enhancement and Servicing Fee (Fannie Mae/DUS Lender)
0.15	Liquidity (Fannie Mae)
0.125	Remarketing
0.125	Issuer Fee
0.050	Trustee/Dissemination Fee
<u>0.10</u>	Escrow for 5-Yr. Cap (BMA + 300 Basis Points = 6.75% Strike Rate for Cap)
5.15%	All in actual borrowing cost at current floating rates
<u>2.00</u>	Spread to BMA required by Fannie Mae for underwriting loan
7.15%	Fannie Mae Underwriting Rate

Of course, if the rate on the Series A Bonds moves up from 3.75% to 4.75%, as has been the case for brief periods in the recent past, the yield on the Series A Bonds would fall to 10.5%.)		
Third Tier Capital Appreciation Bonds (generally payable out of back-end cash flow, which Credit Enhancer for Series A bonds won't underwrite) ("Seller Take Back" or "Developer Fee Bonds")		$ 750,000
Other Subordinated Loan or Other Funds		$ 250,000
	TOTAL:	$10,000,000

Even more advanced models have been used in some recent Section 501(c)(3) and essential function bond financings, incorporating graduated mechanisms and other techniques to maximize the proceeds available from the cash flow. Whenever these techniques are proposed, it is important to assure that such bonds can be placed with a seller (in lieu of a competitive purchase price), the developer (in lieu of competitive developer fees) or other buyers who understand and can evaluate and are willing to assume the risk of such obligations. Where these factors are present, Section 501(c)(3) or essential function bond financings may be quite feasible; where these factors are not present, absent major subordinate funding from some public or other source, Section 501(c)(3) or essential function bond financings may often prove to be infeasible.

<u>Generating Additional Proceeds Through Sale of Premium Bonds</u>

Another technique to raise additional funds and close the equity gap which has been used successfully over the past several years in Section 501(c)(3) and Essential Function Bond financings, has been the sale of credit-enhanced, highly rated Series A Bonds at initial offering premiums. While the market shunned premium offerings of multifamily housing bonds for over a decade following the large number of loan defaults and extraordinary bond redemptions which occurred in the late 1908's and early 1990's, this reluctance to purchase premium bonds has now begun to abate. As a result, in some instances investment banking firms have been able to sell long-term, AAA-rated, credit-enhanced fixed-rate bonds in Section 501(c)(3) or essential function bonds at premiums of 8 to 10% or even higher to provide additional funds. Many of these offerings have occurred in connection with Bond issues backed by FHA insured loans and/or GNMA wraps. HUD has become concerned that such offerings may bear interest rates higher than necessary to achieve reasonable financing goals and may place some limitations on this financing technique in the future.