Preserving Affordable Housing In Massachusetts With Private Activity Bonds And 4% Tax Credits

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Introduction:

Massachusetts has done an excellent job maintaining the affordability of its existing private affordable housing stock thanks in part to a solid commitment from state and local government. With significant public support, the state has preserved over 6,000 affordable housing units in the past 2 years. In 2013, Massachusetts state resources were used to refinance and extend the affordability of 3,260 affordable apartments. In 2014, 3,218 units were preserved as affordable. [1] During the same 2 year period an average of just 402 units annually converted to market rate and were "lost" as affordable housing. Unlike public housing owned by governmental agencies, this stock of private affordable housing has a for-profit or nonprofit owner which has received some form of government assistance in exchange for keeping rents at the project at levels that lower income renters can afford.

Two closely linked funding programs were particularly important to this success. During the last two years over 70% of affordable units were funded or "preserved" though a pair of housing programs known as private activity bonds ("PABs") and 4% affordable housing tax credits ("4% credits"). PABs are one type of tax exempt debt issued by state or local government. Unlike most other forms of tax exempt bonds issued to fund roads, buildings, or provide other government infrastructure, no government agency promises to repay PABs. Instead income from the activity financed is the repayment source for the bonds. Typical PAB programs include single family mortgages, student loans, industrial development, and multifamily affordable rental housing.

The 4% credit is one of two versions of the Low Income Housing Tax Credit, and combined with its sibling the 9% credit, represents by far the largest federal source of funding for affordable rental housing development and rehabilitation. Together PABs and 4% credits have been the unsung heroes for the preservation of this crucial housing stock, often providing new equity of $40,000 to $75,000 per apartment as well as inexpensive mortgage financing. The preservation success in the Bay State has had several parents, especially the quasi-public housing agencies MassHousing and MassDevelopment, which together administer the program, on behalf of the state Department of Housing and Community Development, the official state housing credit agency. In addition the Massachusetts Executive Office of Administration and Finance makes the important decision to award a major portion of the state's annual tax exempt debt allocation to multifamily housing.

This paper will provide information on recent preservation efforts in Massachusetts, and a basic understanding of PABs and 4% housing credits for affordable rental housing. It will conclude with a look at the potential challenges to this crucial housing preservation funding tool.

[1] These totals do not include over 5,000 units preserved through long term Section 8 renewals and other HUD funding without state resources.

Description of the Funding Programs

Private Activity Bonds and 4% Housing Tax Credits are both considered “tax expenditures”, government programs that provide public benefits through the federal tax code. Like many other tax expenditures they represent public spending for a specific purpose, but instead of being direct appropriations by the government, they provide tax benefits that incentivize specific activities. Both PABs and 4% credits are longstanding carefully designed programs that arguably provide public benefits more effectively than could be provided through appropriations.

Private Activity Bonds

PAB’s represent one tiny slice of the overall market for tax exempt bonds which is estimated to total $3.6 trillion dollars annually. The vast majority of this tax exempt debt is in the form of general obligation bonds issued by an entity of local, county or state government where a government agency pledges its full faith and credit for the repayment of the bonds. PABs differ from general obligation bonds in that no government agency is making a promise to repay the debt. Instead, the project being financed, such as a manufacturing plant or rental housing complex, will generate the cash flow to repay the debt, and buyers of the bonds or an intermediary must underwrite the cash flow stream provided by the project being financed. In order to promote these private activities that are seen to benefit the public, each state has a private activity “volume cap” of bonds that can be issued each year. Total volume cap nationally in 2015 is about $35 billion and is essentially allocated among the states (including Washington D.C. and Puerto Rico) based on their population. In 2015, the volume cap for most states is equal to $100 per capita, with 21 smaller population states receiving a minimum of $301.5 million. Individual states decide on the specific uses of the volume cap which typically include single family housing, multifamily affordable rental housing, student loans, and industrial development.[2] Most states do not use their entire volume cap each year, however, and in 2013 the total dollar amount of PAB issued was $8.8 billion, or just 27% of the total volume cap allocated to the states that year.[3]

Purchasers of all forms of tax exempt bonds, including PABs, receive a tax benefit from the government in that the interest received from the bonds is not counted as income on their federal tax return. Most tax exempt bonds are also exempt from state income taxes. As would be expected, the tax savings that bond purchasers receive generally allow the interest rates on these bonds to be priced lower than comparable taxable debt, a benefit to the rental housing or other private activity being financed.

Affordable rental housing is one of the larger uses of PABs accounting for just over half of the total PAB issuance in 2013.[4] It is unique among the uses for PABs in that it also confers an important source of equity that can be used for the project – 4% tax credits. For housing, the economic benefit of the federal tax credit equity dwarfs the impact of the interest rate benefit of the PABs.

Massachusetts is one of the largest issuers of PABs, and has been willing to devote the majority of this volume cap to multifamily housing. In 2013, Massachusetts was the third largest issuer of PAB bonds for housing (though it has only the 14th largest population and volume cap allocation) and allocated $490

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[2] Some types of private activity can be financed with bonds outside volume cap. Examples include airports, veterans mortgage bonds, and nonprofit 501(c)(3) bonds.

[3] Council of Development Finance Agencies, *CDFA Annual Volume Cap Report*, July 2014, p. 2. http://www.cdfa.net/cdfa/cdfaweb.nsf/ord/2014volumecapreport.html/$file/CDFA%20Annual%20VC%20Report%20for%202013.pdf [hereafter “CDFA”]. The 2013 numbers are the most current national numbers as of July 2015, though more recent statistics will be presented for Massachusetts.

[4] CDFA, p. 8.

million in bond cap for multifamily housing, divided between MassHousing and MassDevelopment. In 2014, the state allocated $305.3 million. Massachusetts has budgeted $324.5 in volume cap for multifamily housing in 2015, with $114.5 million for MassHousing and $210 million for MassDevelopment.

Multifamily bond transactions are extremely complex, involving a number of different actors. In addition to the public agency that issues the bonds, the owner of the rental housing and the investors that purchase the bonds, transactions typically also include an underwriter, a credit enhancer, and a trustee. Due to the number of parties (and lawyers) involved, housing transactions using PABs work best when the loan size is at least $5 million.

Another complexity with PABs for multifamily housing involves various arcane rules that go along with the tax exempt nature of the debt. Below are three examples of specific PAB rules that do not otherwise apply to typical affordable rental housing

- 50% Test. This rule requires that at some point in the transaction at least 50% of the "aggregate basis" (essentially the development cost) of the project is financed by PABs. Many affordable rental projects cannot support large amortizing mortgages, so PABs are often used as construction debt to meet the 50% test, and then paid down with 4% credit equity and other sources after the 50% test has been satisfied.
- 95/5 Rule. At least 95% of bond proceeds must be used for "good costs" (i.e. land and depreciable costs) and no more than 5% of bond proceeds can be used for "bad costs" such as bond issuance costs, underwriting, loan origination fees, marketing costs, and other intangible assets.
- Substantial User Rule. The IRS has rules that govern when an entity (typically a corporation) is a substantial user. This is most commonly an issue when a financial institution involved in the bonds also wants to be an investor in the 4% credits.[5]

4% Low Income Housing Tax Credits

The 4% housing credit along with its larger sibling the 9% housing credit are the two different forms of the Low Income Housing Tax Credit (which I will refer together as "LIHTC") and represent by far the largest affordable rental housing development financing program in the country. Since it was was established in the Tax Reform Act of 1986, the LIHTC has financed over 2.4 million affordable rental apartments, averaging roughly 105,000 units per year.[6]

LIHTC is a dollar for dollar tax credit and is therefore much more valuable than a tax deduction. The rules of LIHTC generally mean that the tax credit is most valuable to large corporations. However, the credit is only allowable for the owner of a LIHTC financed housing project, so project sponsors must partner with investors in the ownership of the rental housing project. Since tax credit investors only are interested in preserving the stream of their credits, their incentive is only to see that the sponsor not place their tax credits at risk if the IRS were to audit the property.

This method of involving the private sector with IRS oversight has worked very well. Foreclosure rates for all forms of LIHTC housing are extremely low, and the program after almost 30 years of existence is generally considered quite successful.

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[5] A good primer on PAB issues can be found here: Dan Smith, *Tax-exempt Housing Bond Basics*, Novogradac and Company, http://www.ipedconference.com/powerpoints/Tax-Exempt_Housing_Bond_Basics.pdf .

[6] HUDUSER, LIHTC Dataset web page, http://www.huduser.org/portal/datasets/lihtc.html .

The LIHTC has two distinct flavors which the housing industry has universally come to call the '9% credit' and the '4% credit'. The 9% credit is by far the bigger program and finances the vast majority of LIHTC housing. Each state receives an allocation of 9% credits each year that it in turn awards to housing developers according to its "Qualified Allocation Plan." The competition for 9% credits tends to be intense as this is the only governmental program in most states that can finance new construction projects of more than 15 or so apartments. The amount of tax credits for which a project qualifies is capped by the amount the project is eligible to receive (based on a complicated 'basis' calculation) as well as by the amount of credit that the state is willing to devote to a specific project.

The 4% credit, though much smaller than the 9% credit, still has a very important role to play in housing preservation. Unlike the extremely competitive 9% credit, all developers of eligible rental housing using PABs are eligible for 4% credits. And there is no official limit to the amount of 4% credit that a state may issue per year, only on the PAB volume cap. In almost all jurisdictions there is sufficient PAB volume cap such that the combination of PAB's and 4% credits is not a competitive resource.

There is a reason, however, that developers are not flocking to construct housing with PABs and 4% credits. Although 4% credits are much more available and less competitive, they provide less than half as much credit (and therefore equity) per housing unit. This means that 4% credits do not work well for new construction. Renovating existing housing is significantly less expensive than new construction as the housing already exists and is occupied. Often the new 4% credit equity along with a new tax exempt mortgage is sufficient to finance the renovation of the property without the need for additional scarce public capital.

LIHTC Rules

Although not quite as obtuse as PAB rules, LIHTC has a number of specific program requirements. The following rules are applicable to all forms of LIHTC, but are especially relevant to this discussion.

- 30 year minimum term of affordability. Although the credits flow to the investor over 10 years, the LIHTC program requires that affordability generally continue for a minimum of 30 years going forward.
- Occupancy is limited to households with incomes at 60% or less of the area median income based on family size. HUD publishes tables each year that cap the maximum rent that can be charged for different sized apartments as well as the income limits for new LIHTC residents.
- Only units with tenants whose income is below the income limits generate tax credits. This is particularly important for a purchaser of an existing property who wants to finance the project with LIHTC. If an existing tenant in the building is found to have income even slightly higher than the income limit, the developer may forego $50,000 or more in tax credit equity for that unit.
- In order to qualify for LIHTC, an owner must incur construction or rehab expenses of at least 20% of the value of the building. This can be a problem for a buyer of a property that is in excellent condition. [7]

[7] More information on LIHTC can be found here: Westmont Advisors*, What is the Low Income Housing Tax Credit? An Introduction to the LIHTC*, http://www.westmontadvisors.com/LIHTC/lihtc.html .

Preservation in Massachusetts

In spite of the very strong real estate market in the eastern part of the state , Massachusetts has been extremely successful in preserving the affordability of its stock of privately owned affordable housing. In 2014, using some form of state resources, 3,278 affordable units in 29 separate projects 'closed' on new public financing with affordability restrictions This is similar to the 3,260 units preserved in 2013. [8] At the same time only 804 affordable housing units were 'lost' in 2013-2014 when the projects converted to market rate housing.

A very large subset of the projects preserved with state financing were projects that used PABs and 4% credits. Of the total units preserved in 2014, for example, 2,171 affordable units, (66% of the total), took advantage of PABs and 4% credits. In addition to maintaining the affordability of the housing, all of these projects are undergoing significant renovation. As mentioned above, the minimum rehab allowable is 20% of the value of the apartment buildings but data show that the average level of rehab in these transactions is actually well above the 20% minimum.

As always success has many parents but several are certainly key. The state, through the Executive Office of Administration and Finance, has consistently devoted a significant share of the state's volume cap to multifamily housing. In 2014 multifamily housing accounted for 45% of the state's annual allocation of volume cap. Massachusetts has allocated 48% of its 2015 volume cap for multifamily rental housing. Nationally, using 2013 data, only 3 other states devoted more than 40% of their volume cap to multifamily housing.[9]

In Massachusetts, PABs are issued by two separate quasi-public agencies, MassHousing and MassDevelopment.[10] Developers interested in PABs and 4% credits can approach either agency to finance their transaction. This has generated a fair amount of competition and creativity among the agencies. Over time the two agencies have focused on different structures for financing these projects. While any particular project could probably be financed by either agency, their different financing structures often make one or the other the preferred choice.

Projects financed with PABs and 4% credits in the past two years have ranged in size from 32 units to 967 units with bond amounts from $8.5 million to $171 million. Due to the complexity of PAB transactions it is difficult for projects with less than $5 million in tax exempt debt to be economical, though both MassHousing and MassDevelopment have programs to try to accommodate smaller projects.

Another attribute of PABs and 4% credits is the way that the programs can work well with the Massachusetts state low income housing tax credit ("state credit"). Modeled closely on the federal LIHTC program, the state credit is designed to work side by side with the 4% credit, increasing the amount of equity available to these projects. Unlike the 4% credit, the state credit is competitive and must be applied for in an annual funding round.

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[8] These numbers only count affordable housing units preserved with state resources. Several thousand units were also preserved exclusively with HUD funding in the past two years.

[9] CDFA, pp. 7-8.

[10] These two quasi-public entities (as well as CEDAC that produced this paper) were established by the legislature and have boards of directors approved by the Governor. MassHousing is the state's Housing Finance Agency. MassDevelopment's primary role is fostering economic development activities.

There are two types of historic tax credits that can also be combined with LIHTC. The state and federal historic tax credits function quite differently but both can be combined with 4% credits and PABs if substantial renovation is being made to a historic building. Surprisingly quite a number of affordable housing developments in Massachusetts are located in structures that long predate their conversion to affordable housing sometime in the past 40 years.

The housing efforts described so far are taking place against a backdrop of significant support at the municipal and state level for housing preservation. Massachusetts has a housing preservation law ("Chapter 40T") that requires (1) notices prior to an affordability "termination", (2) tenant protections after a termination, and (3) provision of a right of first refusal if affordable housing is sold without restrictions. A detailed understanding of the affordable housing stock is crucial and CEDAC has played an active role assembling data on projects at risk for loss of affordability as well as coordinating public agency preservation efforts (and occasionally writing and commissioning research papers). The state Dept. of Housing and Community Development has also been willing to allocate capital funding in addition to state credits to preservation projects, especially bond funding from the Capital Improvement and Preservation Fund and the Housing Stabilization Fund. In addition, some cities have devoted significant resources towards housing preservation – with Boston and Cambridge the clear leaders.

Finally it needs to be mentioned that economics has played a role in the success of PABs and 4% credits in Massachusetts. Market rents, particularly in greater Boston are some of the highest in the nation[11]. Many preservation projects have Section 8 rental subsidy for a portion of their units that is pegged to market or to the HUD determined "fair market rent". Through this rental assistance tenants pay 30% of their incomes for rent while the landlord received the much higher market rent proxy. The higher rents from this rental subsidy provide income that can support more project debt, including tax exempt debt from PABs. Areas of the state with weaker housing markets, such as Springfield and Fall River, have had a somewhat more difficult time utilizing PABs since the lower market rents to not allow the projects to service significant performing debt.

Potential Challenges and Conclusion

As this paper has shown, Massachusetts agencies have made excellent use of PABs and 4% credits to preserve the stock of affordable housing. Both 2013 and 2014 were very strong years for preservation in the state and preliminary numbers show 2015 to be even more robust. As of April 2015, pipeline reports from the various state housing agencies show that over 8,000 units of housing in more than 60 projects are in some stage of planning for a preservation transaction, with the vast majority of these projects expected to be financed with PABs and 4% credits.

But while the preservation ship has been steaming full speed ahead there are a few storm clouds on the horizon. The biggest concern relates to changes that Congress may make to the tax code. Both PABs and 4% credits are 'tax expenditures' that cost the federal government annually in lost revenue. The congressional Joint Committee on Taxation estimates that PABs for rental housing cost the federal government about $1 billion per year. The 4% credit is not separated out from the 9% credit in the LIHTC expenditure estimate by the Joint Committee, but it is also estimated to cost approximately $1

[11] The rental market company RentJungle estimates average listing rents for two bedroom apartments within 10 miles of Boston to be $2,446 per month in March 2015. www.rentjungle.com

billion per year.[12] Together these linked programs cost the federal government about $2 billion per year. In 2014, David Camp, then chair of the House Ways and Means Committee proposed a tax reform proposal that included the elimination of both PABs and 4% credits. While that specific tax proposal has not been resurrected this year, there remains an ongoing risk that tax reform could eliminate either the PAB or the 4% credit.

The success of PABs and 4% credits for preservation is also dependent on continued support from the state government. Specifically, if the state Executive Office of Administration and Finance (A&F) were to determine that other programs had a higher priority for volume cap, MassHousing and MassDevelopment could find themselves with insufficient volume cap to finance all of the rental housing projects that apply. A&F's allocation of $325 million of 2015 volume cap to rental housing represents 48% of the state's volume cap and is a solid vote of confidence in the program by the prior administration's A&F (under Governor Patrick)[13]. Staff at MassHousing and MassDevelopment are confident that $325 million will be sufficient for the projects needing volume cap this calendar year. However, with the gubernatorial change, A&F has new leadership and later this year the Baker Administration's A&F will make its first allocation of volume cap. Due to the size of the preservation pipeline, rental housing will likely need an increase in volume cap to issue PABs to all of the preservation projects next year. Insufficient volume cap for rental housing would at minimum create delays for projects and could be a significant impediment to some preservation transactions.

Of all the uses of PABs, only affordable rental housing brings in new federal equity in the form of LIHTC to the state. So while other PAB uses such as student loans and industrial development gain a benefit from low tax exempt interest rates, the 4% tax credit equity represents a federal transfer of funding to Massachusetts that provides significant economic benefits and local employment (particularly construction jobs for the renovation of the apartments). This 4% federal tax credit equity is tremendously valuable to housing preservation projects, often providing as much as $40,000 to $75,000 per housing unit.

With the high housing costs in much of Massachusetts, we can ill afford to lose even a single unit of affordable rental housing. To date, state agencies have used a combination of tools to foster housing preservation, chief among them PABs and 4% credits. These two paired financing sources form an extremely effective housing preservation program that has preserved 4,173 affordable units in Massachusetts in the past two years. Further, based on the projects in the development pipeline, 2015 and early 2016 promise to show even higher numbers. A key goal now is to maintain support for these successful programs at both the federal and state levels. Tax reform in Congress may inadvertently damage either PABs or 4% credits. Within Massachusetts it is critical that the state's Executive Office of Administration and Finance continue to support rental housing in spite of competing uses for PABs from other programs, recognizing the tremendous value of 4% tax credits, and the continued importance of preserving our valuable stock of affordable rental housing.

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[12] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018*, August 5, 2014, www.jct.gov/publications.html?func=startdown&id=4663 . The Joint Committee calculates that the LIHTC (both 9% and 4%) will cost $7.6 Billion in 2015. The author estimates that the 4% credit accounts for roughly 15% of the cost of the LIHTC program or $1 billion per year.

[13] The actual allocations for 2015 were not announced until January 2015, a few weeks after the new administration took office.