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The Use of Private Activity Bonds to Promote Affordable Housing and the Impact of the Tax Cuts and Jobs Act of 2017

Introduction

Private activity bonds are one of the primary ways in which the federal government promotes the development and retention of affordable housing. First established in 1954 and more particularly defined in 1968, private activity bonds provide states and local governmental entities with a way in which to lower financing costs for owners and developers of affordable housing, thereby making affordable housing more financially feasible to develop.

Since the interest paid on qualified private activity bonds is not included in a bondholder's gross income for federal income tax purposes, bondholders are willing to accept a lower interest rate than they otherwise would accept if the interest was taxable. For California residents, an investment in the Fund provides an additional potential benefit in that interest from bonds secured by affordable housing properties in California is also intended to be exempt from California state income tax. The tax benefit is passed through to the owner or developer of affordable housing in the form of lower-interest rate loans.

In 2016, states and local governmental entities issued a total of $20.38 billion in private activity bonds to finance affordable housing, infrastructure, hospitals and other qualified private activities. Approximately $18.47 billion of those private activity bonds were used to finance affordable housing. Private activity bonds were instrumental in the financing of almost all affordable housing projects in 2016 and continue to be a critical component in the development of new affordable housing.

The tax bill originally introduced as the Tax Cuts and Jobs Act of 2017[1] recently signed into law by President Trump preserves the use of private activity bonds to promote affordable housing. While the original bill passed by the House of Representatives eliminated the tax exemption for private activity bonds, the final act retained the tax exemption for qualified private activity bonds.

In retaining the tax exemption for private activity bonds, the U.S. Congress and the President acknowledged the lack of affordable housing, the critical and growing affordable housing problem, and the importance of private activity bonds in fostering the development and retention of new affordable housing projects.

History of Private Activity Bonds

Private activity bonds are bonds issued by or on behalf of local or state government for the purpose of financing the project of a private user. The federal tax code allows state and local governments to use tax-exempt bonds to finance certain projects that constitute private activities. The private activities that can be financed with tax-exempt bonds are called “qualified private activities” and the bonds used to finance qualified private activities are called "qualified private activity bonds".

[1] The Tax Cuts and Jobs Act of 2017 was renamed "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", Public Law No. 115-97.

Private activity bonds were first established under the Tax Code of 1954. In 1968, Congress passed the Revenue and Expenditure Control Act of 1968 (P.L. 90-364) which established the basis for the current definition of private activity bonds. In 1984, Congress adopted an annual state volume in order to cap the volume of tax-exempt bonds used to finance private activities and imposed restrictions on the type of qualified private activities that could be financed with tax-exempt private activity bonds. The annual volume cap and list of qualified activities were modified again under the Tax Reform Act of 1986 (TRA 1986, P.L. 99-514).

Qualified private activity bonds can be used to finance a number of defined private activities which benefit society on the whole. The foregoing includes infrastructure projects, hospitals, transportation facilities and, most notably, affordable housing.[2] Tax-exempt bonds for qualified private activities are unique because, unlike corporate bonds or U.S. Treasury bonds, the purchaser of the bond does not have to include the interest income from the bond in the bondholder's federal gross taxable income.[3] As a result, the bond purchaser is willing to accept a lower interest rate because the interest income is not subject to federal income taxes. The lower interest rate arising from the tax-exempt status subsidizes investment in capital projects. Over the last 30 years, private activity bonds have been a critical financing source for the construction of affordable housing projects.

Currently, the volume cap on private activity bonds for each state is equal to the greater of $100 per capita or $302.88 million. Each state may sub-allocate its volume cap among agencies, municipalities, or private activity bond categories as it chooses. Volume cap that is not used by the end of the year may be carried forward for use in one of the next three years. A state's current volume cap therefore generally can be defined as its new allocation plus its carryforward from the last three years.

The federal government also provides for the issuance of private activity bonds for use by non-profit organizations. Qualified 501(c)(3) bonds are not subject to the volume cap and can be used by non-profit organizations to purchase and develop affordable housing projects.

<u>Use of Private Activity Bonds for Affordable Housing</u>

In 2016, the new volume cap for all 50 states and the District of Columbia was $35.14 billion. The total carry-forward allocation from 2013 to 2015 equaled $63.9 billion, resulting in a total national volume cap of $97.36 billion.

Private activity bond issuance in 2016 was $20.38 billion, an increase of $7.4 billion from 2015. The total does not include the amount of qualified 501(c)(3) private activity bonds issued, a portion of which were used to acquire or develop affordable housing. Multi and single-family housing bonds made up a disproportionate share of total national private activity bond issuance subject to the federally mandated volume cap, accounting for 91% of total private activity bond issuance. 2016 marked the third consecutive year that multi and single-family housing bonds have accounted for more than 80% of all private activity bond issuance.

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[2] The qualified private activities are described in Sections 142 through 145 and 1394 of the Code. Section 142 exempts qualified residential rental projects and Section 145 exempts qualified 501(c)(3) bonds.

[3] Income from tax-exempt bonds is excludable from gross income for purposes of federal income tax, not to be an item of tax preference for purposes of the calculation of individual alternative minimum taxable income and, in certain instances, exempt from state income or other taxes.

In California, the 2016 volume cap including new allocation and carryover totaled $10.011 billion. Of that amount, $4.66 billion of qualified private activity bonds were issued for multifamily housing or 46.5% of the total capacity.

For 2017, California's ceiling for new qualified activity bonds was set at $3.93 billion. Together with the carry forward from the three prior years, the 2017 volume cap in California totaled $11.15 billion.

Critical Need for Affordable Housing

A number of cities and states in the U.S. face a critical and growing shortage of affordable housing. Single family home ownership has fallen from over 69% before the 2008 financial crisis to approximately 63.9% today, and is projected by the Urban Land Institute to decline to about 61% by 2030. The change from before the 2008 financial crisis to today reflects a net shift of approximately 6.25 million households from owners to renters over a 9-year period. Many people lost their homes during the financial crisis and home ownership has declined since then due to tighter credit standards limiting the number of applicants that can qualify for single family home mortgage loans.

The entry of a new generation into the work force, increase in immigration and shift among the elder generation from homes to rental properties for medical, financial or other reasons has all resulted in an increase in the demand for rental housing. From 2005 to 2015, the number of rental households in the U.S. is estimated to have increased by 9 million or 900,000 per year.[4] In 2015 alone, the increase in the number of rental households grew by 1.4 million households.

With the production of new rental housing at an average pace of 400,000 units per year and the loss of approximately 100,000 of units of rental housing each year due to destruction and obsolescence, the net additional inventory of rental housing at 300,000 units per year falls woefully short of the annual demand for rental housing. The foregoing has resulted in a rapid increase in multifamily rents during the last five years that far exceeded the growth in individual disposable income.

As a result, the United States is now in the middle of a critical and growing affordable housing crisis. According to a 2016 study by the Harvard Joint Center for Housing Studies, the number of cost burdened households (those paying more than 30% of their income on housing) rose by 3.6 million from 2008 to 2014. Further, the number of households paying more than 50% of their income on housing increased from 9.2 million to 11.4 million. In all but a small share of markets, at least half of the lowest-income renters have severe housing cost burdens. In higher-cost coastal markets, the housing cost burdens are impacting middle income households as well.

New 2017 Tax Act

The tax act passed by United States Congress on December 20, 2017 and signed into law by President Trump on December 22, 2017 preserves the use of private activity bonds to promote affordable housing.

While the original bill passed by the House of Representatives on November 16, 2017 did not include a tax exemption for private activity bonds, the legislation passed by the Senate on December 2, 2017 and the final bill signed into law retained the federal tax exemption for qualified private activity bonds. The retention of the private activity bond program as it applies to affordable housing is a recognition of the importance of the program in developing and retaining affordable housing. The continuation of the tax-

[4] Harvard University, Joint Center for Housing Studies.

exemption for private activity bonds is projected to result in the development of 75,000 new units of affordable housing per year or approximately 60% of all affordable housing units built each year.

In addition to preserving the tax exemption for private activity bonds, the new tax act lowered the tax rate for corporations and individuals, increased the standard deduction for tax payers, and capped the state and local deduction at $10,000 for property and income taxes.

Align Affordable Housing Bond Fund, L.P.

Align Affordable Housing Bond Fund, L.P. (the "Fund") is a private investment formed by Align Finance Partners GP, LLC to provide financing to affordable housing operators and developers. The Fund will invest in subordinate private activity bonds secured by second mortgages on affordable housing properties or interests in the owners thereof. Interest earned by the Fund on the private activity bonds and corresponding distributions by the Fund to its limited partners are expected to be excludable from gross income for purposes of federal income tax, not to be an item of tax preference for purposes of the calculation of individual alternative minimum taxable income and, in certain instances, exempt from state income or other taxes.[5]

The Fund offers investors the opportunity to invest in affordable housing on a diversified basis and benefit from the experience of the Fund's management team in this property sector. The foregoing is expected to generate for investors a tax-exempt current yield and an attractive tax-exempt IRR on a risk-adjusted basis.

The Fund is seeking total capital commitments of between $100 million and $150 million from qualified investors. The Fund is targeting for investors an average annual tax-exempt yield of between 5% and 6% (equivalent to an 8% to 9.5% taxable yield) and a tax-exempt net IRR of between 7% and 9% (equivalent to a taxable net IRR of between 11.1% and 14.3%).[6]

For California residents, an investment in the Fund provides an additional potential benefit in that interest from bonds secured by affordable housing properties in California is also intended to be exempt from California state income tax. The foregoing is significant given that the new tax law caps the individual deduction for state and local property and income taxes at $10,000. As a result, California residents subject to the maximum individual tax rate of 12.3% likely have a combined federal and state tax rate of 49.3%. The pre-tax equivalent net IRR for California residents investing in the Fund (assuming that the Fund invested solely in bonds secured by affordable housing properties in California) would be 13.8% to 17.7%.[7]

[5] The Fund will invest in bonds that the General Partner reasonably believes, based on opinions of nationally recognized bond counsel delivered on the date of issuance of the bonds, will generate interest that is excludable from gross income for federal income tax purposes, is not an item of tax preference for purposes of the calculation of individual alternative minimum taxable income and, in some cases, is exempt from state taxes as well. The Fund will obtain an opinion of counsel that the Fund will be classified as a partnership for federal income tax purposes, investors should be treated as partners and allocations of interest on the bonds to the investors should be excludable from gross income for federal income tax purposes. Opinions of counsel are not binding on the IRS and there can be no guaranty that the IRS will reach the same conclusions as counsel to the Fund. The Fund will have no obligation to redeem or repurchase an investment in the event the foregoing tax treatment is not achieved.

[6] The stated taxable equivalent yield is based on a current individual federal income tax rate of 37%.

[7] The Fund is projected to invest 50% of its total investment capital in bonds secured by interests in affordable housing properties located in California.

The Fund's management team will utilize its experience in financing, developing, owning and operating affordable housing properties in California and throughout the United States and its relationships with affordable housing owners to originate the private activity bonds. The Fund will invest only in tax-exempt private activity bonds used to finance affordable housing properties.

The private activity bonds generally will provide financing for the portion of the capital stack between 70% and 90% loan-to-cost.[8] Payment of interest on the Bonds will be subordinate to any senior debt, but have priority over distributions to equity investors (projected to be 10% to 15% of the total capitalization). The Fund is subject to the credit risk of its bonds, which are subordinate in lien priority and payment priority herein. The Fund's priority position in front of equity investors is intended to provide additional protection from downturns in the market.

Affordable housing historically has shown to have greater stability than market rate housing. Strong demand among residents for affordable housing coupled with an insufficient supply of available units has resulted in high occupancy and steady revenue. We believe that the lack of new affordable housing coupled with increases in rents for market rate housing will keep the demand for affordable housing high and translate into stable returns for investors in the Fund.

[8] Although bonds acquired by the Fund are expected, on average, to provide financing at between 70% and 90% loan-to-cost, some individual bonds may provide financing at a level that is less than 70% or more than 90% loan-to-cost.