



## Rental Development Program

### Tax-Exempt Obligation Financing

Private activity tax-exempt obligation financing is a popular tool for the creation and preservation of affordable housing because of the interest rates available under certain market conditions and the low-income housing tax credits such financing can generate. Tax-exempt obligation financings include loans financed by MassHousing through the issuance of long term bonds and/or short term notes. The issuance of any tax-exempt obligation is subject to various provisions of the Internal Revenue Code. The following is a summary of some of the more significant requirements imposed by the Code:

1. **Low-Income Set-Aside Requirements.** At all times during the "qualified project period" (see below), projects financed by private activity tax-exempt obligations must meet one of the following unit set-aside tests:

**20% at 50%:** 20% or more of the residential units in the project must be occupied by households whose income is 50% or less of area median gross income; or

**40% at 60%:** 40% or more of the residential units in the project must be occupied by households whose income is 60% or less of area median gross income.

Once made, the owner's election of one of the above occupancy requirements is irrevocable. If a development consists of multiple "projects" under applicable tax-exempt obligation rules, the owner must elect one of the above occupancy requirements for each project. Note that, as with tax credits, full-time students are generally not considered qualified tenants for purposes of the tax-exempt financing set-aside requirements.

2. **Qualified Project Period.** The qualified project period commences on the first day that 10% of the residential units are first occupied and ends on the later of (a) the date that is 15 years after the date on which 50% of the project residential units are first occupied; (b) the date on which no tax-exempt private activity obligations issued with respect to the project are outstanding; or (c) the first day on which any Section 8 assistance provided to the project terminates. This means that an existing project must meet these requirements as of its first drawdown of tax-exempt funds (generally at closing).
3. **Complete Living Facilities.** Section 142 of the Code permits the use of private activity tax-exempt obligation proceeds to finance qualified "residential rental projects." A residential rental project is defined as "...a building or structure, together with any facilities functionally related and subordinate thereto, containing one or more similarly constructed units, that are not used on a transient basis and are available to the general public." A rental "unit" is defined as any accommodation containing complete facilities for living, sleeping, eating, cooking and sanitation. Thus, for example, an apartment containing a living area, bedroom(s), bathroom, and kitchen equipped with a cooktop range, oven, refrigerator and sink, all of which are separate and distinct from other apartments, would constitute a unit. A unit shall not fail to qualify as a residential unit merely because such unit is a single room occupancy unit under the low income housing tax credit provisions of the Code. Applicants proposing assisted living developments should consult with MassHousing Rental Lending staff and/or a tax attorney regarding their facility design.

4. **Used on Other Than a Transient Basis, Available to the General Public.** Section 142 of the Code requires that units in a qualified residential rental project be available to the general public and rented on other than a transient basis. While legal interpretations may differ as to the meaning of "transient basis," most industry experts consider rental leases with terms of at least six months to be an acceptable standard. Owners of developments or applicants proposing developments containing rental units under shorter duration leases should consult with MassHousing Rental Lending staff. Tax-exempt financed developments must also serve or be available on a regular basis for general public use, as opposed to similar types of facilities that are constructed for the exclusive use by members of a social organization (e.g., fraternity or sorority) or provided by an employer for its employees. Set-asides or preferences for charitable or governmental programs serving specific populations, such as veterans or the formerly homeless, however, are generally acceptable under these rules. All tenant selection plans are subject to approval by MassHousing.
  
5. **Existing Properties: Arm's Length Acquisition and Minimum Rehabilitation Requirements.** Section 147(d) of the Code prohibits the use of private activity tax-exempt obligation proceeds to refinance an existing property unless such refinancing involves (a) the acquisition of the property by a party unrelated to the seller; and (b) minimum rehabilitation expenditures equaling not less than 15% of the proceeds of the tax-exempt obligations allocable to the acquisition of the existing building and equipment. Rehabilitation expenditures must generally be incurred within two years after the later of the date on which the building is acquired or the date on which tax-exempt obligations are issued. In determining whether acquisition of an existing property is by a party unrelated to the seller, tax counsel generally will determine whether the seller has a "controlling" interest in the purchasing entity, considering both (a) whether the seller has more than 50% of the capital or profits interest in a purchasing partnership; and (b) whether the seller can be said to control a purchasing partnership by virtue of its decision-making authority over day-to-day management and operational issues, such as the establishment of operating budgets, selection of property manager and other vendors, etc.
  
6. **"Good Money/Bad Money".** Section 147 of the Code requires that at least 95% of the proceeds of private activity tax-exempt obligations be used for qualified expenditures, or so-called "good money" costs. To be considered "good money" costs, expenditures must be both (a) incurred after the passage of either an obligation resolution or some other similar official action indicating the issuer's intent to finance a particular project with tax-exempt proceeds (MassHousing's "Official Action Status" determination generally serves this purpose); and (b) be chargeable to a project's capital account, and not amortized or expensed. Examples of "bad money" expenditures include: (a) expenses incurred prior to receipt of Official Action Status; (b) working capital expenses, such as rent-up deficit monies, marketing costs, legal costs, taxes and other expenses incurred after construction has been completed and the project is placed in service; (c) all costs of obligation issuance, with the exception of certain obligation insurance premiums (these include cost paid by MassHousing from obligation proceeds even though the amounts are not included in the mortgage loan amount); (d) amounts spent on commercial or other facilities intended for use by persons other than residents (e.g., a retail store, a parking garage in which spaces are rented to non-residential tenants, or a day-care facility open to the general public); and (e) profits or developer's fee that are paid to the owner or a party related to the owner. Owners are required to certify at commencement of construction that budgeted expenses will comply with the requirement and again at completion of construction that the actual expenditures did comply with the requirement.
  
7. **Volume Cap Allocation Required.** An allocation of tax-exempt volume cap from an authorized state entity is required to utilize private activity tax-exempt obligation financing. In Massachusetts, the Executive Office of Administration and Finance (EOAF) is responsible for allocating volume cap. Sponsors of multifamily developments may apply to MassHousing for tax-exempt financing on a rolling basis. See MassHousing's website at [www.masshousing.com](http://www.masshousing.com) or consult with MassHousing Rental Lending staff for further information regarding the application process.

8. **The 51% Test.** If 50% or more of a project's cost (total development costs including land) is financed with tax-exempt financing, the entire project may qualify for low-income housing tax credits without an allocation from the state's per-capita tax credit cap. If less than 50% of the development cost is financed with tax-exempt financing, then only those expenditures financed with tax-exempt financing may receive tax credits without an allocation from the state's per-capita tax credits. The balance of eligible expenditures could receive tax credits, however, through an allocation of per-capita credits from the Department of Housing and Community Development.
9. **"Automatic Credits" Not So Automatic.** Tax credits used in projects financed with tax-exempt private activity obligation financing (typically referred to as "4% tax credit" or "obligation-financed" projects) do not count against the state's per-capita tax credit allocation cap and do not have to compete for credits through the state's competitive funding round process, thus giving the impression that such credits are "automatic". However, these noncompetitive projects must meet the requirements of the state Qualified Allocation Plan (QAP), and must be evaluated by MassHousing to ensure that the dollar amount of credit approved for the owner's use does not exceed that needed for project feasibility. The tax-exempt obligations are also subject to the volume cap allocation requirements noted above. The MassHousing Rental Lending staff conducts such evaluations during the course of underwriting a project for tax-exempt financing, and presents to the MassHousing Board of Directors recommendations for approval of the use of a specific tax credit dollar amount. The final approval of the use of the credit is provided by the Department of Housing and Community Development via issuance of IRS Form 8609, subsequent to receipt, review and approval of the owner's tax credit cost certification.

Owners of tax-exempt obligation-financed projects utilizing the 4% credit must also enter into a long-term use restriction agreement with the Department of Housing and Community Development (the "Tax Credit Regulatory Agreement and Declaration of Restrictive Covenants") committing the owner to low-income use for a period of not less than 30 years. While the Code stipulates that this agreement must be executed and recorded no later than the end of the first year in which the owner claims the credit, in practice, the Department of Housing and Community Development generally requires execution of the documents at construction loan closing. This is in addition to the low-income set-aside requirements noted above with respect to tax-exempt obligation financings. Owners are also required to file periodic compliance certifications with the Internal Revenue Service and MassHousing with respect to both the tax-exempt obligation and the tax credit requirements of the Code.

This summary is intended as a preliminary information source for MassHousing borrowers, and should not be construed as legal advice. Due to the complexities of the rules and regulations governing tax-exempt obligation financing, prospective users of this financing are advised to consult with tax counsel concerning their specific projects.

#### IRS CIRCULAR 230 NOTICE

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