

## **Use of 501 (c)(3) Organizations in Residential Projects**

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Of the various tax-exempt and non-profit organizational structures available under both state and federal statutes, section 501 (c)(3) of the Internal Revenue Code (the “Code”) is unique in that it allows a nongovernmental organization, or corporate affiliate of a governmental entity, to maintain tax-exempt status while also allowing the organization to issue bonds for multifamily housing projects.

The ability of these bonds to generate tax-exempt interest for their holders is the key to their marketability in the financial world. To use of 501(c)(3) organization to issue bond for older projects can significantly lower the organization’s carrying costs and enable it to offer attractive acquisition terms to owners of existing projects.

### **Tax-Exempt Bonds For Financial Housing Projects**

Tax-exempt organizations may issue tax-exempt bonds on qualified residential housing projects, significantly increasing the marketability of the bonds. The primary advantage of using tax-exempt bond financing is its significant interest-rate savings; this enables developers to secure permanent financing with very low fixed-interest rate, non-recourse debt and long term affordability. Typically, 501 (c)(3) tax-exempt bonds have a tax-exempt rate that could be as much as 200 basis points below a similarly credit-enhanced market rate loan, although in today’s interest rate environment, the differential could be up to 100 basis points less.

However, the project must meet several Code guidelines that require a significant percentage of the project rental units to be set aside for low and very low income families. The Code definition of low or very low income is based on a percentage of the area’s gross median income. All tenants must demonstrate, and the owners must independently verify, that their income is projected to be within limits at the time of the initial occupancy.

Tax-exempt qualified residential bonds are generally subject to a state volume cap imposed by the Internal Revenue Code based on the population of the state. All non-exempt organizations must participate in a lottery for an allocation of the capped amount for use in housing projects. One of the primary advantages of the use of a tax-exempt 501 (c)(3) organization in housing projects is that they are not subject to the state ceiling. However, the exempt organization is subject to an organizational cap of \$150 million in outstanding exempt bonds. Additionally, the 501 (c)(3) organization must own the entire project that is to be financed with the bonds. This limits the ability of the organization to form joint ventures with other non-exempt businesses, including tax credit financing in tax credit transactions involving bonds, but not for conventionally financed transactions.

### **501(c)(3) Organizations In Residential Projects**

Recent guidelines issued by the IRS indicate that it is now feasible for a 501 (c)(3) organization to enter into a limited partnership with taxable and tax-exempt partners to produce affordable housing. This is of increasing importance in the ability of the organization to take advantage of the mandatory 10 percent allocation of Low-Income

Housing Tax Credits to 501 (c)(3) organization in conventionally financed transactions. The guidelines maintain that the 501 (c)(3) be the sole general partner and control decision making. The main advantage of this partnership is the ability of the 501 (c)(3) to leverage other funds available to the organization and produce additional units of housing or housing for very low income families.

### **Credit Enhancement**

As with other types of bond financings, the interest rates on 501 (c)(3) bonds is largely dictated by the credit rating assigned to the bonds. There are significant financial incentives to minimize interest rates by obtaining to best possible credit rating on the bonds, such as from Standard & Poor's (S&P) or Moody's. Nonprofits may often improve the credit rating on their bonds by obtaining credit enhancement, which insures the principal and interest to the bond holders. Letters of credit, Ginnie Mae and Fannie Mae mortgage-backed securities and Federal Housing Administration (FHA) mortgage insurance programs are effective tools for this type of enhancement. For FHA insurance, with its Fast-Track processing program, the time required to obtain a decision from the HUD now averages between 60 and 120 days. For FHA-backed multifamily programs, the organization has a choice of loan programs for both initial construction or substantial rehabilitation. However, the developer must secure FHA approval of completed plans and specifications before receipt of all financing commitments. The credit ratings assigned to bonds with these types of credit enhancements typically range from A to AAA.

As an alternative to credit enhancement, S&P offers programs for rating 501 (c)(3) bonds based on an underwriting analysis of the project and the non-profit organization. Under this program, S&P analyzes the loan-to-value ration, debt coverage ratio and other project related criteria to determine the applicable credit rating. In addition, S&P reviews that nonprofit's track record as a sign of its financial stability and performance.

Issuers in Texas are currently using the pooled 501 (c)(3) bond financing structure. The typical structure involves one or more series of bonds for the acquisition and rehabilitation of multiple properties. Cross collateralization of the properties produces a credit which is generally stronger than its parts. This type of bond structure could be a valuable aid to your organization's ability to produce substantial affordable housing over a short period and a large area. Several of our clients are considering pooled financings at this time.

Use of 501 (c)(3) organizations for the development of affordable housing can achieve 100 percent of the cost for new construction or acquisition and major rehabilitation for a full 40-year term at tax-exempt interest rates.

The ability to obtain credit enhancement and ratings upgrades the marketability of the bonds and the feasibility and success of their projects. The potential success of the use of 501 (c)(3) organizations for housing projects is further supported by the wide

availability of exempt bond financing structures and federal and state or government supported financing programs.

Many non-profits and housing issuers are working with developers and consultants to produce affordable housing. In the next issue, we will explore some of the guidelines in these relationships, as well as some of the choices, advantages and disadvantages of issuers and non-profits getting into the real estate development business.

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