No Volume Cap, No Problem

Chair:

Matthias M. Edrich Kutak Rock, LLP – Denver, CO

Panelists:

Alison Benge Pacifica Law Group LLP – Seattle, WA
William A. Milford Bryant Miller Olive – Jacksonville, FL
Richard J. Moore Orrick Herrington & Sutcliffe LLP – San Francisco, CA

With volume cap in scarce supply in many states, panelists will discuss tax structures to finance housing (including, for example, governmental workforce housing) and private activity bond-type projects on a tax-exempt basis without volume cap or using the volume cap "recycling" provision of the tax code. (This outline also references related matters such as the general refunding exception to the volume cap requirement, reduced volume cap requirements for certain exempt facility bonds and volume cap carryforward provisions. These related matters may not be addressed during the panel discussion but are included in the outline for future reference.)

A. Overview: Bonds Requiring Volume Cap (I.R.C. §§ 141(e), 146(a) and 146(g))

Most types of private activity bonds are subject to "volume cap" limits under section 146 of the Internal Revenue Code of 1986 (the "Code"). *See* I.R.C. § 141(e)(2). This means such bonds are subject to an overall limit each calendar year, within each state, on the amount of such bonds that can be issued for such calendar year. The predecessor to section 146 of the Code was originally added by the Tax Reform Act of 1976. For application of the volume cap rules to draw down bonds, see Notices 2010-81 and 2011-63.

The private activity bond limit is determined first by reference to the maximum amount of private activity bonds that all issuers within a state may issue in any calendar year and second by reference to the allocation of authority to the particular issuer to issue private activity bonds under the state ceiling amount pursuant to the allocation procedures contained in sections 146(b) and (c) of the Code or pursuant to the state's own allocation procedure.

For calendar year 2023, the state ceiling applicable to any state is the greater of (1) $120 multiplied by the state population, or (2) $358,845,000, as set forth in Rev. Proc. 2022-38. The state ceiling is subject to an annual cost-of-living adjustment. For purposes of determining the population of any state (or issuing authority) for a calendar year, the most recent census estimate of the resident population of such state (or issuing authority) released by the Bureau of Census before the beginning of such calendar year is used. The most recent population figures reported by the Treasury Department were published on March 21, 2022 in Notice 2022-12, and technically apply only to calendar year 2022 volume cap.

The volume cap provisions apply to all exempt facility bonds, *except* (I) bonds for airports, docks and wharves, environmental enhancements of hydroelectric generating facilities, qualified public educational facilities, qualified green building and sustainable design projects and qualified highway or surface freight transfer facilities described in paragraphs (1), (2), (12), (13), (14) or (15) of section 142(a) of the Code and (II) governmentally owned solid waste disposal facilities, high-speed intercity rail facilities or qualified broadband projects described in paragraphs (6), (11) and (16) of section 142(a) of the Code. Certain special partial exemptions to the volume cap provisions may apply to qualified carbon dioxide capture facilities and non-governmentally-owned high-speed intercity rail facilities and qualified broadband projects. Furthermore, the volume cap requirement also applies to governmental bonds to the extent that the proceeds thereof used for any private business use exceed $15 million.

The volume cap provisions do not apply to qualified 501(c)(3) bonds under section 145 of the Code. For qualified veterans' mortgage bonds, qualified highway or surface freight transfer facilities, tribal economic development bonds and various types of special purpose exempt facility bonds (such as empowerment zone facility bonds, Liberty Zone bonds, Gulf Opportunity Zone bonds, Midwestern Disaster Area Recovery Zone bonds, Hurricane Ike Bonds and recovery zone bonds under the American Recovery and Reinvestment Act of 2009) special volume limitations apply that are set forth in other sections of the Code and are outside of the scope of this panel discussion.

As noted in the introduction to this outline, volume cap under section 146 of the Code has become scarce in many states, due in large part to consistently high demand for exempt facility bonds for low income rental housing under section 142(d) of the Code and qualified mortgage bonds for single family mortgages under section 143 of the Code. While efforts have been underway especially by housing advocates to increase volume cap or reduce volume cap requirements, ongoing limited supply of cap has caused issuers and their advisors to look for tax-exempt bond solutions that do not require cap. The following sections of this outline identify several possible solutions.

B. <u>Refunding Exception</u> (I.R.C. § 146(i))

I. Under section 146(i)(1) of the Code, no volume cap is required for "any bond which is issued to refund another bond to the extent that the amount of such bond does not exceed the outstanding amount of the refunded bond." There are special rules for student loan bonds, qualified mortgage bonds and bonds for residential rental projects. Notice 2019-39 provides a special refunding exception for certain targeted bond programs that do not otherwise address current refunding exceptions. Typically, a refunding exists only when the obligor of one issue is the obligor (or related party) of the other issue. *See* Treas. Reg. § 1.150-1(d)(2)(ii).

II. What is the "amount" of the refunding bonds? *See* Rev. Rul. 83-154, which states that the issue price rather than the face amount of obligations to be issued at a discount is the "amount" of bonds issued for purposes of determining the necessary volume cap for a bond issuance. *See also* PLR 9431007, in which the Treasury Department notes that, for purposes of the carryforward provision in I.R.C. § 146(f), the terms "aggregate amount" and "aggregate face amount" are both intended to refer to the issue price of the bonds to be issued rather than, for example, the par value or stated redemption price at maturity. *See also* CCA 201937016 (Aug. 9, 2019) and Notice 2019-39.

III. Does the "outstanding amount" of the refunded bonds include interest capitalized to or accrued on the refunded bonds? For example, assume bonds were issued at a discount but are callable at 102 percent. Is the outstanding amount: (1) the unaccreted outstanding issue price; (2) the accreted outstanding issue price; (3) the stated redemption price at maturity; or (4) the redemption price, including the 102 percent redemption amount? (Probably safe to conclude that (3) and (4) are not the right answers.) *See* PLR 201447023, which suggests that the outstanding amount of refunded bonds may include interest capitalized to or accrued on the refunded bonds. Does it matter that original volume cap would have been given based on the issue price and not the accreted amount? *See also* CCA 201937016 (Aug. 9, 2019) as well as Notice 2019-39 with respect to volume cap exceptions for various targeted bond programs. Notice 2019-39 states that, for refunded bonds originally issued with more than a *de minimis* amount of original issue discount or premium (as defined in Section 1.148-1(b) of the Regulations), the present value of the refunded bonds (as determined under Section 1.148-4(e) of the Regulations) must be used instead of the outstanding stated principal amount.

IV. Section 1313(a) of the Tax Reform Act of 1986 provides a transition rule for current refundings. The transition rule looks to the "amount" of the refunding bond as compared to the "outstanding amount" of the refunded bond and also looks to whether the average maturity of the

refunding bond exceeds 120 percent of the remaining useful life of the "facilities" financed or whether the maturity date of the refunding bond exceeds 17 years (32 years for certain mortgage bonds) after the date the original bonds were issued. *See* TAM 200622047, which analyzes the transition rule for current refundings in the context of mortgage bonds.

V. What if the refunded bonds were issued by an issuer that is different from the issuer of the refunding bonds, but the conduit borrower remains the same? For example, assume bonds were originally issued in the State of Y with volume cap received from the State of Y, for a water furnishing facility. Several years later, an issuer in the State of Z issues bonds to current refund the original bonds. The amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. What if the proposed refunded bonds are small issue manufacturing bonds under section 144(a) of the Code? Consider Rev. Rul. 77-317 and GCM 36133, both of which appear to question whether a different issuer than the original issuer may issue bonds to refund small issue manufacturing bonds. What if the proposed refunded bonds are Gulf Opportunity Zone Bonds under section 1400N of the Code? Consider the requirement in section 1400N(a)(2)(B) stating that bonds must be issued by the State of Alabama, Louisiana or Mississippi (or any political subdivision thereof).

C. Volume Cap Recycling for Residential Rental Projects (I.R.C. § 146(i)(6))

I. *History*

A. Many bonds issued for residential rental projects are structured so that most or all of the bonds are retired after only a few years, meaning that volume cap was allocated to bonds with a very short duration.

B. Strong lobbying convinced Congress that volume cap should be useful for more than just bonds that are outstanding for a few years.

C. Response was section 146(i)(6), which was enacted in 2008 as part of the Housing and Economic Recovery Act of 2008 (HERA), Pub. L. 110-289 (Jul. 30, 2008).

D. Basic premise is that, if statutory requirements outlined below are satisfied, a loan repayment from a bond that financed a qualified residential project (Project #1) can be used for a different qualified residential rental project (Project #2). The bonds that finance Project #2 (Bonds #2) will repay (directly or indirectly) the bonds that finance Project #1 (Bonds #1) and, notwithstanding that the two deals have different conduit borrowers, Bonds #2 will be treated as refunding bonds for purposes of the volume cap rules.

II. *Statutory Requirements*

A. Loan of repayment to borrower on Bonds #2 must be made within 6 months of the date of the loan repayment on Bonds #1.

B. Bonds #2 must be issued no more than 4 years after the original issue date of Bonds #1.

C. Latest maturity date of any bond of the refunding issue may not be later than 34 years after the date on which Bonds #1 were issued.

D. TEFRA must be satisfied for Bonds #2.

III. *Practical Issues*

A. BONDS THAT USE RECYCLED CAP DO NOT COUNT FOR PURPOSES OF THE 50% TEST UNDER THE LIHTC RULES.

B. If recycled cap is used, which of the rules under section 142 for qualified residential rental projects are inapplicable? NONE.

C. Experience has proven that it is nearly impossible to coordinate the loan repayment date of Bonds #1 and the closing date of Bonds #2. The solution has largely been to use a bridge loan (often taxable) to take out Bonds #1. The bridge loan is collateralized by the loan repayment and, within 6 months of the loan repayment, the bridge loan is repaid by Bonds #2.

D. Do cashflows have to match structure? Many bond counsel have gotten comfortable that it does not as long as a "Funds Exchange Agreement" is in place. (Consider whether new transactions should expressly allow for bonds to be repaid from proceeds of other issues as part of a recycling transaction under section 146(i).)

E. Drawdown deals – Can bonds that use recycled cap be done on a drawdown basis as long as the first draw is made within 6 months of the loan repayment?

D. Residential Rental Projects Financed by Governmental Bonds

I. *Overview*. Because volume cap is only required for certain private activity bonds, residential rental projects financed with proceeds of traditional governmental bonds do not require volume cap (except to the extent the $15 million limit of section 141(b)(5) of the Code is exceeded). This applies to both pure governmental bonds (*e.g.,* bonds issued by a local housing authority for governmentally-owned and operated housing) and governmental P3 bonds issued to finance residential rental property owned by a governmental unit but operated by a private entity pursuant to a qualified management contract.

A. *Pure Governmental*. Traditional governmental bonds may be used to finance residential rental projects owned by a governmental unit, such as a municipality or housing authority issuing the bonds. So long as the residential rental property is owned and operated by the governmental unit, these transactions present very few tax complications.

B. *Governmental P3 Model*. Recent years have seen proposals for workforce/essential housing bond structures for the acquisition of existing rental developments. Under this structure, a governmental unit will be identified to own the property subject to a long-term management contract. These structures also often include

a subordinate debt component held by the developer or an affiliate. Although this structure arose in the context of workforce housing, as volume cap becomes more scarce, we may see proposals for similar structures in affordable housing.

C. *Common Tax Issues*.

a. Arbitrage "investment property" issue: property must be located in the jurisdiction of the issuer.

i. Section 148(b)(2). The term "investment property" means—(E) in the case of a bond other than a private activity bond, any residential rental property for family units *which is not located within the jurisdiction of the issuer*…

ii. What issuers are available that will comply with the investment property restriction? Local government? Housing Authority? Housing Finance Authority? Joint Powers Authority? State Issuer?

b. Subordinate debt. Many P3 structures include a high-coupon subordinate bond held by the developer or an affiliate.

i. True debt analysis: How does bond counsel get comfortable that the subordinate debt is not a disguised equity interest?

ii. How does bond counsel obtain comfort on the pricing of the subordinate debt?

iii. In general, the Treasury Regulations (the "Regulations") do not permit contingent payments to be treated as tax-exempt interest. The subordinate debt structure and cashflows should be analyzed to determined whether the subordinate debt would be characterized as a contingent payment debt instrument *See* Treas. Reg. § 1.1275-4.

c. Management Contracts. Are there circumstances that would cause you to question a management contract even if it strictly meets the safe harbors of Rev. Proc. 2017-13?

E. Residential Rental Projects Financed by 501(c)(3) Bonds (I.R.C. § 145(d))

I. *Overview*. Pursuant to section 146(g)(2) of the Code, volume cap is not required for qualified 501(c)(3) bonds. As volume cap becomes more scarce, residential rental projects may increasingly turn to qualified 501(c)(3) bonds as an option for tax-exempt financing when volume cap is unavailable.

II. *Differences between Qualified 501(c)(3) Bonds and 142(d) Bonds*

A. 501(c)(3) borrower

a. What is the organization's exempt purpose?

i. Affordable Housing: Rev. Proc. 96-32 sets forth a safe harbor under which organizations that provide low-income housing will be considered charitable because they relieve the poor and distressed. The safe harbor generally tracks the set-asides required under section 142(d), but also requires that 75% of the units be occupied by residents that qualify as low-income.

ii. Workforce/Essential Housing: Although there is no direct guidance suggesting that the provision of "workforce" or "essential" is an exempt purpose, the IRS may consider this an exempt purpose depending on the facts and circumstances of the particular organization.

iii. Lessening the Burdens of Government: A determination of whether an organization is lessening the burdens of government requires consideration of whether the organization's activities are activities that a governmental unit considers to be its burdens, and whether such activities actually "lessen" such governmental burden. Consideration must be given to all facts and circumstances including the level of involvement of the local government and the acknowledgement of the "burden" being lessened. *See* Rev. Rul. 85-2.

b. Organizational history. Bond counsel may want to consider whether the organization is an established 501(c)(3) with a history of providing affordable housing or whether it was created or pulled "off the shelf" by the developer for the purpose of obtaining bond financing.

B. Ownership requirement. Section 145(a)(1) requires that all property financed with proceeds of the issue be owned by a 501(c)(3) organization or governmental unit.

C. Private business use limitations apply (5% limit)

a. Management contracts subject to Rev. Proc. 2017-13

b. Private business use includes use by 501(c)(3) organizations engaged in activities that constitute unrelated trade or business activity.

i. Are market rate units treated as an "unrelated trade or business"? Rev. Proc. 96-32 suggests that 25% market rate units would not constitute unrelated trade or business. What if the organization is outside of the safe harbor or has a different exempt purpose?

D. Land acquisition limits do not apply

E. Substantial user limits do not apply

F. $150 million limit applies to some financings

a. Developers may propose financing working capital and additional funded interest (beyond the placed-in-service date). While these are permissible for qualified 501(c)(3) bonds under the working capital exceptions of section 1.148-6 of the Regulations, if less than 95% of the net proceeds are used to fund capital expenditures the bonds may be subject to the $150 million limitation of Section 145(b) (tested in aggregate with respect to all bonds of the Borrower and related parties).

G. Acquisition of existing property (Donnelly Amendments) – Section 145(d)

a. Although qualified 501(c)(3) bonds are not subject to the used property requirements of section 147(d), section 145(d) imposes certain similar restrictions for qualified 501(c)(3) bonds to be used for residential rental housing for family units, requiring that such projects with used property must comply with section 142(d) set-asides or heightened substantial rehab (100%).

III. *Other Tax Issues*

A. Subordinate Debt. If the subordinate debt is not a "true" debt, it may create an impermissible private ownership interest in the project.

B. Fees / Accounts / Flow of Funds

a. Should bond counsel seek additional representations on the reasonableness of fees paid to developers and other parties to the transaction?

b. Capital and Operating Reserves. Developers often seek to fund as much as possible with bond proceeds. Consider how and when amounts on deposit in the reserves are expected to be spent. Section 1.148-2(f) of the Regulations provides an overall 10% limitation on funding reserves.

IV. *Using Qualified 501(c)(3) Bonds as a Bridge to LIHTC*

A. Reasonable expectations test. Under section 1.141-2 of the Regulations, an issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. However, under section 1.141-2(d)(2)(ii) of the Regulations, an action that is reasonably expected, as of the issue date, to occur after the issue date to cause the private business tests to be met (such as the sale of the property in a future LIHTC transaction) may be disregarded under the reasonable expectations test if (i) the issuer expects that the financed property will be used for a substantial period before the action, (ii) the issuer is

required to redeem all nonqualifying bonds within six months of the date of the action, (iii) the issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that specific action, and (iv) the mandatory redemption of bonds meets all conditions for remedial action.

a. What is a "substantial period" for which the property must be used?

B. Future LIHTC deal must meet all LIHTC requirements including 50% basis test and 95/5 good costs test.

C. Future LIHTC deal must be set up as an acquisition, which requires 15% rehabilitation requirement to be met. (To accommodate this, current rehabilitation may be minimized).

F. Non-Housing Financed by 501(c)(3) Bonds (I.R.C. § 145(d))

I. The limitations of section 145(d) of the Code apply to bonds issued to finance "residential rental property for family units." In some cases, a nonprofit facility may not meet the definition of residential rental property and will not be subject to the section 145(d) restrictions.

II. Facilities that are not available to the general public are not residential rental property for family units.

A. University housing available only to faculty, staff and graduate students is not residential rental property for family units. FSA 001752 (February 1, 1993); *see also* Committee Reports for HR 100-795, P.L.100-647.

B. A qualified residential rental project won't fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants described in section 42(g)(9) of the Code, including tenants with special needs, tenants who are members of a specified group under a federal program or state program or policy that supports housing for such a specified group, or tenants who are involved in artistic or literary activities.

III. Facilities providing transient housing such as hotels, motels, rooming houses, trailer parks and courts for use on a transient basis are not residential rental property. Section 1.103-8(b)(4) of the Regulations.

A. Under section 142(d)(2)(D) of the Code (by reference to section 42(i)(3)(B)(iv)), a single-room occupancy unit is not treated as used on a transient basis merely because it is rented on a month-by-month basis.

B. Housing for homeless expected to be leased for periods of at least 30 days was not transient housing and constituted residential rental property. PLR 9209020.

IV. Health care facilities such as hospitals, nursing homes, and sanitariums are not residential rental property.

A. Health care facilities may be characterized by certain common qualities: (1) they are regulated by the appropriate health department of a state as health care institutions, (2) they specifically accentuate the availability of immediate medical services to and/or the care of the persons being serviced, (3) the laws of the state, and/or the regulations and rules of that state's health department specify numerous procedures, measures, and standards pertaining to both the medical treatment of residents and the staff, and (4) the required treatment of the residents/patients is far beyond a landlord-tenant relationship that may limit use by the tenant or may require the landlord to provide amenities such as food and laundry services. PLR 9740007.

B. Facilities that provide continual or frequent nursing, medical, or psychiatric services are not residential rental facilities. Rev. Rul. 98-47. However, a facility providing meals, daily living activity assistance, medication assistance, housekeeping, equipment assistance, and health monitoring and assessment was a residential rental facility. PLR 200038001.

V. Each residential rental unit must include separate and complete facilities for living, sleeping, eating, cooking, and sanitation. Treas. Reg. § 1.103-8(b)(8).

A. Housing with Pullman kitchen fails "complete unit" test and is not considered residential rental property. PLR 8221149. Housing with shared toilets fails "complete unit" test and is not considered residential rental property. PLR 8308051. IRS allowed small issue IDBs to be issued for the projects. But, see IRC §142(d)(2)(D), discussed below.

B. Units containing a small refrigerator, a sink, a pull-down table, and two burner stove with an oven were residential rental units. Stove could be replaced with a microwave to address safety concerns for aging residents. Rev. Rul. 98-47.

C. SROs. Section 142(d)(2)(D) of the Code was enacted in 2008 and states that a unit shall not fail to be treated as a residential unit merely because such unit is a single-room occupancy unit (within the meaning of section 42 of the Code). Under section 42(i)(3)(B)(iv) of the Code, a single-room occupancy unit is not treated as used on a transient basis merely because it is rented on a month-by-month basis.

G. <u>Limited Volume Cap for Certain Exempt Facilities</u> (I.R.C. § 146(g))

Volume cap for only 25 percent of the amount of an exempt facility bond for high-speed intercity rail facilities (section 142(a)(11)), qualified broadband projects (section 142(a)(16)) and qualified carbon dioxide capture facilities (section 142(a)(17)) is needed. This means no volume cap is needed for the remaining 75 percent. In other words, volume cap for only 1/4th of such an issue is needed. With scarce supply of volume cap already, will this 75 percent exemption have a meaningful impact?

H. Governmental Ownership of Certain Exempt Facilities (I.R.C. § 146(g) and (h))

I. No volume cap is needed at all for an exempt facility bond for high-speed intercity rail facilities (section 142(a)(11)) and qualified broadband projects (section 142(a)(16)), if all of the property to be financed by the net proceeds of the issue is to be owned by a governmental unit.

II. "Ownership" for the purpose of I above has the same meaning as in the lease and management contract safe harbor of section 142(b)(1). The safe harbor states that a governmental unit owns property even if it leases the property to a private lessee, as long as the following requirements are met: (1) the lessee irrevocably elects not to claim depreciation or an investment credit with respect to the property; (2) the lease term is not more than 80 percent of the reasonably expected economic life of the property (the "lease term requirement") (consider PLR 201918008); and (3) the lessee has no option to purchase the property other than at fair market value (as of the time the option is exercised). Can the lessee be given the right to demand the purchase (versus having a right of first refusal) at a future time, even if the purchase price satisfies the fair market value requirement?

III. No volume cap is needed at all for an exempt facility bond for solid waste disposal facilities (section 142(a)(6)), if all of the property to be financed by the net proceeds of the issue is to be owned by a governmental unit. The same "ownership" test in II above applies, *except* the lease term requirement (in (2) of the test in II above) is deemed satisfied if the term of the lease is not more than 20 years. In other words, even if the term exceeds 80 percent of the reasonably expected economic life of the property, the safe harbor can apply as long as the term doesn't exceed 20 years.

I. Carryforward Volume Cap (I.R.C. § 146(f))

I. Authority and Guidance

A. Section 146(f)(1) of the Code: If an issuing authority's volume cap for any calendar year exceeds the aggregate amount of tax-exempt private activity bonds it issues during the calendar year, the authority can elect to carry forward the excess amount.

B. Notice 89-12: Form 8328, Carry forward Election of Unused Private Activity Bond Volume Cap, must be filed with the Internal Revenue Service by the earlier of (1) February 15 of the calendar year following the year in which the excess amount arises, or (2) the date of issue of bonds issued pursuant to the carry forward election

C. Temporary Regulations §1.103(n)-4T: Final regulations were never adopted and these temporary regulations were not updated to reflect updated provisions in Section 146.

II. Limitations

A. Carryforward timing. Under IRC §146(f)(3)(A), carryforward must be used within the 3 calendar years following the calendar year in which the carryforward arose.

Carryforwards elected with respect to any purpose shall be used in the order of the calendar years in which they arose.

B. Carryforward purpose. Under IRC §146(f)(5), the term "carryforward purpose" means—

1. the purpose of issuing exempt facility bonds described in 1 of the paragraphs of section 142(a),

2. the purpose of issuing qualified mortgage bonds or mortgage credit certificates,

3. the purpose of issuing qualified student loan bonds, and

4. the purpose of issuing qualified redevelopment bonds.

These purposes are only a subset of the types of private activity bonds that require volume cap. As a result, volume cap cannot be carried forward for certain uses, including small issue IDBs or governmental bonds that exceed the $15 million private business use limitation.

III. Elections

A. The "issuing authority" must make an election to carry forward volume cap that:

1. identifies the purpose for which the carryforward is elected, and

2. specifies the portion of the excess which is to be a carryforward for each such purpose.

B. Any carryforward election, including any identification or specification contained therein, once made, is irrevocable.

* * *