There are two main types of tax-exempt bonds that can be used to finance affordable multifamily housing projects: governmental bonds and private activity bonds. In general, governmental bonds are tax-exempt bonds that are issued to finance projects owned by a governmental entity. Multifamily housing projects financed with governmental bonds must comply with rules that limit the extent to which private businesses participate in the operations, use, or financing of those projects.

Private activity bonds are tax-exempt bonds that are used to finance projects owned by private businesses, including not-for-profit or “501(c)(3)” organizations. There are two main subcategories of private activity bonds that are used to finance multifamily housing projects. They are “501(c)(3) Bonds” and “Qualified Exempt Facility Bonds.” “Qualified 501(c)(3) Bonds” are limited to only those multifamily housing projects that will be owned by 501(c)(3) organizations, while Qualified Exempt Facility Bonds may be used to finance multifamily housing projects owned by any private business, governmental entity, or 501(c)(3) organization.

There are several benefits to using tax-exempt bonds to finance multifamily housing projects. One of them is providing access to lower interest rates than are available for conventional or “market-rate” debt products. As we will discuss in Chapter 4, as
of the writing of this book, for certain types of financings, the “taxable/tax-exempt yield spread” has been inverted for several years, meaning that interest rates on conventional debt have been lower than those on comparable tax-exempt loans. Why then are developers using tax-exempt bonds to finance affordable multifamily housing? The answer, in many cases, is the Low Income Housing Tax Credit or “LIHTC.” Since the LIHTC is the subject of a standalone text available from the ABA Affordable Housing Forum\(^1\), we will not go into great detail about the LIHTC here, but a brief description of the “4% LIHTC” is necessary to gain a thorough understanding of the largest driver of volume in the multifamily housing bond market.

In 1986, Congress enacted the Tax Reform Act of 1986, which first established the LIHTC. Made permanent in 1993, the LIHTC is composed of two distinct “tax credits,” the 9% credit and the 4% credit. We are concerned here only with the 4% credit since it is “coupled” with multifamily housing bonds. We refer to this credit in this text as the “4% LIHTC.” However, both types of tax credits, at their most basic level, provide an economic incentive for the private markets to invest in affordable housing by providing a certain amount of tax credits (which reduce tax liability dollar for dollar) to affordable rental facilities based on a formula. Typically those credits are then sold to investors in exchange for an equity investment in the project.

While the 9% tax credit is subject to a competitive process, the 4% LIHTC is available in connection with exempt facility bonds that satisfy the requirements of Section 142(d) of the Code (“Qualified Exempt Facility Bonds”). In order to receive the 4% LIHTC, at least 50% of a project’s aggregate basis must be financed with the proceeds of Qualified Exempt Facility Bonds\(^2\). We will discuss this “50% Test” in more detail later in the text. Note that whether or not the 50% Test is satisfied is not determinative of whether the interest on the Qualified Exempt Facility Bonds is

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excludable from gross income of the owners thereof; rather it applies only to the eligibility of the Project to receive the 4% LIHTC.³

It should be noted that while generating tax credit equity may be the primary reason many developers use tax-exempt bonds, it’s certainly not the only reason. For example, in many higher-income areas such as large urban centers on both coasts, using tax-exempt bonds may allow borrowers to meet local zoning rules regarding affordability, or may allow the owner to qualify for property tax abatement or other state or local incentives. Cities such as New York and Los Angeles have developed their own framework of rules and requirements designed to meet the affordable housing needs of their large and diverse citizenry, and those rules and requirements may differ significantly from what one would encounter in, say, Akron, Ohio. We provide some detail on these structures in Chapter 5 as we explain the use of recycled bonds and bifurcated structures.

I. Types of Tax-Exempt Bonds

Before we dive deeper into the specifics of Qualified Exempt Facility Bonds, let’s briefly discuss the two other main categories of tax-exempt bonds used to finance affordable rental housing.

*Governmental Bonds.* Governmental entities may access the tax-exempt markets to finance affordable housing units that are owned by the governmental entity. The most obvious examples of this type of housing are the public housing developments found in most major cities across the country. These facilities may be owned by Public Housing Authorities (PHAs) created by the city or county in which the facility is located, or sometimes the city or county itself or some other entity created for the specific purpose of owning and operating public housing. Tax-exempt bonds issued by governmental entities to finance their own housing stock are exempt from many, although not all, of the tax-exempt bond tests we will discuss in this book. In addition, LIHTCs are not available for public housing units financed

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