NCSHA 2015 Annual Awards Entry Form

(Complete one form for each entry)

Deadline: Wednesday, June 10, 2015

Visit ncsha.org/awards to view the Annual Awards Call for Entries.

Instructions: Type entry information into the form and save it as a PDF. Do not write on or scan the form. If you have any questions contact Matt Cunningham at mcunningham@ncsha.org or 202-624-5424.

Fill out the entry name *exactly* as you want it listed in the program.

Entry Name: Bifurcated Structures for 80/20 or Mixed-Income Financing

HFA: NYC Housing Development Corporation ("HDC")

Submission Contact: (Must be HFA Staff Member) Richard M. Froehlich **Email:** rfroehlich@nychdc.com

Please provide a 15-word (maximum) description of your nomination to appear on the NCSHA website.

HDC's utilization of a bifurcated structure in financing mixed-income developments to reduce volume cap need

Use this header on the upper right corner of each page:

HFA:

Entry Name:

Select the appropriate subcategory of your entry and indicate if you are providing visual aids.

Communications	Homeownership	Legislative Advocacy	Management Innovation
○ Annual Report ○ Creative Media ○ Promotional Materials and Newsletters	○ Empowering New Buyers ○ Encouraging New Production ○ Home Improvement and Rehabilitation	○ Federal Advocacy ○ State Advocacy	○ Financial ○ Human Resources ○ Operations ○ Technology
Rental Housing	**Special Needs Housing**	**Special Achievement**	Are you providing visual aids?
◉ Encouraging New Production ○ Multifamily Management ○ Preservation and Rehabilitation	○ Combating Homelessness ○ Housing for Persons with Special Needs	○ Special Achievement	○ Yes ○ No

Introduction

The availability of private activity bond volume cap plays an instrumental role in the preservation and creation of multi-family affordable housing units. For the last several years more than 80% of the New York State's private activity bonds have been issued for the financing of multi-family housing. Generally, all available volume cap authority is utilized with a cushion of $500 million carry-forward managed by the State. The extraordinary demand for volume cap in NYS continually challenges HDC to explore new ways to leverage scarce volume cap resources to maximize the production of affordable housing.

With the scarcity of private activity bond volume cap, HDC continues to pursue financing structures to conserve volume cap allocation, with an ultimate goal of allocating only a minimum amount of volume cap needed to pass the 50% test under the federal low income housing tax credit rules. In addition to creating a successful recycling program for multi-family bonds, HDC has creatively used condominium structures as a tool for mixed income financings to bifurcate the low income units and the market rate and commercial units. The 80/20 and mixed-income developments, which all have a portion of units exceeding the 4% LIHTCs income limit, became the focus of HDC's efforts to create an alternative structure – a Bifurcated Structure - to limit the amount of volume cap needed to pass the 50% test.

The Problem

Mixed income projects were enormous users of volume cap but provided a limited number of affordable housing units. A recent study by the Citizens Housing Planning Council regarding the use of volume cap in New York showed that the average bond allocation per affordable unit in NYSHFA's 80/20 developments prior to the policy change was $1,984,364. The new policy change should reduce that amount to about $375,000.[1]

Implementation

Utilizing a Bifurcated Structure, only the low income units in an 80/20 or mixed income project are financed with tax-exempt private activity bonds and the as of right 4% Low-Income Housing Tax Credits ("4% LIHTCs"), therefore greatly reducing the volume cap needed to meet the 50% test under the federal low income housing tax credit rules. Typically, developers of mixed income properties have the following priorities when financing a project: to qualify for tax abatements (in NY §421(a)); finance qualifying units with LIHTC; and lower financing costs by utilizing tax-exempt bond financing.

By creating separate condos (or sub-leases) for the low income and market rate units, tax-exempt bonds can be issued to finance the construction of the low income units and either taxable bonds or bank loans can be used to finance the market rate units. In a Bifurcated Structure, all units targeting low-income tenants are owned in a single condominium unit by a single purpose entity and financed using Tax-Exempt Bonds; all other units (e.g., market-rate, commercial) are owned in a separate condominium unit or units by a different entity. This structure separately finances the low-income portion of a development with tax-exempt bond proceeds, thus enabling an 80/20 or mixed-income project to satisfy Federal low-income housing tax credit requirements with a smaller allocation of new private activity bond volume cap. Once construction is completed and the low income units are placed in service, the tax-exempt debt is retired with the proceeds of the tax credits. There is no permanent tax-exempt debt outstanding for the low income units.

Tax Issues

Section 42(h)(4)(B) of the Code provides that where 50% or more of the aggregate basis of any "building" (as defined in Section 42) and the land on which the building is located are financed by tax-exempt bonds that carry with them volume cap, then the building shall be entitled to claim 4% low-income housing tax credits on its eligible basis. The Bifurcated Structure is based on Temporary Treas. Reg. section 1.42-1T(f)(1)(ii). Temp. Treas. Reg. section 1.42-

[1] Citizens Housing Planning Council, "Pump up the Volume", 2014. Available at: http://chpcny.org/assets/2_19-Pump-up-the-Volume-FINAL.pdf

1T(f)(1)(ii) provides that the determination of what portion of the proceeds of a bond issue are used to finance: (A) the eligible basis of a building and (B) the aggregate basis of the building and the land on which it is located shall be based upon the allocation of bond proceeds described in the bond indenture or related document where such allocation is consistent with the method used to determine if 95% of the net proceeds are used for exempt purposes. If the bond issuer either fails to provide an allocation, or is not consistent in making the allocation, the proceeds are allocated on a pro rata basis, according to cost, to all of the property financed by the issue.

In a project in which the affordable units are separated into a separate "building" (as defined in Section 42 of the Code), such as through the formation of a condominium unit (which is treated as a "building" under Section 42) or a master lease that is bifurcated into a separate partnership, it is possible to satisfy the 50% test of Section 42(h)(4)(B) of the Code by allocating volume cap bonds only to the "building" consisting of the affordable units.

<u>Benefits of a Bifurcated Structure:</u>

HDC has implemented the Bifurcated Structure for three financings to date with several others in its pipeline. We have presented 261 Hudson Street as a case study. The scarcity of volume cap in New York State has challenged the Corporation to seek out creative solutions to leverage its tax-exempt financing capacity. This structure benefits the Corporation, borrower and investor in several ways:

- A Bifurcated Structure is a viable tool to preserve the volume cap because only the low income units instead of all of the units are financed with tax-exempt bonds thereby reducing the amount of volume cap needed to meet the 50% test.
- This approach simplifies administration because there is no need for deep rent skewing and annual income certification since all units in the tax-exempt financed condo are low income.
- Under federal law, only the low income condo is considered a low income building and the market component is irrelevant, but for New York law, the development is considered to be one unified building and will qualify for the §421(a) tax abatement.
- The bifurcated structure allows the developer to sell the credits for the low income units without allocating the tax credit investor the income from the market rate units.
- Tax credit investors may prefer this structure because they are able to acquire the credits and the losses generated by the low income units.
- Tax and regulatory compliance is easier for the manager of an all low-income development.

<u>Case Study – 261 Hudson Street</u>

261 Hudson Street, an 80/20 development in lower Manhattan, is one of HDC's initial transactions that has utilized the Bifurcated Structure to create the same number of affordable units as the standard 80/20 model while using less volume cap. In June 2014, HDC issued tax-exempt private activity bonds to finance the construction of the low income portion of the 261 Hudson Street development, while the remaining market rate units were financed via a participation agreement between HDC and TD Bank pursuant to which TD Bank and other participants would acquire a 100% interest in such loan.

261 Hudson Street is a 201-unit mixed-income development located in the Soho neighborhood of Manhattan. It is comprised of 160 market rate units and 41 low-income units affordable to households making less than 60% of AMI. All residents will share the common area amenities and have similar individual apartment amenities. The low-income and market rate units will be dispersed throughout the physical building as per Inclusionary Housing's distribution requirements.

Of the 201 units, HDC issued tax-exempt bonds for 41 units (20% of total) and the remaining 160 market rate units (80% of total) were financed via a participation loan with TD Bank. Three separate condominium units will be formed prior to conversion to facilitate the transaction; one condominium for the market rate units, one condominium for the low-income units and a separate condominium for the retail space. The Corporation made a $13,000,000 senior loan to the low-income units funded from the sale of tax-exempt variable rate bonds. The low-income condo unit is treated as a separate low-income project for tax purposes. Therefore, the $13,000,000 bond allocation is sufficient to meet the 50% test on the approximately $25,000,000 million total development cost for the 41 unit low-income condo as opposed to needing over $60 million in volume cap to meet the 50% test for the entire 80/20 development .

In addition to the tax exempt financing, HDC originated a $101,000,000 loan to the Borrower of which TD Bank has 100% participation. The $101 million loan funds the 160 market rate units and the $101,000,000 TD Bank loan is subordinate to HDC's $13,000,000 loan. The two loans are cross-collateralized and cross-defaulted such that TD Bank is fully at risk for the entire $114,000,000 in financing.

TD Bank will be the servicer for both loans during construction. At conversion (expected to be in the summer of 2017), the TD Bank loan will be increased by $13,000,000 to pay off the senior HDC loan. HDC will then assign its interest in the TD Bank loan when the TD Bank letter of credit has been released and the bonds have been redeemed. After conversion, TD Bank will be the sole lender/servicer while HDC will remain as the Regulatory Agency insuring 35-years of affordability for the low-income units and monitoring the project's tax-credit compliance.

Summary of Results

Most states don't currently have a scarcity of private activity bond cap. But this has not always been the case. New York's situation is unusual, but the Bifurcated Structure explained above is an important innovation that has been adopted by the New York State Housing Finance Agency as well. By using this structure New York is able to encourage the production of mixed income housing in high cost areas and ensure that affordable housing is built in some of the most expensive neighborhoods in the country. At the same time, by frugally limiting the amount of volume cap needed for such transactions, New York is ensuring that more affordable housing can be financed with this limited resource.

Before the Bifurcated Structure was created high cost mixed income projects competed with more affordable projects for volume cap and in certain years both mixed income and low income projects had to be deferred until there was an allocation available for such projects. Although resource allocation will always play a role in managing a pipeline, the use of the Bifurcated Structure means that New York will have more volume cap available for low income projects as well as mixed income projects.

This balanced approach would be beneficial to and replicable by other states when and if they face more competitive volume cap environments.