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## Financing Supportive Housing with Tax-Exempt Bonds and 4% Low-Income Housing Tax Credits

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Development and Finance Team.

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## Inquiries

If you are interested in developing a supportive housing project, please see [www.csh.org](http://www.csh.org) for additional on-line resources and materials, including information regarding the communities in which we currently work. If you have questions or comments regarding this publication, please contact the CSH Resource Center at [info@csh.org](mailto:info@csh.org). This publication is available to download for free at [www.csh.org/publications](http://www.csh.org/publications).

CSH provides technical assistance through its local and regional offices, and may be able to advise interested public agencies. For example, CSH was instrumental in the design and implementation of the New York State Office of Mental Health's bond/tax credit financing initiative and plays an ongoing role in assisting project sponsors with technical and predevelopment loan support. CSH identified the key players, convened meetings with these agencies, and engaged consultants, attorneys and tax credit investors to assist in the design of the program. For more information, please feel free to contact Brigitt Jandreau-Smith, Managing Director, Project Development & Finance, at [brigitt.jandreau-smith@csh.org](mailto:brigitt.jandreau-smith@csh.org)

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## Background on Tax-Exempt Bonds and 4% Tax Credits

Tax-exempt bonds partnered with 4% Low-income Housing Tax Credits (LIHTC) have been widely used by affordable housing developers. It has taken longer for this financing structure to be used by permanent supportive housing developers since most assume their projects cannot support debt service on the bonds. In recent years, a number of states have devised strategies to address the debt service issue and non-profit sponsors of supportive housing have become increasingly sophisticated in the use of these financing tools.

This approach can expand the funding sources available for supportive housing, especially in those states and localities lacking dedicated capital programs for supportive housing and where competition for every affordable housing dollar is intense. For those public agencies that are already administering capital development programs, the use of bonds can leverage significant additional equity. In addition, this approach can create rental subsidy and service funding because tax credit equity can be used to fund reserves for these costs.<sup>1</sup> While this financing technique can be complex and more costly, its benefits generally far outweigh the costs and is showing great potential for the supportive housing industry.

This report is intended to introduce this technique to local and state officials considering bond financing, presenting several case studies and answering some of the most commonly asked questions.

## Tax-Exempt Bonds and 4% Low-income Housing Tax Credits

Tax-exempt bonds are debt obligations issued by state or local government agencies for multi-family rental housing, infrastructure improvements and other qualified municipal endeavors having a public purpose. The IRS Code (Section 103) allows the purchasers of the bonds to deduct the interest income from the bonds from their federal gross income taxes. Thus the interest rate on tax-exempt bonds is lower than conventional bank financing (typically by about 2%), and these savings can promote housing affordability.

Another feature of tax-exempt bonds is that they provide “as-of-right” (non-competitive) 4% Low-income Housing Tax Credits for housing projects that meet certain requirements. 9% Low-income Housing Tax Credits, which are more commonly used for supportive housing, are competitive and limited by the state’s allocation. The project equity that can be raised through the tax credits, along with lower interest rates, can be a potent financing tool for supportive housing, where tenants’ incomes are very low and support limited or no debt.

Housing bonds can be tax-exempt or taxable. Tax-exempt bonds have a lower interest rate and come with tax credits, whereas taxable bonds have neither of these advantages. The main benefit of taxable bonds is that they are not capped by the federal government, so therefore are more readily available.

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<sup>1</sup> See CSH’s *Capitalized Rental Subsidy Reserve* concept paper available at <http://documents.csh.org/documents/ResourceCenter/DevOpsToolkit/CapitalizedReservepdf.pdf>.

Tax-exempt housing bonds are often referred to as “private activity bonds,” a term also applied to other tax-exempt bonds limited by federal tax laws (see the “volume cap” discussion below).

## Requirements for Tax-Exempt Bonds and Tax Credits for Supportive Housing

### *Eligible Issuer of Bonds*

Only certain state or local public (or quasi-public) agencies are authorized to issue tax-exempt bonds, and only these agencies can participate in the program outlined here. In all states, the Housing Finance Agency is authorized to issue tax-exempt bonds for multifamily rental housing, and most major cities also have local authorities (e.g., housing or redevelopment agencies) that can also issue bonds.

### *Volume Cap*

Tax-exempt bonds are limited by federal law, often referred to as the “volume cap.” The limit imposed by the IRS Code is the greater of \$85 *per* state resident or \$256,235,000. States with large populations, like New York and California receive significant allocations - in 2007, New York State received \$1.64 billion and California received almost \$3.1 billion. Supportive housing projects must compete with other eligible projects (which may include infrastructure projects) for volume cap in order to utilize this financing.

### *95/5 Requirement*

At least 95% of the bond proceeds must be used to pay for or reimburse so called “good costs.” These are costs that are incurred after the project has been “induced” with a resolution from the bond issuing agency. Conversely, no more than 5% of the bonds may be used for “bad costs,” (costs incurred before the inducement) or non-residential costs (e.g., commercial space). Also, only up to 25% of the bonds can be used to pay for acquisition costs, and the bond funding used for the cost of issuance of the bonds is limited to 2%.

### *50% of Bonds in During Construction*

To qualify for an allocation of 4% Low-income Housing Tax Credits, 50% or more of the project’s development costs must be funded by bonds during construction. The bonds need not come into the project at construction closing, but must be committed to the project before construction is completed.

### *Tax Credit Requirements*

In addition to threshold requirements for bonds, the use of Low-income Housing Tax Credits has its own conditions, including: Rents must be affordable to persons under 60% of the area median (not an issue for supportive housing); apartments must be self-contained (have their own kitchen and bath); and housing must remain affordable for at least 15 years. There are a host of other requirements, and it is recommended that any jurisdiction contemplating this approach seek the advice of tax credit and bond experts.<sup>2</sup>

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<sup>2</sup> See “Further Reading” at the end of this document for additional reference materials on tax credits.

## Comparison of the Different Project Financing Models

There are two distinct financing models employed when using tax-exempt bonds and 4% credits for supportive housing: bonds used during construction only and bonds used for both construction and permanent financing.

### *Bonds for Construction Financing Only*

Bonds must be used during construction and must cover at least 50% of the total development costs in order to trigger 4% tax credits, but they need not remain as a permanent source of financing. If the bonding agency is willing to assign the bonds to construction only, to be taken out at the conversion to permanent financing, the project can benefit from the tax credits and lower construction interest, and use more favorable financing and/or grant sources in the permanent phase.

One of the challenges to this model is that the construction-only bond strategy uses valuable volume cap for only a limited term and still requires other permanent sources, so volume cap is not maximized. Also, construction-only bonds are an expensive way to secure tax credits (given the high bond transaction costs) and may only be feasible on larger-scale projects or when they are bundled by a public agency.

### *Bonds for Construction and Permanent Financing*

Another financing structure involves tax-exempt bonds being used during both construction and permanent terms, with the public agency (e.g., State Office of Mental Health or Substance Abuse Services) paying the debt service through the Sponsor.<sup>3</sup> This approach takes full benefit of the limited volume cap and also provides below market interest rates. It is also a more efficient transaction since it does not introduce new sources at conversion to permanent financing and spreads the transaction costs over the two loan periods.

The challenge of this technique is that the debt service is typically not supportable by the project's income and, therefore, needs to be funded by a public agency.

### *Bond Buy-Down at Permanent Financing*

A hybrid of the two models discussed above is where the bonds are used during construction and then bought-down by other sources at permanent conversion. A portion of the bonds remain in the permanent financing package. The amount of the bonds that remains is based on the amount of debt that can be supported (factored by a “debt service coverage ratio”) and the balance of permanent sources are the tax credit equity, grants or non-amortizing loans with deferred or no interest. In this way, the use of bonds is maximized and the project can still maintain affordability.

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<sup>3</sup> Since tax credits require that the project be owned by a limited partnership, which must incur the debt, the public debt service payment must flow through the partnership rather than directly to the bond issuing agency.

## Benefits to State or Local Governments Using Bond and Tax Credit Financing for Supportive Housing

There are number of benefits to state or local governments utilizing the combined tax-exempt bonds and 4% credits for the development of permanent supportive housing, among them:

- The leverage from private tax credit equity investment extends limited public funds. This is perhaps the most compelling argument for using this financing, and state and city budget departments highly value the leveraging effect on their funds. The budget impact can be as great as a 20% to 40% reduction of local contribution, depending on the uses of equity.
- Public agencies that provide capital for supportive housing can expand their development pipeline through the use of tax credits, or meet ambitious production goals that would be difficult to support otherwise.
- Public agencies can use the same production system they have been using and overlay the bond/credit financing onto their current system, so it is not disruptive.
- Tax credit equity can fund operating and replacement reserves, building upgrades, rental subsidy reserves, supportive services or additional acquisition and construction cost that the agency could not otherwise support.
- Use of “as-of-right” 4% credits takes pressure off of the competition for 9% credits, which are usually oversubscribed because they are limited.
- Projects using tax credits are generally very competitive due to the low income targeting (most private activity bonds only target 20%-40% of units for low-income) and public agencies are under pressure to increase the affordability of the projects they finance.
- Because the 4% credits are as-of-right by virtue of using tax-exempt bonds, they are far more reliable than 9% competitive credits for budget planning and production purposes.

Projects utilizing this financing structure will still typically have to meet threshold requirements for 4% LIHTCs in most states.

## Availability and Access to Tax-Exempt Bonds

The availability of tax-exempt bonds from local or state authorities varies considerably among states and bond issuing agencies, and from year-to-year based on public priorities and the demand for volume cap. Bonds for multifamily housing compete directly with other infrastructure and public facilities projects, and state and local priorities have much to do with the availability of tax-exempt bonds for supportive housing, or housing in general. The state’s allocation of volume cap in relation to the demand for volume cap from developers is also a factor, and in some cases, state or city agencies have bond programs that are underutilized. As noted above, even in very competitive situations, supportive housing projects tend to compete well given the income targeting and compelling public benefit.

In order to access tax-exempt bonds and 4% credits, the program must identify an agency that is authorized to issue the bonds and is willing to use its volume cap for supportive housing. Often there is already a bond issuer that finances housing and it is a matter of having them issue tax-

exempt private activity bonds rather than other types of ineligible bonds (e.g. New York State's use of 501(c)(3) bonds). In other cases, the agency responsible for supportive housing development has not used bonds and must broach the idea with an eligible agency. In addition to identifying the bond issuer, there must also be an agency that can review tax credit applications, underwrite and allocate tax credits and monitor tax credit compliance on an ongoing basis, which is typically the local or state agency that allocates the 9% tax credits.

## Complementary Financing and Ineligible Financing

Programs that combine tax-exempt bonds and tax credits may also include other complementary sources of financing:

- ***Permanent loans with no debt service, using bonds for construction financing only:*** Supportive housing projects may not be able to afford to pay debt service on permanent bonds (unless the funding agency pays debt service) and must then convert to debt-free financing once operating. For example, in New York City, Common Ground Community developed a project that only used Housing Development Corporation tax-exempt bonds during construction (in order to trigger the tax credits) and used other public funds, including the City's Supportive Housing Loan Program and the tax credit equity, to satisfy the bond obligation at conversion. Alternatively, the debt-free loans can buy down the bonds to an affordable level.
- ***Grant sources, such as the Federal Home Loan Bank Affordable Housing Program, HUD Supportive Housing Program, HOME funds, and local and state programs:*** These grants must be deducted from basis for tax credit purposed unless they are structured as a loan from the Sponsor to the Limited Partnership.

One source that cannot be combined with the bonds 4% credits is 9% Low-income Housing Tax Credits.

## 4% Credits versus 9% Credits

From a developer's perspective, the 4% credits are worth only about one-half of the of 9% credits since the federal credit rate is roughly half of the 9% rate. However, there are several reasons why the 4% credits may still be preferable to the 9% competitive credits:

- They are more reliable since they are available "as-of-right" along with tax-exempt bonds. This is very important for the planning of supportive housing production pipeline and the associated public cost.
- They don't count against limited 9% state (or city) allocations and therefore extend the 9% credits for affordable housing.
- The amount of tax credits per project is not capped, whereas 9% credits are usually capped by state Qualified Allocation Plans. This may actually result in a larger allocation of credits (and equity) than the 9% credits in the case of large-scale projects.



# Advancing the Tax-Exempt Bond and 4% Credits Financing Models at State or City Agencies

## *Making the Case*

As discussed earlier, the most compelling case for using tax-exempt bonds and 4% credits is the leveraging of private equity against limited public capital. Also a strong case can be made where the volume cap is undersubscribed and 9% credits have stiff competition.

But who typically needs to be involved in building the case, and where should it be directed? The lead public agency or agencies responsible for supportive housing production should be at the forefront in proposing this financing structure, and the “constituents” for the housing programs should lend active advocacy support. These may include mental health advocates, homeless advocates, non-profit Provider organizations that would utilize the funding, and localities that are most active in the field. Local Providers should also be urged to contact their representatives in the legislature to promote this proposal, including inviting them on tours of their supportive housing projects. To the extent that there are state-wide or city-wide trade associations for supportive housing (e.g., the Supportive Housing Network of New York), their support should be enlisted as well.

Lead agencies wishing to initiate this type of program can direct their case to the state or city budget office, which should appreciate the benefits of attracting private equity and buying-down their capital contribution. They should also recognize the favorable outcomes of social services reserves, capitalized with tax credit equity, on the public operating subsidies.

The case should also be made to the governor’s or mayor’s office, which will be sensitive to the positive budget impacts as well as the political gain achieved by helping solve the homeless housing and services problems. Given the governor’s (or mayor’s) role in assigning public priorities for their capital resources, they will also be able to advise the lead agency on the allocation of volume cap among the state’s (or city’s) needs, and whether this use is likely to gain support.

## *Securing Volume Cap*

The public agency that is the lead for developing supportive housing must identify the source for providing the tax-exempt bonds, which should be an agency willing to devote a portion of its volume cap to the program. Strategically, this should be an agency whose volume cap has not historically been fully utilized and/or shares a mission with the lead agency (e.g., has an affordable housing mandate, such as the state HFA). The agency providing the bonds could also be an agency that has been providing ineligible tax-exempt bonds (e.g. 501(c)(3) bonds) or taxable bonds, and could shift over to tax-exempt private activity bonds (see attached *Case Study #6* from the State of New York). This has the advantage of having an established working relationship and procedures between the two agencies that can be built upon.

## *Assessing the Demand for 9% Credits*

Since excess demand for competitive 9% tax credits makes a stronger case for use of 4% credits as an alternative, it is imperative that the lead agency assess the state-wide (or local) demand for allocations. Shifting a portion of the supportive housing pipeline from 9% to 4% credits would take some pressure off of the competitive 9% credits and free them up for traditional low-income housing projects. And in states where there is no set-aside for special needs housing, it would help “level the playing field”.

Staff in the tax credit allocating agency should be contacted and engaged in a review of the recent level of applications in relation to the allocation of credits available. That agency may also be responsible for issuing tax-exempt bonds for housing and may welcome the opportunity to offload supportive housing from 9% credits to 4% credits.<sup>4</sup>

### ***Identifying Sources of Bond Repayment or Permanent Take-out***

In order to use tax-exempt bonds as a permanent source of financing, there must be an income source to cover the debt service on the bonds. This coverage can be from the projects' rental income, as is done in Michigan (see attached *Case Study #4*), or may be paid by a third party, such as a state mental health agency, as is the case in New York State. As a basic matter of program feasibility, it is important to establish up front whether there is the ability to repay the bonds, and from what source. If there is no third party source, the bonds' interest rate will likely need to be reduced, and the amount of the bond will also need to be constrained.

Where the ability to cover the bonds' debt service is limited or unavailable, a permanent source or sources that can take out the construction period bonds is necessary (see *Case Study #5* from the State of New Jersey as an example of this structure). The source of take-out financing must be identified early in the program design stage, and it must be a reliable source. Examples of permanent take-out financing are: city or state loan programs with no interest or accruing interest; grant programs; HOME funds; and tax credits.<sup>5</sup>

### ***Promoting Cooperation Among Agencies - Roles and Responsibilities***

A public agency with the lead supportive housing development responsibility should be identified, and it is this agency that would assemble the needed financing to work directly with Sponsors on their projects. This may be a state or city housing development agency or a services agency that operates a residential development program.

Also key is a social services agency that provides the contracted services funding for supportive housing, often a mental health or homeless services agency. In some instances, this same agency may provide project operating support or rental subsidies, and, depending on the source of its funding, pay the debt service on the bonds. The lead development agency would partner with the services agency in the early stages of program design (e.g., enter into a MOU for the ongoing coverage of debt service on tax-exempt bonds).

As noted above, a bond-issuing agency that is willing to devote a portion of its volume cap to the program is a threshold requirement for moving forward. The lead development agency should enter into an MOU (assuming that it is a separate agency) that includes the amount of volume cap per year to be assigned. The bond agency must also coordinate with the lead agency around inducement, bond issuance and the timing of closing.

A tax credit underwriting and allocating agency should also be designated. This is typically the state Housing Finance Agency, which is already administering the Low-income Housing Tax Credits

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<sup>4</sup> Most state Housing Finance Agencies are the tax credit allocating agency and are typically also authorized to issue tax-exempt bonds and underwrite the 4% credits.

<sup>5</sup> Note that grant sources should be structured as loans from the General Partner to the Limited Partnership in order to maximize the basis and amount of tax credit equity that can be raised. For tax credit purposes, grants are deducted from basis whereas loans are includable.

program for the state. Importantly, the underwriting standards to be used by the lead agency need to be incorporated into the underwriting agency's review process to ensure consistency.<sup>6</sup>

Other partners may include city or state capital funding agencies that provide supplementary financing or permanent take-out loans, and public housing agencies that apply for or assign rental subsidies to the supportive housing projects.

## Further Reading

*Question & Answer: Can Supportive Housing Incorporate Tax-Exempt Bond Financing and Non-Competitive 4% Low income Housing Tax Credits?*, prepared by Ramon Mendez, Jr. of the California Housing Partnership Corporation on behalf of the Corporation for Supportive Housing, available at: <http://documents.csh.org/documents/ResourceCenter/SysChgToolkit/FinancialLeverage/4PercentLIHTCQ&A.pdf>.

*Multifamily Rental Housing: Financing with Tax-Exempt Bonds*, published by Orrick, Herrington & Sutcliffe LLP, available at <http://www.orrick.com/fileupload/211.pdf>.

*Introduction to Tax-Exempt Multifamily Housing Bonds*, by Eichner and Norris, available at [www.enbonds.com/articles.html](http://www.enbonds.com/articles.html).

*Tax Credits for Low-Income Housing, 2<sup>nd</sup> Edition*, by Joe Guggenheim, [info@housingtaxcredits.net](mailto:info@housingtaxcredits.net).

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<sup>6</sup> This may need to be done within the context of the state's Qualified Allocation Plan (QAP) review, which is usually done every one to two years.

## Financing Models Case Studies

- Case Study #1:* Financing Model Using Bonds Only During Construction  
(State of Ohio)
- Case Study #2:* Financing Model Using Bonds Only During Construction  
(City of New York)
- Case Study #3:* Financing Model Using Bonds Only During Construction  
(State of California)
- Case Study #4:* Financing Model Using Bonds During Construction and for Permanent Financing  
(State of Michigan)
- Case Study #5:* Financing Model Using Bonds During Construction and for Permanent Financing  
with Prepayment  
(State of New Jersey)
- Case Study #6:* Financing Model Using Bonds During Construction and for Permanent Financing  
with Debt Service Paid by State Agency  
(State of New York)
- Case Study #7:* A Hybrid Financing Model  
(State of Illinois/City of Chicago)



## Case Study #1: Financing Model Using Bonds Only During Construction (State of Ohio)

While the State of Ohio has not yet used tax-exempt bonds and 4% credits to finance supportive housing, the option is available and at least one non-profit sponsor seems poised to use this approach. The sponsors of supportive housing have traditionally relied on a range of capital financing sources for their projects, including:

- 9% credits (QAP provides a set-aside for supportive housing)
- State Housing Trust Fund gap financing – grant or soft loan up to \$750,000
- City and/or County HOME Investment Partnership Program (HOME) funds
- HUD’s Continuum of Care programs

In Ohio, the Department of Development (ODOD) designates specific pools for the volume cap, which includes \$120 million for multifamily housing. These funds are administered on a lottery basis and could include supportive housing projects, though none have applied to date.

If a non-profit sponsor wanted to use bonds or 4% credits, they would go through the Ohio Housing and Finance Agency (OHFA), which underwrites and allocates Low-income Housing Tax Credits, and issues tax-exempt bonds. OHFA could also provide gap financing through their Housing Trust Fund.

One reason that bonds haven’t been used for supportive housing is that the projects cannot support debt service and there is no source to cover it from other agencies. There are sources for services funding, but not for debt service or operations.

Additionally, while the demand for 9% credits is strong, there is a set-aside for supportive housing. In the last round, one-half of the supportive housing projects received awards. The others generally go back the following year for credits. And the larger projects, which would be better candidates for bonds/credits, tend to compete well for 9% credits.

As the structure contemplates using the bonds only for construction, identifying a grant or subsidized loan is required to take out the bonds. One non-profit organization -- Community Housing Network in Columbus – is looking to structure an approach whereby the OHFA or ODOD construction-period bonds could be taken out by the Ohio Department of Mental Health (ODMH) bonds. Since the ODMH pays the debt service on its bonds, this would obviate the need for debt service payments from the project’s income. The obstacle to using this structure is that the ODMH typically forgives its mortgage over the loan’s term, which is not allowable under the tax-credit program and would preclude using the 4% credits. Once this structure is retooled, it is expected to be utilized by non-profit supportive housing providers in Ohio.

*This case study is based on an interview conducted on July 26, 2007 with Sean Thomas, Director of the Office of Planning, Preservation and Development, Ohio Housing Finance Agency and information provided by the CSH Ohio Office staff.*



## Case Study #2: Financing Model Using Bonds Only During Construction (City of New York)

### New York City Housing Development Corporation (HDC)

In addition to the NYS OMH Program, the City of New York’s Housing Development Corporation has used tax-exempt bonds and 4% credits to finance a large-scale supportive housing project and is considering others. That project is known as Schermerhorn House and is being developed by the non-profit Common Ground in downtown Brooklyn. It will provide supportive housing for 217 formerly homeless single adults and is sponsored in partnership with the Actor’s Fund (which is developing housing for its members in the building).

The tax-exempt bonds are being used during construction only and will be taken out in permanent by tax credit equity and a deferred loan from the City’s Department of Housing Preservation and Development. Common Ground decided to pursue this approach as a more reliable route to a tax credit allocation (since 4% credits are as-of-right). Moreover, since the State’s 9% credits are capped per project, the 4% actually yielded more credits and equity than the 9% program would have provided.

The sources and uses for the Schermerhorn House are as follows:

Uses	Amount
Acquisition (Donated land)	\$0
Predevelopment costs	\$2,000,000
Construction	\$40,708,500
Construction contingency	\$2,035,425
Soft costs	\$1,987,860
Developer's fee/Reserves	\$7,700,000
Working Capital	\$865,500
Underwriting Costs/Const. Int.	\$3,759,341
<b>Total</b>	<b>\$59,056,626</b>

Construction Financing Sources	Amount
Tax Exempt Bonds	\$30,000,000
City*	\$13,391,826
State*	\$6,749,800
Federal Home Loan Bank*	\$675,000
4% Tax Credit Equity	\$1,040,000
Deferred Developer Fee	\$7,200,000
<b>Total</b>	<b>\$59,056,626</b>

Permanent Financing Sources	Amount
City*	\$19,809,342
State*	\$6,749,800
Federal Home Loan Bank*	\$675,000
4% Tax Credit Equity	\$28,417,209
Deferred Developer Fee	\$3,405,275
<b>Total</b>	<b>\$59,056,626</b>

*\*Non-amortizing debt - interest accrues at 1%*



## Case Study #3: Financing Model Using Bonds Only During Construction (State of California)

### **Laurel Gardens Apartments**

*Note: The following is a summary of a [case study of the Laurel Gardens Apartments](#) prepared by Ramon Mendez, Jr. and Meg McGraw-Scherer of the California Housing Partnership Corporation (CHPC) on behalf of the Corporation for Supportive Housing.<sup>7</sup> CHPC also acted as the Consultant on this project, and the Sponsors are Resources for Community Development, a non-profit housing developer, and Caminar/CLC, a services agency that works with disabled and homeless persons.*

### **Background**

The Consultant on this project decided to use tax-exempt bonds and 4% credits since they are less competitive in California than the alternative approach of taxable bonds and 9% tax credits. As the local public housing agency was not authorized to issue bonds, the CHPC identified the California Statewide Communities Development Authority as the issuer of the tax-exempt bonds.

### **Project Description**

This project involved the new construction of a 30-unit project (3 studios, 13 one-bedroom and 14 two-bedroom units) for persons with mental illness, eight of whom are formerly homeless individuals. The housing provides permanent independent living, and has an on-site manager and services coordinator.

### **Financing Structure**

This project utilized tax-exempt bonds for 56% of the total costs during construction (providing a comfortable cushion against the 50% minimum requirement) and fully took out the bonds at permanent conversion with other public loans, grants and tax credit equity. Recognizing the limited ability of the project rental income to support debt service, even the permanent loans were repayable to the extent of net operating income (“residual receipt loans) or interest-accruing loans.

The specific sources and amounts of construction and permanent financing are outlined below:<sup>8</sup>

Construction Financing Sources	Amount
Tax Exempt Construction Loan (Bonds)	\$4,250,000
State HOME Loan	\$1,410,000
State Housing Loan	\$0
City Loan	\$1,100,000
Supportive Housing Program (HUD)	\$400,000
Deferred Developer Fee	\$210,000
4% Tax Credit Equity	\$270,000
<b>Total</b>	<b>\$7,640,000</b>

<sup>7</sup> The full case study of [Laurel Gardens Apartments](http://documents.csh.org/documents/ResourceCenter/SysChgToolkit/FinancialLeverage/LaurelGardens4percentCaseStudy.pdf) is available at <http://documents.csh.org/documents/ResourceCenter/SysChgToolkit/FinancialLeverage/LaurelGardens4percentCaseStudy.pdf>.

<sup>8</sup> Note that the difference between the construction and permanent sources - \$1,360,000 - is attributed to reserves, developer’s fee, and financing fees paid from tax credit equity, which has been back-loaded to improve the tax credit raise.

<b>Permanent Financing Sources</b>	<b>Amount</b>
State HOME Loan	\$2,790,000
State Housing Loan	\$1,700,000
City Loan	\$1,100,000
Supportive Housing Program (HUD)	\$400,000
Deferred Developer Fee	\$210,000
4% Tax Credit Equity	\$2,800,000
<b>Total</b>	<b>\$9,000,000</b>

The project also utilizes Project-based Section 8 rental subsidies, which make the higher rent units affordable and provide an internal subsidy for the 8 homeless units.





## Case Study #4: Financing Model Using Bonds During Construction and for Permanent Financing (State of Michigan)

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### Background

The Michigan State Housing Development Authority (MSHDA) has used tax-exempt bonds and 4% tax credits on six supportive housing projects as a way to expand the resources dedicated to addressing the State's homelessness problem. The 9% tax credit program has been very competitive and the lottery structure of the program places non-profit sponsors at a disadvantage since for-profit developers submit more applications. With approximately 81,000 homeless persons in the state, MSHDA taps the full range of housing finance tools and subsidies to impact the need, and the bonds/credits is viewed as one of the tools available.

### Financing Structure

MSHDA has two models of supportive housing that utilize tax-exempt bonds and 4% tax credits – supportive housing set-aside and 100% supportive housing projects.

The Supportive Housing Set-Aside model reserves up to 25% of the units in a tax-exempt bond project for homeless households, and folds in the additional subsidy from HOME needed to maintain affordability (up to \$65,000/unit). The MSHDA loans are offered at reduced interest rates, with approximately .5 point deducted from the interest rate for every 15% of units reserved for homeless persons, with a 4% interest rate being typical. In addition, MSHDA has been able to have Section 8 vouchers from the Public Housing Authority converted to Project-based Section 8 and made available to all of the units in these projects. Subsidies are sized at a level to induce for-profit developers to carve-out units for supportive housing, though there are no minimum requirements.<sup>9</sup>

The 100% Supportive Housing model also takes advantage of tax-exempt bonds and 4% tax credits, but must also access other subsidies in order to meet the affordability levels (30% of Area Median Income or less). Since these projects must pay their own debt service, loans and subsidies are sized to allow the rental income to cover the loan repayment. The typical financing structure includes:

- MSHDA tax-exempt bonds at 1% interest<sup>10</sup>
- Tax credit equity from 4% credits
- MSHDA HOME Funds (including those targeting chronically homeless)
- Deferred Developer's Fee
- Project-based Section 8 (for all units)

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<sup>9</sup> MSHDA's draft 2008 Qualified Allocation Plan (QAP) includes a minimum required set-aside of 10% for supportive housing in projects using 4% tax credits. It is uncertain at this time if this requirement will be in MSHDA's final 2008 QAP.

<sup>10</sup> A percentage of MSHDA's funds must be invested at 1% interest, with MSHDA writing down the rate with its own funds.

### Illustrative Project

MSHDA is currently underwriting a large stand-alone project in Detroit that would provide 150 one-bedroom units for homeless veterans. The permanent financing sources and amounts are:

Permanent Financing Sources	Amount
MSHDA Mortgage (Tax-exempt Bonds)	\$9,957,865
Equity Contribution from 4% Tax Credit Syndication	\$7,087,917
MSHDA HOME	\$1,744,447
Wayne County Environmental Grant and Loan	\$320,000
Developer Loan/ Deferred Developer Fee	\$900,000
GP Capital Contribution for Resident Service Fund Account	\$60,000
<b>Total</b>	<b>\$20,070,229</b>

The MSHDA Mortgage is set at 1% interest for a 40-year term, which is the only debt on the project and is repayable from project income.

### Program Administration and Roles

MSHDA is the lead state agency in the development of supportive housing in Michigan and its Executive Director, Michael R. DeVos, has been very interested in promoting supportive housing. Their Supportive Housing and Homeless Initiatives Unit spearheads these projects state-wide and partners with non-profit and for-profit developers to carry out housing plans. Other state agencies serving homeless disabled persons (e.g., Community Mental Health Boards) do not have their own residential development programs, nor do they pay debt service on projects serving their populations. Instead, they generally rely on placing individuals in existing housing and look to MSHDA for new housing opportunities.

The financing of supportive housing with tax-exempt bonds as well as the allocation of the 4% credits are done within MSHDA, making for a very efficient and coordinated “one-stop” system. Moreover, MSHDA uses its own volume cap for these projects, which has not been constrained since supportive housing is a high priority for the agency.

### Status and Future of Program

Given their success with using tax-exempt bonds and 4% credits in Michigan, MSHDA intends to continue offering this product as only one of many financing tools to address supportive housing needs. Since the 9% credits provide more subsidy, this program may become more widely used for supportive housing if the new QAP has a required set-aside for special needs housing.

MSHDA’s initial six supportive housing projects were part of a CSH demonstration program and the project for homeless veterans in Detroit is the first large-scale congregate project for the State. These projects have created a foundation that the State intends to build on.

*This profile is based on a phone interview conducted on July 13, 2007 with Gary Stockard, Program Specialist, Supportive Housing Development Unit, MSHDA.*



## Case Study #5: Financing Model Using Bonds During Construction and for Permanent Financing with Prepayment (State of New Jersey)

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The New Jersey Housing Mortgage Finance Agency (HMFA) has used tax-exempt bonds and 4% credits to finance several supportive housing projects and offered the Robins Nest supportive housing project as an example. This project involved the development of 20 units of supportive housing for youth aging out of foster care.

The financing is somewhat unusual – the New Jersey Special Needs Trust Fund (SNTF) was used during construction, because HMFA funds would have required prevailing wage construction, whereas the SNTF does not. Tax-exempt bonds were used as the permanent take-out, and the project met the 50% test for 4% tax credits.<sup>11</sup> Since the project could not support the debt service on the bonds, the HMFA used the SNTF to pre-pay the bonds after one year outstanding.<sup>12</sup> The SNTF was structured as a 20-year deferred loan with interest accruing, so there was no debt service. And the project was able to raise tax credit equity through the use of a 4% credit allocation. The staff of the HMFA noted that they expect to use this tax-exempt bond financing approach more in the future.

Credit enhancement for the bonds was from a state general obligation for the larger bond issue, which was made by the HMFA on behalf of the state's mental health agency.

### **Program Administration**

The NJ HMFA acts as the development arm for the New Jersey Department of Human Services, Division of Mental Health Services, which has no capital programs of its own and does not have the housing development infrastructure.

The projects are typically 100% special needs populations and typically include between 3 and 10 units.

*This case study is based on presentation on February 2, 2007 delivered by Eileen A. Hawes, CFO, NJ HMFA at a meeting of the Corporation for Supportive Housing in NYC.*

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<sup>11</sup> While the more common approach to meeting the 50% test for 4% credits is to use the bonds prior to construction completion and placed-in-service, the NJ HMFA's legal counsel approved using the bonds for permanent take-out.

<sup>12</sup> The tax-exempt bonds must be outstanding for a period of time in order to qualify for the 4% credits and one year was deemed acceptable to the HMFA Counsel.



## *Case Study #6:* Financing Model Using Bonds During Construction and for Permanent Financing with Debt Service Paid by State Agency (State of New York)

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The New York State Office of Mental Health’s (OMH) use of tax-exempt bonds and 4% tax credits offers an excellent model of reworking a current bond program to include 4% credits that can be replicated by other states where circumstances allow.

### **Background**

OMH has financed approximately 200 residential projects for mentally ill single adults through the use of 501(c)(3) bonds and annual appropriations that fund debt service, operating costs and supportive services costs. To date, they have worked through the Dormitory Authority of the State of New York (DASNY) on the issuance of \$300 million in bonds.

Over 10 years ago, the Corporation for Supportive Housing (CSH) approached OMH with the idea of utilizing Low-Income Housing Tax Credits in tandem with OMH capital as a way to leverage federal/private funding. While OMH had considered the use of tax credits, the 9% credits are not compatible with the 501(c)(3) bonds, so this approach was not pursued at that time.

In 2006, CSH assembled a team to design a financing system that would enable OMH to use its existing housing model to leverage tax credits. OMH was particularly open to finding a way to leverage outside funds since it had recently entered into the “New York/New York III”<sup>13</sup> agreement with the City of New York, which has very ambitious production goals.

### **Program**

What emerged from these efforts was a financing structure that utilizes tax-exempt private activity bonds instead of the 501(c)(3) bonds, which DASNY is authorized to issue, along with the as-of-right 4% tax credits. DASNY has sufficient volume cap to devote to this new program on an ongoing basis and is experienced in working in partnership with OMH. Importantly, the debt service on the bonds is fully covered by the OMH, as they had done for the 501(c)(3) bonds.

The tax credits are underwritten and allocated by the state’s Division of Housing and Community Renewal (DHCR), which already administers the 9% and 4% tax credit programs.

The ownership structure for Sponsors participating in the new program needed to change to accommodate the tax credit requirements. While the OMH can only lend to a “Voluntary Mental Health Agency (VMHA),” the tax credits require that the project be owned by a Limited Partnership owned by the equity investors. To reconcile this, the VMHA will form a for-profit subsidiary general partner, which will participate in the Limited Partnership. Also, the title to the property will

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<sup>13</sup> New York/New York III is a 2005 agreement between the City and State of New York that commits funding for the development of 9,000 units of supportive housing over 10 years, along with funding for the necessary on-site supportive services.

be divided between the VMHA (holding “record title”) and the Limited Partnership (holding “beneficial title”). This structure gives the Sponsor the control over day-to-day operations while providing the Limited Partners the tax credit benefits associated with ownership. In addition, the operating/services contract and debt service payments flow through the VMHA into the Partnership.

### **Typical Financial Structure**

On a typical project, the tax credit equity raised pays for approximately 35% of the total development costs and reduces OMH’s cost by about 23% over what they would have otherwise funded (without syndication-related costs).

The DHCR has agreed to allow an overall developer’s fee of 15% of total development costs from which the Sponsor agency receives \$7,500 per unit toward its own compensation for developing the project. The amount of developer’s fee in excess of the sponsor’s compensation can be used for OMH-approved costs, which may include:

- Social Services Reserves (which are spent-down over 15 years for supplementary services costs not funded by OMH);
- Owner upgrades (e.g., green building features, amenities, video security systems);
- Unusual site development costs (e.g., environmental remediation);
- Property acquisition costs that exceed OMH’s caps; and
- Seed Money for future supportive housing projects.

The tax credit equity is available upon the issuance and closing of the tax-exempt bonds, which can take place at any point during construction. Since OMH looks to the equity as a construction source, the syndication closing must occur early enough in the construction process to take over construction funding once OMH funds are fully disbursed.

OMH has developed its own underwriting guidelines, which in some cases diverge from those of DHCR, and is currently in the process of working with DHCR to try to adopt these uniform program standards (through the Qualified Allocation Plan and administrative policies of DHCR).

### **Status and Future of Program**

The NYS OMH initially identified 6 projects that were already in their production pipeline for the new program, and they will be closing on these projects at the end of 2007. The most recent RFP issued by OMH requires that the Sponsors use 4% tax credits, which is helping the agency cover the capital costs of the ambitious New York / New York III production program.



## Case Study #7: A Hybrid Financing Model (State of Illinois / City of Chicago)

The Illinois Housing Development Authority (IHDA) has participated in three projects that have used tax-exempt bonds and 4% credits to finance supportive housing, including:

- Coppin House (55 units for grandfamilies - grandparents raising children - and youth aging out of foster care);
- Clare’s Village (52 units for homeless families); and
- San Cofu (54 units for youth aging out of foster care).

The impetus for this financing approach was the Sponsor – Interfaith Housing – which decided to use 4% credits as a more reliable and faster route than the 9% credits. The 9% credits are quite competitive in Illinois, which receives 3 times more requests than its allocation.

The tax-exempt bonds were issued by the City of Chicago, which has less demand on it than does the State’s scarce volume cap for housing. The City was also responsible for underwriting the tax credits and issuing the allocation.

In order to maintain affordability, the projects required significant subordinate financing from IHDA and the City of Chicago. The bonds used during construction were both long and short-term, with the long-term bonds staying in as a permanent source and the short-term bonds acting as a bridge against the tax credit equity. The equity takes out the short-term bonds (\$5,560,062) at permanent and the long-term bonds are sized at a level supportable by rental income. There are no sources of debt service payment available from other state agencies in Illinois, so the bond repayment relies on rental income.

### Coppin House Sources of Construction Financing and Equity

Type	Amount	Term	Rate
Collateral Mortgage (Long-term Bonds)	\$2,745,000	40 years	5.400%
Harris Bank (Short-term Bonds, Equity Bridge)	\$5,560,062	18 months	4.000%
IHDA HOME 3rd	\$3,500,000	40 years	0.000%
IHDA Trust Fund 4th	\$750,000	40 years	0.000%
FHLB AHP Grants	\$600,000		
Illinois Energy Grants	\$213,215		
Enterprise Foundation Grant	\$25,000		
Enterprise Community Investment Equity	\$1,547,406		
Deferred Developer Fee Equity	\$829,112		
<b>Total Project Cost:</b>	<b>\$15,769,795</b>		

IHDA is trying to promote the use of tax-exempt bond financing along with 4% credits for supportive housing. Their concern, however, is that bonds utilized only during construction lose value since volume cap is used up without providing the additional long-term benefits of the bonds (e.g., lower interest rates). They are reviewing whether the bonds could be recycled into other

projects as permanent financing (though the credits could only be claimed once).

Additionally, IHDA has been working on revisions to the state's Qualified Allocation Plan to increase the competitiveness of supportive housing projects. If these changes are approved, it may take some pressure off of the use of tax-exempt bonds and 4% credits for supportive housing, or may further extend the pipeline of projects.

*This case study was based on an interview conducted on August 2, 2007 with Michael Lomeier, Director of Multifamily Programs, Illinois Housing Development Authority.*