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Local Conduit Issuances of Affordable Housing Bonds in North Carolina: The Basics

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North Carolina **suffers** from a lack of affordable housing options for low and moderate income households. And as my colleague Tyler Mulligan **has noted**, the public sector cannot be expected to solve this problem without private sector capital and expertise.

In a **May 2022 post**, Tyler outlined many of the ways in which North Carolina's local governments can aid the development of privately owned affordable housing. But some units of local governments in our state possess at least one additional tool not mentioned there: the ability to serve as a "conduit issuer" of tax-exempt debt that a private entity can use to finance the construction or rehabilitation of privately-owned affordable multifamily rental housing for low and moderate income individuals.

This blog post explains what a "conduit issuance" is, details the types of local governments in North Carolina that may serve as conduit issuers of tax-exempt bonds for affordable multifamily rental housing, and the advantages of using tax-exempt debt for this purpose. It is not a comprehensive treatment, but instead outlines—in broad terms—some of the federal and state laws and processes that govern conduit bond financing for multifamily affordable housing projects in North Carolina.

How Developers Finance Construction or Rehabilitation of Affordable Housing

Like any private business, an affordable housing developer can rely upon two types of financing when constructing or rehabilitating an affordable housing project: debt financing and equity financing.

Debt and equity financings for affordable housing projects can take a variety of forms. Equity financing might come in the form of a developer's funds or an investment from a third-party investor in exchange for the right to claim federal income tax credits that an affordable housing development generates. Debt financing might take the form of a traditional loan from a bank or a governmental entity; it also might take the form of a "tax-exempt" bond.

As the name suggests, interest paid to a holder of a tax-exempt bond is exempt from federal income tax.**[1]** Because the holder of such a bond can receive tax-free interest, it will accept an interest rate that is lower than a comparable debt instrument paying taxable interest. The use of tax-exempt bonds can lower a developer's costs to complete an affordable housing project and might help to make a project feasible. The federal tax code—the Internal Revenue Code of 1986, as amended (the "Code")—outlines in detail how a bond issued to support a privately owned affordable housing development must be structured to qualify as a tax-exempt bond.

The Internal Revenue Code and Conduit Issuances of Affordable Housing Bonds

Tax-exempt bonds generally come in two varieties under the Code: (1) governmental bonds; and (2) "qualified private activity" bonds.

Governmental Bonds

Units of local government and public authorities in North Carolina frequently issue tax-exempt governmental bonds to finance projects that they will own and operate.**[2]** In these cases, a local government is both an "issuer" (i.e., it *issues* the debt) and an "obligor" (i.e., it is legally *obligated* to repay the debt). For example, a municipality might issue general obligation bonds to finance the construction of a city park or it might issue revenue bonds to finance improvements to its water and sewer system. In each case, under state law, the municipality would be responsible for the repayment—from, respectively, general property tax proceeds or the revenues of its water and sewer system—for the debt incurred.

By contrast, in a typical "conduit" financing, a governmental entity acts as an "issuer," but is not responsible for the repayment of debt. In these cases, a governmental issuer "borrows" money, issue bonds evidencing the debt, and loan that money to a private entity to carry out a statutorily authorized public purpose.**[3]** In turn, the private entity repays principal and interest on the loan, which corresponds to and equals the principal and interest owed on the issuer's bonds. As discussed later in this post, local housing authorities in North Carolina frequently serve as conduit issuers of debt to finance affordable housing projects.

The Code restricts the extent to which bond proceeds can benefit non-governmental entities and still retain their status as tax-exempt governmental bonds. A full explanation of these restrictions is not possible here, but the Code generally will deem a bond to be a "private activity bond"—and interest paid upon such a bond to be taxable—if, among other things, more than five percent of the bond proceeds are loaned to non-governmental persons. *See* **26 U.S.C. § 141(c)**. A bond that a governmental entity uses to finance a loan to a private affordable housing developer is necessarily a private activity bond.

Despite this restriction, though, Congress has permitted interest paid upon certain types of "*qualified* private activity bonds" to retain the tax exemption afforded to interest paid to holders of traditional governmental bonds. With proper structuring, bonds issued to finance "qualified residential rental projects"—the construction or rehabilitation of privately owned affordable housing developments—can qualify as tax-exempt qualified private activity bonds under **Section 142 of the Code**.

Qualified Private Activity Bonds for Affordable Housing: "Qualified Residential Rental Projects"

Section 142(d) of the Code and **associated IRS regulations** detail what types of projects a private affordable housing developer can finance using the proceeds of tax-exempt bonds issued for a "qualified residential rental project." At least 95% of the proceeds of a tax-exempt bond issuance for a qualified residential rental project must be used for related capital costs (e.g., construction or rehabilitation of a residential building and related facilities), and no more than 25% of the proceeds of a bond may be used to acquire land. *See* **26 U.S.C. § 147(c)**.

Most critically, an eligible project generally requires that either (1) at least 20% of the residential units are occupied by individuals whose income is 50% or less of the area median income (the "20/50 test"), or (2) at least 40% of the residential units are occupied by individuals whose income is 60% or less of the area median income (the "40/60 test").**[4]** *See* **26 U.S.C. § 142(d)(1)(A) and (B)**.

Often, developers exceed these minimums, in part to ensure that their project obtains separate low-income housing tax credits that can accompany tax-exempt bonds. For more information on that topic, see "*The Critical Advantage of Qualified Residential Rental Bonds = Eligibility for "4% Tax Credits*" below.

Why Are Local Governments Involved in Conduit Issuances of Bonds for Privately-Owned Housing Projects?

Qualified private activity bonds—including bonds issued to finance a qualified residential rental project—still must be issued by a "[s]tate or political subdivision thereof" to qualify for tax-exempt status. **26 U.S.C. § 103(c)(1)**. Therefore, a state or local governmental entity (e.g., a local housing authority) must be a participant in the bond financing structure, even if it only acts as a "conduit" for a private borrower.

Units of Local Government and Public Authorities That May Serve as Conduit Issuers of Tax-Exempt Bonds for Affordable Housing in North Carolina

State law—not federal tax law—serves as the source of legal authority for North Carolina's local governments to participate in a conduit financing and issue tax-exempt bonds for privately owned and operated affordable housing.**[5]** At present, North Carolina law permits five types of units of local government to issue multifamily housing revenue bonds and loan the proceeds of those bonds to a private entity (e.g., a housing developer): (1) a municipal housing authority; (2) a county housing authority; (3) a municipality exercising the powers of a housing authority; (4) a county exercising the powers of a housing authority; and (5) a regional housing authority. Because municipal and county housing authorities issue the vast majority of tax-exempt bonds used to finance privately owned affordable housing in North Carolina, this section only includes information about these types of local governments.**[6]**

Municipal or County Housing Authority – G.S. Chapter 157, Article 1

Under North Carolina law, municipal and county housing authorities are independent governmental entities respectively that a municipality or county creates. *See* **G.S. 157-9(a)**; **G.S. 157-33**, **-34**. Among other things, a housing authority may "carry out . . . housing projects." *See* **G.S. 157-9(a)**. A "housing project" includes the provision of "loans" to "public or private developers of housing for persons of low income, or moderate income, or low and moderate income." **G.S. 157-3(12).**

State law permits a housing authority to issue bonds for the purpose of providing these loans—and in connection with the issuance of these bonds, a housing authority may make the bonds payable from and secured by "*[e]xclusively* the income and revenues of the housing project financed in whole or in part with the proceeds of such bonds." **G.S. 157-14**.

Read together, these statutes permit municipal and county housing authorities to act as "conduit issuers" of debt for private developers of affordable housing. In a "conduit issuance," a housing authority (1) "borrows" money and issues a bond evidencing the debt, and (2) loans that money to a private developer (most commonly a special purpose entity created solely for the purpose of owning the financed housing project) to construct or rehabilitate affordable rental housing. In turn, the private developer repays principal and interest on the loan, which corresponds to and equals the principal and interest owed on the housing authority's bonds.

In a conduit financing, neither the county nor municipality that creates the housing authority assumes any obligation to repay the debt. *See* **G.S. 157-14**. And if a bond is payable from and secured exclusively by the income and revenues of the financed project, a housing authority will

not assume any credit risk by engaging in a conduit financing. A bondholder's sole recourse in a conduit financing is to obtain payments from the borrower from revenues that the financed affordable housing project generates. If those payments are insufficient to cover debt service, bondholders—not the issuing authority—will suffer a loss.

Selected Steps and Approvals to Issue Tax-Exempt Bonds for a Qualified Residential Rental Project

To close a successful issuance of tax-exempt bonds for a qualified residential rental project, the Code and North Carolina law require certain approvals. Bond counsel—a private law firm retained by the issuer to provide a legal opinion that bonds have been issued in accordance with state law and qualify for tax-exempt status under the Code—typically assists in guiding transaction participants through required approvals at the local and state levels and preparing related documentation.

1. **Issuer Adoption of "Inducement" / "Reimbursement" Resolution**

The Code and IRS regulations generally limit the extent to which the proceeds of tax-exempt bonds —including qualified residential rental bonds—can be used to reimburse expenditures made prior to the date that a bond is issued. *See generally* **Treas. Reg. § 1.150-2**. An issuer that adopts a declaration of "official intent"—typically in the form of a resolution adopted by its governing board —can reimburse itself for capital expenditures occurring up to 60 days prior to the adoption of that declaration. *See* **Treas. Reg. § 1.150-2(e)**. Because this "declaration" is usually in the form of a governing board resolution and occurs prior to the issuance of any bonds, it is commonly referred to as either an "inducement" resolution or a "reimbursement" resolution.**[7]**

In a transaction in which a county or municipal housing authority will act as a conduit issuer of tax-exempt bonds, the authority (not the private borrower or the county or municipality that created the authority) will adopt such a reimbursement resolution. Adoption of a reimbursement resolution does not obligate the authority to take any additional actions in a particular financing, but it is an important step to preserve tax-exempt financing eligibility for expenditures made early in a project.**[8]**

2. **"TEFRA" Public Hearing and Approval (26 U.S.C. § 147(f); Treas. Reg. § 1.147(f)-1)**

Since the adoption of the Tax Equity and Fiscal Responsibility Act of 1982—also known as "TEFRA"— the Code has generally afforded tax-exempt status to "private activity bonds" only if an "applicable elected representative" of a governmental unit "having jurisdiction over the area" containing the financed facility approve the issuance of the bond after (1) a public hearing, (2) following "reasonable" public notice. **Pub. L. No. 97-248, § 215, 96 Stat. 468**; **26 U.S.C. § 147(f)**. To satisfy this provision, municipal and county governing boards are commonly called upon to "approve" a housing authority's issuance of tax-exempt bonds.

Because the governing boards of municipal and county housing authorities in North Carolina are not elected, these entities do not have an "applicable elected representative" under the Code. *See* **G.S. 157-5(a)** (providing for appointment of municipal housing authority governing board members by mayor); **G.S. 157-34** (providing for appointment of county housing authority governing board members by board of county commissioners). In this situation, the Code and associated IRS regulations provide that the "applicable elected representative" for approval purposes is the "applicable elected representative" of the governmental unit from which these housing authorities "derive" their authority. **26 U.S.C. 147(f)(2)(E)(ii)**; **Treas. Reg. § 1.147(f)-1(e)(2)(i)**. Municipal and county housing authorities derive their authority from, respectively, the municipality or county that

they serve. Therefore, the governing board of a county or municipality is eligible to provide the required "TEFRA" approval after a public hearing.

The public hearing that the Code requires need not necessarily occur before the governing board of a municipality or county, but it must provide a "reasonable opportunity for interested individuals to express their views, orally or in writing, on the proposed issue of bonds and the nature of the proposed project to be financed." **Treas. Reg. § 1.147(f)-1(d)(1)**. Often, these public hearings are held before an official of the housing authority, with the comments (if any) being reported to the board that will approve the issuance.

Bond counsel typically assists in preparing the public notice required under the Code (see **Treas. Reg. § 1.147(f)-1(d)(4)**) and an approving "TEFRA" resolution. For an example of a "TEFRA" approval resolution, see **City Council of the City of Charlotte Resolution Book 53, Page 683 (Mar. 13, 2023)**. Although a governing board is not obligated to approve a "TEFRA" resolution, approving a financing for purposes of the Code does not subject the approving municipality or county to any liability for repayment of the bonds if issued.

Ultimately, the governing board of an issuer (e.g., housing authority)—in a separate authorizing resolution—decides whether to authorize a particular transaction.

3. **State Approvals**

A conduit issuance of tax-exempt bonds by a county or municipal housing authority cannot occur without the involvement of at least one, and sometimes two, bodies at the state level.

- ***North Carolina Federal Tax Reform Allocation Committee / North Carolina Housing Finance Agency – Award of Volume Cap***

In the early 1980s, Congress began to cap the aggregate volume of certain tax-exempt private activity bonds that could be issued annually in each state. *See* **Dennis Zimmerman, *The Volume Cap for Tax-Exempt Private-Activity Bonds: State and Local Experience in 1989* (Advisory Commission on Intergovernmental Relations, July 1990), at 4-5.** In passing the Tax Reform Act of 1986, Congress capped the aggregate volume of tax-exempt private activity bonds that, in particular, could be issued to finance qualified residential rental projects in each state. *See* **Pub. L. No. 99-514, § 1301, 100 Stat. 2603**. That limitation has continued into the present day—and the Code only affords tax-exempt status to private activity bonds issued for qualified residential rental projects if an issuance has received an allocation of a state's "volume cap." *See* **26 U.S.C. § 146**.

The North Carolina Federal Tax Reform Allocation Committee—also known as "TRAC"—is a state-level body that is empowered to allocate North Carolina's annual volume (**approximately $1.283 billion in 2023**) to certain projects. *See* **G.S. Chapter 143, art. 51B**; **S.L. 1987, c. 588**. The **North Carolina Housing Finance Agency** ("NCHFA")—another state agency—serves as TRAC's agent in evaluating applications to receive a portion of North Carolina's tax-exempt bond volume for qualified residential rental bonds.

Each year, NCHFA releases a Qualified Allocation Plan ("QAP") that details how affordable housing developers may apply for and obtain allocations of North Carolina's tax-exempt bond volume for qualified residential rental projects. The QAP sets out in significant detail the requirements that a developer must meet and how applications for volume cap will be evaluated. *See, e.g.*, **The 2023 Low-Income Housing Tax Credit Qualified Allocation Plan For the State of North Carolina, Section V (Allocation of Bond Cap)**. Although NCHFA does not technically approve or authorize a local housing authority to participate in a conduit issuance, its award of "volume cap" for a

particular residential housing project is necessary to secure the tax-exempt status of any bond issued to finance that housing project.**[9]**

- ***The Critical Advantage of Qualified Residential Rental Bonds = Eligibility for "4% Tax Credits"***

Since 1986, the Code has permitted developers to claim two types of "low-income housing tax credits" when construction or rehabilitating affordable housing projects: (1) a "9% credit", and (2) a "4% credit." A full discussion of low-income housing tax credits is beyond the scope of this post, but these programs serve as the one of the most vital sources of capital for the construction and rehabilitation of affordable housing in the United States. Developers—or, more commonly, institutional investors who purchase these tax-credits in exchange for equity financing in a project—claim low-income housing tax credits over a ten-year period.

The availability of the "9% credit" is restricted to projects that are not otherwise federally subsidized, meaning that the use of other federal subsidies (e.g., tax-exempt bond financing) makes a project ineligible to generate 9% credits. The 9% credit is intended to deliver up to a 70% subsidy of the qualified basis (i.e., the construction cost) of a low-income housing development. Congress has capped the amount of 9% credits that can be awarded in each state—and as it does for tax-exempt bonds for affordable housing, NCHFA serves as the entity that allocates our state's low-income housing tax credits. It **conducts a competitive allocation process** to award these credits each year.

One fundamental reason that developers are interested in the conduit issuance of tax-exempt bonds for qualified residential rental projects is the **availability of "non-competitive "4%" low-income housing tax credits under Section 42 of the Code**. Unlike the other "9%" low-income housing tax credits, these tax credits are not subject to a competitive allocation process. Instead, these credits are automatically available as long as a borrower (1) obtains an allocation of volume cap from NCHFA for a conduit issuance of bonds to finance a qualified residential rental project, and (2) finances 50 percent or more of the project using the proceeds of those bonds. *See* **26 U.S.C. § 42(h)(4)(B)**. 4% credits—**originally intended to subsidize 30% of the qualified costs of a project**—can still be a critical financing source for affordable housing when paired with tax-exempt bonds.

- ***Local Government Commission Approval***

Based upon the specific financing terms of a conduit bond issuance, state law might require the Local Government Commission ("LGC")—a nine-member body contained within the Department of the State Treasurer—to approve the issuance of the debt. Generally speaking, the LGC must approve the issuance if the term of the bond extends for five years or more. *See* **G.S. 159-148(a)**. An issuer (e.g., a housing authority) must make certain findings about a proposed financing and provide information about the transaction to the LGC for its consideration. *See* **G.S. 159-153(d)/(e)**, and bond counsel typically assists the issuer and other transaction participants in navigating this approval process.

Financing Structures

Conduit issuances involve complex webs of contractual relationships between public and private entities, require the preparation of a variety of technical legal documents, and entail collaboration between a large number of parties. For example, a single transaction might entail—at a minimum—an issuer (e.g., a housing authority), a borrower (i.e., private developer), a purchasing underwriter or other financial institution, a governmental entity providing other gap financing, a tax-credit investor, and counsel for each of these entities.

Financing structures also can vary substantially—some might include short-term bonds (e.g., bonds outstanding only for a construction term) or long-term bonds (e.g., bonds outstanding for a full-tax credit period). Each transaction is unique and its form will be determined by the sources of capital involved.

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[1] The Code generally subjects "gross income" to federal income tax. "Gross income" includes, among other things, "interest." See **26 U.S.C. § 61(a)**. But the Code also contains a critical exception to that general rule: "gross income does not include interest on any *State or local bond*." **26 U.S.C. § 103(a)** (emphasis added). Interest paid to a holder of a debt instrument that qualifies as a "State or local bond" is exempt from federal income tax. Certain bonds issued to finance "qualified residential rental projects" can qualify as State or local bonds under the Code.

[2] North Carolina law permits municipalities and counties to issue debt to finance certain projects. At present, these local governments may issue general obligation bonds, limited obligation bonds (also known as installment financings), revenue bonds, special obligation bonds, and engage in project development financings. *See* **G.S. Chapter 159, Article 4** (general obligation bonds); **G.S. 160A-20** (installment financings / limited obligation bonds or certificates of participation); **G.S. Chapter 159, Article 5** (revenue bonds); **G.S. Chapter 159, Article 7A** (special obligation bonds); **G.S. Chapter 159, Article 6** (project development financing).

[3] In North Carolina, conduit issuers other than housing authorities include, among others, the **North Carolina Capital Facilities Finance Agency**, the **North Carolina Agricultural Finance Agency**, the **North Carolina Medical Care Commission**, and **local industrial and pollution control facilities finance agencies**.

[4] The Code imposes these restrictions for the "qualified project period," which begins when 10% of the residential units in the financed project are occupied and ends on the later of (1) 15 years following the date upon which 50% of the residential units are occupied, (2) the date upon which no tax-exempt private activity bond issued to support the project is outstanding, and (3) the date upon which Section 8 assistance from HUD ends. *See* **26 U.S.C. § 142(d)(2)(A)**.

[5] North Carolina's local governments derive all of their powers from delegations of authority made by the General Assembly. *See* **N.C. Const. art. VII, § 1**.

[6] North Carolina law permits the governing boards of cities and counties to directly exercise the powers of local government housing authorities. They may do so even if a local housing authority already exists in their jurisdiction. *See* **G.S. 160D-1311(b)**. For example, the **City of Goldsboro** issued bonds for the benefit of a privately owned affordable housing development in 2021. North Carolina law also permits the governing boards of two or more contiguous counties having an aggregate population of more than 60,000 to create a regional housing authority for all such counties. *See* **G.S. 157-35**, **-36**, **-37**. A regional housing authority generally may issue bonds on the same basis as a municipal or county housing authority. *See* **G.S. 157-37**. Regional housing authorities in North Carolina include, among others, the Eastern Carolina Regional Housing Authority, Northwestern Regional Housing Authority, and Mid East Regional Housing Authority.

[7] Among other things, a "declaration" must describe the project for which the original expenditure is paid, the maximum principal amount expected to be issued for the project. *See* **Treas. Reg. § 1.150-2(e)(2).**

[8] If a developer is interested in using tax-exempt bonds to finance a qualified residential rental project, it should approach a prospective issuer to discuss a potential adoption of a reimbursement resolution.

[9] NCHFA allocated $303 million in tax-exempt bond volume cap in 2023 to projects in Buncombe, Catawba, Cumberland, Durham, Forsyth, Gaston, Mecklenburg, New Hanover, and Wake counties.