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Build America Bonds: A New Tool to Finance Government-Owned Affordable and Workforce Housing

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For housing authorities, municipalities, and other governmental entities that self-develop and desire to provide government-owned affordable housing, including workforce housing, Build America Bonds (Direct Payment BABs) provide a new financing vehicle to do this. Authorized by the American Recovery and Reinvestment Act of 2009 (ARRA), Direct Payment BABs can provide significant cost savings over previous options to finance rental housing that addresses specific local housing needs. These needs might include workforce housing, mixed-income housing, and housing targeted toward first responders, teachers, firefighters, police officers, and hospital workers.

Likewise, there are opportunities for private developers to work with housing authorities in developing mixed-use and mixed-income communities that include government-owned affordable-housing financed by Direct Payment BABs.

Basics About BABs

Congress has long been concerned that the tax-exempt bond market is not efficient in delivering the federal subsidy to state and local governments intended through the exemption of interest income on the bonds from federal income taxes. Direct Payment BABs are designed to address this concern for the governmental bond portion of the municipal market.

Direct Payment BABs, which must be issued before 2011, bear taxable interest. In lieu of bondholders (i.e. investors) receiving a lower interest rate on the bonds (as occurs with tax-exempt bonds), Direct Payment BABs are sold with a taxable interest rate and the governmental issuer receives a direct payment from the federal government (Treasury Payment), equal to 35 percent of the interest paid to the investors.

This taxable interest approach is also intended to expand the investor market for municipal bonds, which has been stagnant for the past year or so. An investment with a tax-exempt return is not attractive to a segment of the market that does not pay federal income tax, such as pension funds and nonprofit foundations. Direct Payment BABs that finance affordable housing may be attractive to pension funds and foundations both from a return standpoint and to meet social investment goals.

As taxable market participants, credit rating agencies, and issuers have become more familiar with Direct Payment BABs, the volume of Direct Payment BABs issued has increased. So far, the Treasury Payment has caused a reduction in the net interest rate on Direct Payment BABs below rates on comparable tax-exempt municipal bonds issued to finance the same type of facility.

Governmental Bonds

Direct Payment BABs are governmental bonds that may be issued by any governmental entity authorized under state law to issue bonds. The proceeds from Direct Payment BABs may be used for any purpose for which tax-exempt governmental bonds may be issued, including affordable rental housing. There are no statutory limitations as to the term of the bonds or interest rate. Actual financial terms are dictated by the market.

Direct Payment BABs may be secured by the same sources the governmental entity would use if issuing tax-exempt governmental bonds for affordable housing, such as federal public housing capital funds or public housing capital grants provided under ARRA. The Treasury Payments will likely be an important source of payment and security for Direct Payment BABs. While low-income housing tax credits, an important source of financing for privately owned affordable rental housing, cannot be used to fund government-owned housing, public housing authorities and housing finance agencies have other sources of "gap financing" that might be used to help finance government-owned housing, perhaps in the form of soft subordinate loans. Some of these common sources are federal dollars under the Community Development Block Grant, Home Investment Partnerships, and Neighborhood Stabilization Programs administered by the U.S. Department of Housing and Urban Development, and HUD Section 108 guaranteed loan funds.

Direct Payment BABs do not trigger Davis-Bacon prevailing wage rules or the Buy American rules of ARRA, but some gap financing sources or local laws may impose these or similar requirements.

Direct Payment BABs are subject to several limitations not generally applicable to tax-exempt bonds. For instance, proceeds of Direct Payment BABs cannot be used to refund outstanding tax-exempt or taxable obligations. Proceeds must be used to fund capital expenditures, or to reimburse capital costs that may be financed under the tax-exempt rules, such as short-term bridge loans issued after February 17, 2009. Proceeds may also be used to pay up to 2% of bond issuance costs and to fund a reasonably required reserve (maximum 10% of proceeds).

Direct Payment BABs are subject to the same limits on private business use, private business payment, and security that apply to tax-exempt governmental bonds. A governmental entity must be the owner of the financed project for federal tax purposes, but private developers can receive fees to develop and construct the housing and to manage the project within management contract safe harbors published by the Internal Revenue Service (IRS). In cases where Direct Payment BABs will be repaid from generally applicable taxes (e.g., property, sales, recordation, or payments in lieu of taxes) there are no private business use limitations. For example, if an issuer gives the land to the developer or ground leases it to the developer for a nominal amount, and neither the property nor property revenues are pledged to make payments on the bonds, the developer's private ownership of the property or leasehold interest will not preclude the issuance of Direct Payment BABs. Private business use is not permitted if the bonds are secured by the privately used project or by lease payments from the project's tenants. Tax analysis is extremely important here, because private business use beyond the tax law limits could eliminate the Treasury Payment.

Unlike with private activity bonds, no public hearing or prior approval is required to issue Direct Payment BABs, although local sunshine laws may apply. Direct Payment BABs also are not subject to any annual bond volume cap.

The tenant income restrictions applicable to rental housing projects financed by tax-exempt private activity bonds or low-income housing tax credits do not apply to housing financed by Direct Payment BABS. But again, local laws may impose income limitations, such as for workforce housing, based on local conditions or needs.

Treasury Payments Issues

There remain some issues and concerns about the Treasury Payments. IRS Notice 2009-26 provides that the issuer or a designee (e.g., bond trustee) must file IRS Form 8038-CP for each interest payment period. The IRS expects to provide Treasury Payments by check within 45 days of the receipt of a properly filed Form 8038-CP. Treasury Payments related to variable interest rate bonds will be paid quarterly in arrears with the filing of each Form 8038-CP, once the total interest paid during the previous quarter is known.

Timing of the bond interest payments is one concern that the municipal market is working through. Each issuer must make full taxable interest payments to bondholders on specified interest payment dates. If the issuer does not receive the Treasury Payments on time, or receives them in arrears, the parties will need to address the timing issue upfront. The first Treasury Payments were scheduled to be made on July 1, 2009, so there is not operational history at this point.

Notice 2009-26 also clarifies that Treasury Payments are a “refund” from the IRS, and that the IRS therefore can deduct, from the Treasury Payment amount, any payments owed by the issuer to the federal government, such as payroll taxes. This characterization as a refund suggests that payment of Treasury Payments is not subject to congressional appropriations. Issuers, rating agencies, and potential bond purchasers are still assessing the degree of certainty that Treasury Payments will be made to issuers, because of the “refund” nature of the payment, and about whether the federal government will be able to fund these payments over the next 30 to 40 years.

BABs for Mixed-Use Projects

Private developers cannot own or lease multifamily housing financed by Direct Payment BABs because of the private business restrictions previously mentioned. However, developers may include workforce housing financed with Direct Payment BABs within a larger mixed-use or mixed-income development. To further mixed-income project goals, this can be accomplished utilizing a scattered-unit condominium structure, where Direct Payment BABs are used to fund the workforce units, and low-income housing tax credits (9%, or 4% with tax-exempt bonds) are used to fund the tax credit units.

Direct Payment BABs secured by a general tax may also be used to finance the acquisition of land by an issuer that is then ground leased to a private developer. These ground lease payments must be nominal to avoid the private payment test, and the land cannot secure the Direct Payment BABs. The land represents a distinct property interest, permitting the developer to obtain other sources of financing for the buildings, such as tax-exempt private activity bonds or housing credits.

Summary

Direct Payment BABs are an evolving market. Published reports indicate that the market is responding positively to these new obligations; already a number of Direct Payment BABs issued for various governmental purposes have been oversubscribed.

Authority to issue Direct Payment BABs is set to expire on December 31, 2010. In the meantime, for government-owned workforce or affordable housing projects that are “shovel ready,” Direct Payment BABs may be an efficient source of financing.

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