

MEMORANDUM

To: The City Attorney for the City of Ann Arbor, Michigan

From: Orrick, Herrington & Sutcliffe, Counsel to The Sequel Companies

Date: June 9, 2026

Re: Overview of Qualified 501(c)(3) Bonds — Key Legal Requirements
and Issuer Responsibilities

In communities that are experiencing a workforce housing shortfall, local governments are the key to accessing tax-exempt financing for middle-income rental housing without low-income housing tax credits¹ (LIHTC) or recycled volume cap.² Local governments are uniquely able to provide access to tax-exempt qualified 501(c)(3) bonds for charities that lessen the burdens of government. Currently, lessening-the-burden bonds are the only types of private activity tax-exempt bonds that may be used to finance the construction, acquisition and preservation of residential rental housing exclusively for middle income residents.

Side-by-Side Comparison. Attached is a chart comparing 501c3 bonds, governmental bonds, and exempt-facility bonds, along with brief explanations of certain key terms and concepts.

Michigan Housing Commissions and Lessening the Burdens Bonds

If empowered to do so by the local government that created it, Michigan housing commissions may form nonprofit corporations for any purpose not inconsistent with the purposes for which the commission was formed and serve as a shareholder or member of such nonprofit corporations.³ The housing commission also may issue tax-exempt revenue bonds and loan such proceeds to a nonprofit for the purchase or development of a housing project.⁴ The proceeds of the bonds may be used to make loans for defraying the cost of purchasing, acquiring, constructing, improving, enlarging, extending, or repairing a housing project.⁵

Bonds issued to make loans to nonprofits that are recognized as 501(c)(3) entities by the IRS to finance housing projects that are owned by such nonprofits may be issued on a tax-exempt basis and are called “qualified 501(c)(3) bonds”. To be eligible to borrow using tax-exempt bonds, all of the following must be true:

¹ LIHTC projects rarely include middle-income housing. They instead are used either for 100% low-income projects or, in limited cases, for “80/20” projects in which 20% of units are restricted for households earning 50% of AMI or less, and the remaining units are rented at market rates without income restrictions.

² Although recycled volume cap is more readily available to finance 80/20 projects in some states. Michigan currently does not have a volume cap recycling program, and accordingly a discussion of recycled cap is beyond the scope of this memo.

³ The Housing Facilities Act 18 of 1933 (Ex. Sess.)

⁴ Id

⁵ Id

- The nonprofit 501(c)(3) corporation that acts as the borrower must have received a determination letter from the Internal Revenue Service qualifying it as an organization of the type described in Section 501(c)(3) of the Internal Revenue Code,
- The financing must further the 501(c)(3) borrower's charitable purpose. Section 501(c)(3) generally contemplates nonprofit corporations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational or other purposes, and the board of each nonprofit determines which charitable purpose or purposes it will serve.
- The project financed with the proceeds of the tax-exempt 501(c)(3) bonds must be owned at all times by the nonprofit entity and must not have more than a de minimis amount of "private business use."
- The bonds must be approved by an applicable elected representative of the approving governmental unit following a public hearing for which there was reasonable public notice (a.k.a. a "TEFRA hearing").

Charitable Purposes. To be eligible to finance middle-income housing facilities, nonprofits must serve one or more charitable purposes that will be furthered by the middle-income housing facilities. However, how each such charitable purpose is furthered by the facilities is crucial.

Accordingly, local governments have started to look at the charitable purpose of "lessening the burdens of government" for middle-income housing projects. There are no tax rules requiring specific income set asides or rent limits associated with lessening the burdens of government, except in certain acquisition financings as described below. Instead, any AMI limitations are set by the government whose burden is being lessened in order to assure that the housing project, in fact, lessens the community need identified by the government.

The determination of whether an organization's activities lessen the burdens of government involves two tests. First, it is necessary to determine whether the governmental unit considers the activities to be its burden. Second, the activities must actually lessen such burden of the government.

An activity is a burden of government if there is an objective manifestation by a governmental unit that it considers the activities of the organization to be its burden. Whether an objective manifestation exists may be shown by a variety of factors - some of which should be given more weight than others. More specifically, the following factors (among others) may be relevant:

- (1) Interrelationship between the governmental unit and the 501(c)(3),
- (2) If the activity previously was conducted by governmental unit,
- (3) If the 501(c)(3) pays governmental expenses,
- (4) The sources of funding of the 501(c)(3) (Note that revenue bond financing alone is given little weight), and
- (5) Whether activity is one that could be performed directly by governmental unit.

As a general matter, all these factors will be met if the 501(c)(3) is formed and controlled by a local governmental entity, such as a 501(c)(3) nonprofit that is formed and controlled by a Michigan housing commission.

Special Rule for Acquisition Financings. Regardless of the 501(c)(3) borrower's charitable purpose, for any 501(c)(3) financing to acquire existing multifamily rental housing facilities (as opposed to financing ground up new construction), the "Donnelly Amendments" contained in Section 145(d) of the Internal Revenue Code require compliance with one of the following income set-asides:⁶

20% at 50% of AMI, or
40% at 60% of AMI

In either case, the applicable set-asides must be maintained for as long as the tax-exempt bonds are outstanding and in any event for a period of at least 15 years.⁷

Governmental bonds are in many ways the most flexible tool available for tax-exempt financing of middle-income housing. Qualified 501(c)(3) bonds remain popular, however, in part because they are a common and well-understood way to finance multifamily rental housing on a non-recourse basis. Most if not all states have at least one program for "conduit" (i.e., no recourse to the bond issuer) 501(c)(3) financings for a variety of purposes, including, but not limited to, housing.

Additional Considerations Regarding the Owner Role

Qualified 501(c)(3) bonds require that no for-profit entity have an ownership or possessory interest in any portion of the tax-exempt bond-financed facilities or an interest that is too similar to an ownership interest. This is determined on a substantive basis — it is not merely a matter of who shows up on title as the record owner — and many types of contractual and financial arrangements can create an ownership interest or an interest that is too similar to an ownership interest. In other words, for governmental and 501(c)(3) bonds, the owner really has to be the owner. As a result, the owner cannot raise funds by way of equity investments or a joint venture (except with another government or 501(c)(3)).

Management of the Project

The 501(c)(3) owners of middle-income housing facilities may perform property-related functions themselves, such as acquiring, building, developing or operating the project. Alternatively, the owner may hire a developer/operator or "sponsor" to perform some or all such roles. This sort of arrangement is particularly common in governmental ownership transactions. Engaging a sponsor can benefit both the owner, who is relieved of responsibilities and liabilities they may not be equipped to take on, and the sponsor, who receives compensation for its services.

Tax-exempt financing limits the compensation that can be paid to sponsors, particularly if they are for-profit entities, to commercially reasonable amounts. For-profit entities may provide a variety of services and derive compensation in a number of ways in a 501(c)(3) or governmental bond financing, but they

⁶ Depending on the charitable purpose of the 501(c)(3) borrower, additional income set-asides may apply.

⁷ There is an exception for "property that will be substantially rehabilitated within a 2-year period beginning 1 year after the date of acquisition of such property." However, because "substantially rehabilitated" generally means incurring rehabilitation expenditures at least equal adjusted basis of building, this exception is rarely if ever used.

cannot hold an ownership interest in any bond-financed facilities at any time. This is a substantive requirement that cannot be overcome by way of structuring (in other words, calling something a “lease” or a “note” does not prevent it from being characterized as an equity interest).

Additional Benefits of Tax-Exempt Bonds for Middle Income Housing

Interest Exemption. The interest tax-exemption benefit is particularly valuable in middle-income housing financings, as compared to low-income transactions, because deal sizes are relatively large and the amount of long-term tax-exempt debt is high as a percentage of total project funding. Middle-income housing transactions are also typically executed as public bond offerings and not in the form of private placements or bank loans. Retail and institutional bond investors derive more value from tax-free interest than commercial banks that typically buy bonds in private placements, further reducing borrowing costs.

Favorable Underwriting. Most bonds issued for middle-income housing are unrated and are sold and traded in the high-yield municipal bond market. This market functions largely independently of the mortgage market, which typically imposes strict underwriting standards including a maximum loan-to-value (LTV) ratio (often 80-90%); a minimum debt service coverage ratio (often 1.15-to-1 or 1.20-to-1); required, scheduled amortization; limited or no “balloon payments” or refinancing risk; completion and repayment guaranties from the developer/sponsor; and loan-to-cost limits for construction debt.⁸

By contrast, in “risk on” environments, when bond investors are seeking yield and willing to take risk, it is not uncommon to see non-recourse project financings in the high-yield bond market featuring

- 100% debt financing,
- Lower projected debt service coverage (as low as 1.10-to-1)
- Long-term (30+ years) fixed rate, callable debt,
- Sequential pay or “turbo” amortization as opposed to fixed/scheduled principal payments,
- “Balloon” payments or planned refinancings, to the extent permitted by tax law
- Relatively light guaranties, and
- Acceptance of construction risk as part of long-term debt financing (i.e., no separate construction loan).

Public and private sector actors have been able to execute middle-income housing transactions in the high-yield bond market with terms that could not be achieved in the conventional multifamily mortgage market or the LIHTC market.

Property Tax Exemption. Property tax is a major expense for most multifamily rental housing facilities. Because taxes are paid ahead of debt service, every dollar of property tax owed represents a dollar

⁸ Similar requirements apply to financings with investment grade rated municipal bonds unless investors are provided with recourse to a highly rated guarantor or obligor (e.g. a pooled financing undertaken by a state housing finance agency with an investment grade issuer credit rating or indenture rating).

reduction of net operating income (NOI) available to pay debt service. Likewise, any reduction or elimination of the obligation to pay property tax directly increases NOI and therefore project feasibility.

It is also worth noting that obtaining a property tax abatement or exemption is often a matter of both law and administrative practice, with some experience and effort required in local government relations.

City Must Approve the Bonds

Although the City's primary role in this proposal is to approve the bonds under state law and to approve the grant to the project, the City also must approve the bonds for federal tax law purposes after and notice and hearing procedure commonly known as a TEFRA notice and hearing. Other post-issuance compliance responsibilities for the bonds will be assigned to the housing commission and the borrower.

TEFRA Approval: The Public Hearing and Approval Process

One of the most important procedural requirements for qualified 501(c)(3) bonds is the requirement for "TEFRA approval" which takes its name from the Tax Equity and Fiscal Responsibility Act of 1982. This requirement is codified at Section 147(f) of the Code, and it applies to qualified private activity bonds, including qualified 501(c)(3) bonds.

TEFRA approval is a two-step process. First, a public hearing must be held on the proposed bond issuance. The hearing must be preceded by reasonable public notice — often published in a newspaper of general circulation in the area where the financed facilities will be located — at least seven days before the hearing date. The notice must include certain information specified by the Code and Treasury Regulations, including a general description of the type and location of the facilities to be financed, the maximum principal amount of the bonds to be issued, and the name of the initial owner or principal user of the facilities (i.e., the 501(c)(3) borrower). The public hearing provides an opportunity for members of the public to comment on the proposed issuance.

Second, after the public hearing has been held, the bonds must be approved by an "applicable elected representative." In most cases, this means the governing body of the issuer. However, in this case the board of directors of the housing commission is appointed and not elected. Therefore, the responsibility falls on the elected City Council for the City that authorized and appointed the housing commission board.

The approval is typically given in the form of an official action, such as an ordinance or resolution, adopted after the public hearing. It is important to note that the TEFRA approval requirement is a federal tax law requirement, not merely a state or local procedural step, and is in addition to any approvals required under state and local laws for the issuance of the bonds. If TEFRA approval is not properly obtained, the bonds will not qualify as tax-exempt obligations, regardless of whether all other requirements are met.

The City's Limited Financial Obligation

Importantly, repayment of the bonds — including all principal, interest, and premium, if any — is the sole responsibility of the 501(c)(3) borrower. When the City approves the qualified 501(c)(3) bonds, the City will not be assuming any liability for the bonds and will not be responsible for paying the bonds. The borrower will execute a loan agreement or similar financing document obligating it to make payments sufficient to cover debt service on the bonds, and the bonds will be payable solely from those loan payments and any other security provided by the borrower.

Unless the City voluntarily and affirmatively covenants otherwise, the bonds will not constitute a debt, liability, or obligation of the City. The City will not be required to pay debt service on the bonds from its general fund, its tax revenues, or any other City funds or resources. The bonds will not be secured by the full faith and credit of the City, and the City's taxing power will not be pledged to the payment of the bonds. The bond documents and the bonds themselves will contain clear language to this effect, and the

official statement (the disclosure document provided to investors) will prominently disclose that the bonds are limited obligations payable solely from payments made by the 501(c)(3) borrower.

We welcome the opportunity to discuss this memorandum with the City Council and to answer any questions that may arise as the City evaluates this financing.