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MEMORANDUM

TO: Denver City Council

CC: Department of Finance
Office of Economic Development
Office of HOPE

FROM: Julie Mecklenburg, Assistant City Attorney
Laura Lopez, Fellow, City Attorney's Office

DATE: March 1, 2018

RE: Use of Bonds for Affordable Housing Purposes

QUESTIONS PRESENTED

I. What are the limitations on the use of general obligation bonds to finance affordable housing?

II. What is the process for issuing bonds?

III. What other bonds and alternatives are available to leverage future income streams for affordable housing?

IV. How have bonds been used in other jurisdictions to support affordable housing?

SUMMARY

The city has authority to issue debt pursuant to Article VII, Part 5 of the City Charter and Chapter 20, Article V of the Denver Revised Municipal Code. Debt issued by the city must also comply with state law (including but not limited to TABOR), federal tax law and federal securities regulations. In addition to debt issuance authorized by the City Charter, the city is authorized to issue private activity bonds pursuant to Section 29-3-101, et seq., Colorado Revised Statutes, as amended, and receives private activity bond volume cap allocation pursuant to Section 24-32-1701, et seq., Colorado Revised Statutes, as amended.

There are a number of financing mechanisms that the city can use to finance affordable housing, which are described briefly herein. It should be noted that there are significant financial and policy questions related to financial stewardship that should be considered and addressed in relation to any proposal for bond financing. Those important financial and policy issues are outside of the scope of this memorandum.

ANALYSIS

I. General Obligation Bonds

Cities often use general obligation bonds to finance a variety of capital expenditures supporting affordable housing. General obligation bonds are direct obligations and pledge the "full faith and credit" of the governmental entity issuing them[1] and require a vote to authorize their issuance. General obligation bonds may either be issued as tax-exempt or taxable to the bond holders, depending on the purposes for which they are issued and how the proceeds are used:

A. Tax-exempt. All tax-exempt bonds are subject to certain federal tax law requirements. Because the IRS is foregoing any revenue it may generate from income tax imposed on the interest earned by bondholders, it has imposed a number of limits on how tax-exempt bond proceeds may be spent, which entities may use bond-financed facilities, and how collateral for a tax-exempt bond issuance may be treated. Bond counsel will typically require that an issuer (and the borrower, in a conduit bond transaction) certify that it currently complies with the relevant IRS requirements and reasonably expects to comply with such requirements for the life of the bonds. For example, the issuer of non-private activity bonds must reasonably expect and covenant at closing that either (1) less than ten percent (10%) of the bond proceeds or the bond-financed property may be used in the trade or business of a non-governmental entity, or (2) not more than

[1] When the City and County of Denver issues GO bonds, it typically issues what are known as unlimited tax general obligation (UTGO) bonds. These bonds are issued with a pledge to raise taxes, without limit, to pay debt service until the obligation is repaid. As a result, these bonds generally have stronger credit ratings and purchasers accept lower interest yields. Some other jurisdictions have chosen to use limited tax general obligation (LTGO) bonds for affordable housing purposes. LTGO bonds are secured by specified (or all) revenues the issuing municipality generates that are not otherwise pledged.[1] If such revenues are insufficient to pay debt service, the municipality will have to increase taxes, but such increase will be subject to a maximum specified in the bond's provisions. This type of bond is considered to be marginally riskier than an unlimited tax general obligation bond, so LTGOs are usually rated slightly lower and have marginally higher interest rates.

five percent (5%) or $5 million of bond proceeds may be used to directly or indirectly make or finance loans to non-governmental entities.[2]

If the City were to issue tax-exempt bonds to support affordable housing, those bond proceeds would be highly restricted (see the table in Section II.E. below). Generally, they could be used for acquisition, development and rehabilitation of affordable housing properties owned by the City or the Denver Housing Authority (DHA) and operated by DHA. Such bond proceeds could *not* be provided as gap financing for affordable housing projects developed by third parties (which is currently a manner in which the City often leverages its dollars to support affordable housing development).

B. Taxable. The "public purpose" and "public use" requirements for tax-exempt bonds set forth in the Internal Revenue Code ("IRC") are far more restrictive than one would assume based on common usage of the terms "public purpose" or "public use" or interpretations of the terms found in other areas of law. However, the city may also choose to issue *taxable* bonds, which are subject to significantly fewer federal tax law requirements. While taxable bonds still must be for purposes that benefit the public, neither the spend-down requirement (described in II.C. below) nor the tax code's highly-restrictive "public purpose"/"public use" requirements apply to taxable bonds.

If the City were to issue GO bonds and use the proceeds to finance affordable housing projects owned or operated by third parties (i.e., not owned by the city and/or DHA), such GO bonds would need to be taxable. Issuing taxable bonds for affordable housing projects still allows the developers to use other federal tax subsidies like 9% low income housing tax credits. It also allows for funds to be spent on a variety of other programmatic uses.

Whether taxable or tax-exempt, GO bonds must be used for a public purpose to comply with Colorado state law and the city's charter.

II. <u>Bond Offering Process, Timeline & Cost of Issuance</u>

A. TABOR

Pursuant to the Colorado Taxpayer's Bill of Rights (TABOR), any action that may result in an increase in taxes (or the extension of a tax that is due to expire) or in a multiple fiscal year obligation on the part of a municipality must be approved at an election of voters. Thus, any bond that is based on the full faith and credit of the city, which will include every GO bond (whether or not it is *expected* to result in a tax increase), is subject to a TABOR election.

[2] See 26 U.S.C. §141.

If the City were to propose issuance of a bond to be repaid with the existing half mill currently dedicated to the affordable housing fund[3], the bond issuance would require the approval of voters[4] (even though the use of the existing half mill to repay the bonds would *not* require voter approval).

B. Bond Ordinance and Issuance

Bonds must be issued pursuant to an ordinance specifying the particular purpose for the bond. The maturity date of municipal bonds is structured to match the expected revenue flows repaying the debt as well as the life expectancy of the asset being constructed.

Once a ballot question authorizing the issuance of bonds for a particular purpose is certified to the ballot and approved at an election, bonds can only be issued for the purpose enumerated in the ballot question. The expenditure of bond proceeds for any other purpose is unauthorized and invalid. If the proceeds of the bond issue will be used for different or unrelated purposes, separate ballot questions should be drafted for each purpose.

The Department of Finance and the City Attorney's Office work collaboratively with bond counsel and the project team to develop the bond ordinance and other documentation for the issuance of bonds. The process usually takes about four to six months.

C. Timing for Use of Proceeds

Section 103 of the IRS Code imposes requirements on the speed at which *tax-exempt* bond proceeds must be spent. However, there is no requirement that the city issue the total amount of bonds authorized at one time. If debt is issued, it may be done in several series over a period of time to ensure the city can spend the proceeds within the anticipated timeframe and comply with IRS spend down requirements (which vary, but require a large portion of bond proceeds to be spent within three years).

Taxable debt is <u>not</u> subject to the IRS spend-down requirements, but may also be issued in several series over a period of time.

Colorado courts have not established a definitive rule regarding staleness of voter authorization of debt. The CAO recommends that the city issue all voter authorized debt within a ten-year period.

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[3] Note that, although referred to herein for ease of reference as a "half mill," the millage rate was equal to 0.5 mills only in the original year it was assessed. Due to 2012's Measure 2A, as property values increase, the dedicated tax "floats" downward and is currently 0.442 for taxes to be collected in 2018.

[4] Note further that the term of the GO bonds would presumably extend past the dedicated housing fund ordinance sunset date of December 31, 2026, so if bonds were issued with a pledge of the half mill, in addition to voter approval, the ordinance would need to be amended to extend or eliminate the sunset date so that the term of the half mill dedication would be available for the full term of the GO bonds.

D. Limitations

Denver places a great deal of importance on maintaining high creditworthiness in its bond ratings. Generally speaking, investors will pay more for bonds with higher ratings due to a perception of lower default risk. The higher purchase price drives the interest rate on the bonds lower, which keeps the cost to taxpayers low when the city needs to borrow money.

Section 7.5.2 of the Denver City Charter limits the amount of general obligation debt outstanding at any time to three percent (3%) of the actual value of the taxable property in the city.

The City's Debt Policy provides guidance for issuing obligations based on established "best practices" as promulgated by the Government Finance Officers Association (GFOA). It currently permits the issuance of bonds only for funding of capital projects.[5]

The City and County of Denver has the authority to construct, own and finance the development of affordable housing projects in the city. However, by law,[6] possession of any housing project that the City directly constructs, acquires or leases must be turned over to DHA for operation and maintenance. (The City is required to retain ownership of such projects.) By statute,[7] DHA shares the City's authority to construct, own and finance – including through the issuance of bonds – public affordable housing projects in the City of Denver. DHA additionally has the authority to operate its affordable housing projects.

E. Flexibility – Uses of Bond Proceeds vs. Uses of Existing Mill Levy

If the City were to issue bonds secured by a pledge of the income stream from the half mill levy that has been dedicated for affordable housing,[8] the income from that half mill levy would no longer be available for some purposes for which it is currently used (due to the restrictions discussed above). The table below summarizes the current uses of mill levy funds and the uses that could also be financed with tax-exempt and taxable bond proceeds.[9]

[5] As noted later in this memorandum, some cities have used bond proceeds for down payment assistance and other uses where there is an underlying capital asset. Bond proceeds are not, however, used for operating expenses, which may include services.
[6] See CRS 29-4-107
[7] See CRS 29-4-209
[8] Note again that, in this case, the half mill would need to be extended for a time period corresponding to the term of the bond.
[9] Note that the table is very general -- the particular uses proposed for any bond issuance would need to be reviewed and approved by bond counsel.

Types of funding	Real Property Acquisition (land or building)	Financing development or preservation of affordable housing rental units	Financing development of new for-sale affordable housing units	Supportive services (mental health, substance abuse, vocational and life skills training, etc.)	Grant Assistance Programs (rental, foreclosure, utility, etc.)	Loan Assistance Programs for income-qualified participants (down payment, home repair, etc.) ♦	Administrative costs of programs
Mill Levy	✓	✓	✓	✓	✓	✓	✓
Tax exempt bonds	✓(acquisition by city only)	✓(with project limitations)	✓(with project limitations)			✓(with project limitations)	*consult bond counsel*
Taxable bonds	✓	✓	✓	▲	▲	✓	▲

♦ Loan programs like down payment assistance – where a lump sum is needed up front for a particular purpose, where repayment is often anticipated, and where the loan is secured by an asset – are distinguished here from other assistance programs where funds are put toward ongoing expenses. Although these programs would be permissible uses of bond proceeds, using bond proceeds to finance these types of loans would currently be contrary to the City's debt policy since they do not involve a capital project. Additionally, it should be noted that, with few exceptions, the IRS prohibits the use of *tax-exempt* bond proceeds for working capital (such as rent and salaries) and other costs that are not capital expenditures.

▲ It may be legally permissible for taxable bond proceeds to be used for some purposes falling into these categories. However, there are significant costs associated with issuing bonds, including interest costs. While bonds are appropriate for capital projects that require a large up-front investment, it is hard to justify the use of bond funds for operational expenses and services which are more appropriately funded with ongoing revenue streams. Additionally, as indicated previously, the term of a bond is typically tied to the expected life of the assets being financed. For that reason, the City's Debt Policy stipulates the issuance of bonds only for funding of capital projects.

III. Other Bonds and Financing Alternatives

A. Private Activity / Multifamily / Single Family

Private activity bonds (also known as pass-through or conduit bonds) are bonds that are issued for specific, privately-developed projects that are deemed to benefit the public (which can include affordable housing projects). Pursuant to the IRC, each state is annually given a finite amount of private activity bond volume cap allocation, which permits the issuance of a certain amount of *tax-exempt* private activity bonds.

Multifamily housing revenue bonds and single-family mortgage revenue bonds are types of private activity bonds with particular requirements under the IRC. Multifamily housing revenue bonds are specifically for the acquisition, renovation and new construction of affordable rental housing for low- to moderate-income families. Multifamily housing revenue bonds are secured by the rental income from the project. Single-family mortgage revenue bonds are used to support the origination of qualified mortgages for certain (generally lower-income, first-time) homebuyers. Single-family mortgage revenue bonds are secured by the homeowners' payments on the underlying mortgages.

The city is not responsible for the payment of the debt service on private activity bonds and, therefore, the approval of voters is not required. The City and County of Denver's annual private activity bond volume cap allocation is fully utilized each year.

B. Tax Increment Revenue Bonds

Tax increment financing (TIF) is a method of using future increased property tax revenues (in excess of existing property tax revenues) and, in some cases a portion of incremental sales taxes, to finance certain costs related to new development in areas affected by "blight." In certain circumstances, tax increment revenue bonds may be issued to support the costs of developing infrastructure to support new affordable housing in a TIF district.

C. Certificates of Participation

Certificates of Participation (COPs) are another means of capital financing for a *particular* real property asset or project. They are not used to create a pool of funding for multiple projects. Through the purchase of COPs, investors are entitled to receive a proportionate share of the city's rental payments on the asset.[10] The city's payments are subject to annual appropriation and, therefore, the use of COPs by the city does not require voter approval.

IV. Other Cities' Use of Bonds for Housing[11]

A. Portland

In November 2016, the voters in the City of Portland approved a $258.4 million general obligation (GO) bond for affordable housing. The interest income on the bond is tax-exempt to investors and the proceeds will be used for acquisition, construction, rehabilitation, and capital maintenance and repairs on affordable rental housing that is owned by the City of Portland through the Portland Housing Bureau (which is a Portland city entity). The bond proceeds may not be lent or used as gap financing for buildings/land to be owned by other private entities organizations (including non-profit developers) or for supportive or resident services. The bond authorization requires the city to create 1,300 housing opportunities affordable to those who make 60% of the area median income (AMI) or less, including 600 units that will be affordable to those who make 30% or less of AMI.

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[10] Payments are generated through a particular ownership/lease structure that is beyond the scope of this memo.

[11] The cities referenced in this section may have organizational structures or regulatory environments that differ from Denver's and that may affect their ability to issue certain types of bonds and/or use bond proceeds for certain purposes. They also are not subject to TABOR requirements.

In February 2017, the City of Portland used approximately $47 million from their General Fund to provide interim financing for the purchase of an affordable housing project containing 263 units, which were to be reimbursed with bond proceeds through an interfund loan mechanism. The Portland Housing Bureau has solicited and is reviewing ideas for building and acquiring other affordable housing sites. In December 2017, the Mayor of Portland announce plans to use bond proceeds to build 200 to 300 affordable apartments on a property purchased by the city in August 2017, which had been previously operated as a strip club.

B. Seattle

In November 2016, for the first time since 1981, the Seattle City Council[12] approved the use of GO bonds for affordable housing. The $29 million taxable bonds were approved just a few months following the approval by voters of a $290 million tax levy for affordable housing. The bonds were to be issued as 30-year limited tax general obligation (LTGO) bonds, funded by using the city's existing bond mill capacity. Potential uses that were identified for the bond proceeds included gap financing, home ownership subsidies, seismic retrofits of residential buildings, and funding of predevelopment, development and preservation costs of nonprofit and LIHTC affordable housing developers. The bond measure has been criticized for the estimated $27 million in associated interest payments.

In February 2017, the Seattle City Council approved a non-revolving bridge loan from the city's general fund for the full $29 million, to be repaid by the LTGO bond proceeds. These funds were used to support the creation of 300 affordable units, including units in two large-scale transit-oriented developments and units in other affordable housing projects selected through the Seattle Office of Housing's annual competitive award.

C. Austin

In November 2013, voters in Austin approved $65 million in taxable general obligation (GO) bonds for affordable housing. The bond was issued in installments beginning in 2014 and proceeds have been used for rental housing development (including grants and loans to non-profit and for-profit developers of affordable housing), home ownership programs, and home repair programs.

D. San Francisco

In November 2015, San Francisco voters approved $310 million in taxable general obligation (GO) bonds for affordable housing. San Francisco began issuing bonds in installments beginning in

[12] Note that Seattle has no TABOR-like restrictions and was not required to obtain voter approval for the inclusion of this bond in the city's budget

October 2016. Bond proceeds have been and will be used to provide funding for the acquisition, construction, predevelopment, development, and preservation of affordable housing by non-profit and for-profit developers, to repair and reconstruct public housing, and for homeownership down payment assistance (in the form of both repayable and forgivable loans to homebuyers).

E. Los Angeles

In November 2016, Los Angeles voters approved Proposition HHH, authorizing the city to issue $1.2 billion in general obligation bonds to be used to create approximately 10,000 units of supportive and affordable housing for the homeless. Eighty percent (80%) of the bond proceeds are targeted for development of permanent supportive housing (PSH) and not more than twenty percent may be used for affordable housing for extremely low-income, very low-income, or low-income individuals and families, who are at risk of homelessness.

The city has established a loan program and plans to issue calls for projects three times each fiscal year, in July, October and February. Through these RFPs, it will solicit proposals for acquisition, development and/or rehabilitation of PSH projects and homeless facilities (such as service centers, clinics, storage facilities, showers, etc.) by private, nonprofit or public entities. Projects are generally required to be financially structured using tax-exempt bonds and 4% tax credits, but the city will also consider “alternative financing structures” for innovative housing proposals. The city plans to issue bonds to finance projects that have been selected and approved through those RFPs/calls for projects.

The city’s first issuance of bonds under Proposition HHH occurred in June 2017 and comprised approximately $86 million in taxable GO bonds for financing the renovation of homeless facilities and the development of nine specified permanent supportive housing projects. Bond funds are not permitted to be used for operations or services.