

LIHTC MONTHLY REPORT

A MONTHLY PUBLICATION OFFERING NEWS, OPINION, FEATURES AND COMMENTARY ON THE LOW-INCOME HOUSING TAX CREDIT INDUSTRY

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Complex Transaction Closes Under HUD's 811-202 Mixed Finance Program

By Mark Kantor, Kantor Taylor McCarthy PC

On February 24, 2005, Housing Resources Group (HRG), a not-for-profit housing developer, closed the final financing phase of Genesee Housing, a mixed-finance project in Seattle, Wash. The transaction, which is the first of its kind in the nation, brought together a host of partners and financing sources and involves not only a condominium structure but also bifurcates the operations of the housing to provide for debt service payments on those units not receiving the HUD 811 assistance. As the first project of its kind to close under the HUD 811-202 Mixed Finance program, the project faced a myriad of HUD and tax issues. The tax issues will be addressed in a subsequent article, this discussion will focus on the finance structure and strategies used to deal with the HUD issues involved in the deal.

The financing for Genesee Housing combines a U.S. Department of Housing and Urban Development (HUD) 811 Supportive Housing for People with Disabilities award, 4 percent low-income housing tax credits (LIHTCs), tax-exempt bonds and a variety of other public and private financing sources. The project is located in the Rainier Valley neighborhood of southeast Seattle on land previously owned by the Housing Authority of the City of Seattle (SHA). It will be subject to a condominium declaration whereby 50 units of housing for low-income households will constitute a single condominium unit, owned by Genesee Limited Partnership and a separate commercial condominium unit will be purchased and owned by SHA.

The project is located at the heart of the SHA's Rainier Vista HOPE VI redevelopment and will include 22 units for people with physical and developmental disabilities, including, but not limited to, people living with HIV/AIDS.

Housing Resources Group as the sponsor and developer of the project formed a single-asset 501(c)(3) not-for-profit corporation, Genesee Housing, to serve as the general partner of Genesee Limited Partnership. Genesee Housing was also the recipient of the HUD 811 Capital Advance. NEF Assignment Corporation, as nominee, provided tax credit equity for the project in the amount of \$2,392,543.

For purposes of including the award in the project's qualified basis, the proceeds of the capital advance in the amount of \$2,085,500 were subsequently loaned from Genesee Housing to the partnership in the form of a 40-year cash-flow-only loan bearing interest at 0.5 percent. To secure Genesee Housing's obligations to HUD under the capital advance, the note from the partnership to Genesee Housing and the mortgage securing the note, were assigned to HUD for security purposes. To facilitate the assignment of the note and mortgage to HUD, these documents were, with certain required modifications, in the standard HUD 811 – 202 promissory note and mortgage forms.

Financing for the project includes tax-exempt private activity bonds in the aggregate amount of \$4,600,000 issued by SHA. The Series A bond in the amount of \$1,327,904 bears interest at the rate of 5.10 percent per annum and will be due January 1, 2038. The Series A bond requires payments of interest only beginning March 1, 2005, and continuing until January 1, 2008. Thereafter, principal and interest are payable in equal monthly installments in the amount necessary to amortize the principal and interest over a 30-year period. The Series B bond in the amount of \$3,272,096

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bears interest at the rate of 3.81 percent each year, and matures on January 1, 2008. Interest only on the Series B bond is paid prior to maturity. The Series A and Series B bonds were purchased by Washington Mutual Bank (WAMU). WAMU also provided taxable construction financing for the commercial component of the project, which will be sold to SHA prior to the project being placed in service.

The City of Seattle provided financing for the project in the form of an initial \$600,000 Housing Opportunities for People with AIDS (HOPWA) land acquisition loan. The loan was made directly to Genesee Housing and was re-loaned to the partnership in the form of a long-term cash-flow-only loan accruing interest at one percent. In addition, the City of Seattle made a long-term cash-flow loan accruing interest at one percent in the amount of \$485,000 from Seattle's housing levy program.

Financing for the project also includes a \$900,000 loan from the Washington State Department of Community, Trade and Economic Development. The loan was made to HRG and subsequently was assigned to the partnership pursuant to an assignment, assumption and consent agreement. The loan bears interest at 1 percent with quarterly payments commencing on March 31, 2026 with the full principal and all accrued interest due and payable on or before December 31, 2045.

AIDS Housing of Washington provided HRG with \$290,450 in capital campaign funding, which in turn loaned these funds to the project, along with the proceeds of an award from the Federal Home Loan Bank (FHLB), King County and the Bill and Melinda Gates Foundation – Sound Families Initiatives, in the form of a \$790,410 sponsor loan. The sponsor loan is cash flow only, accrues interest at 0.5 percent and is due and payable on or before December 31, 2056.

In addition to its financial contribution to the project, AIDS Housing of Washington coordinated the community outreach efforts, provided design input to maximize the project's suitability for its intended residents and provided technical assistance to the sponsor regarding HUD 811 funding issues.

The HUD 811 units will receive rental assistance pursuant to a HUD Project Rental Assistance Contract (PRAC). The HUD regulations do not permit revenues from the HUD 811 units to support or pay project debt service. To enable the project to carry hard debt payable to WAMU and the state, the various financial partners showed great flexibility. The project was underwritten and documented in a manner in which the rental income from the non-HUD 811 units will support the debt service required on these loans. In addition, the HUD mortgage, note and regulatory agreement were all modified in a manner acceptable to the WAMU and HUD, to cover only the HUD 811 units.

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In addition to the debt service issues, HUD provided formal waivers on key issues under the HUD 811-202 interim regulations. These waivers included the ability to set the interest rate on the reloan of the capital advance funds at an interest rate less than the Section 202 or 811 interest rate; a waiver permitting the partnership, as opposed to the capital advance recipient, to enter directly into the PRAC with HUD; and several other waivers relating to the specific documentation to be submitted with the firm commitment application. In each instance, HUD demonstrated an awareness of the need for flexibility in adopting the 811-202 programs to mixed finance programs. ❖

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Tax Issues in Combining HUD 811, 202 with LIHTCs Can be Overcome with Planning, Flexibility

By Mark Kantor and Tom Nelson, Kantor Taylor McCarthy PC

In the June 2005 issue of the *LIHTC Monthly Report*, we discussed the complex financing structure and various U.S. Department of Housing and Urban Development (HUD) waivers involved in the Genesee Housing HUD 811 — LIHTC project. As promised, this article will address several of the tax issues that arise in attempting to combine HUD Section 202 or Section 811 projects with low-income housing tax credits (LIHTCs) provided for under Section 42 of the Internal Revenue Code (IRC) of 1986. These issues, some of which were addressed directly in the Genesee project, are at the center of attention on the numerous Section 202 and Section 811 mixed-finance projects currently in the predevelopment or development phase.

The American Homeownership and Economic Opportunity Act of 2000 (the 2000 Act) amended in part Section 202 (12 USC Section 1701q) of the Housing Act of 1959 and Section 811 (42 USC Section 8013) of the National Affordable Housing Act to allow participation of for-profit limited partnerships with a single-purpose nonprofit organization as the general partner in mixed-finance development projects. An objective of these changes by the 2000 Act is to extend to the sponsors the opportunity to use low-income housing tax credits to obtain project equity in conjunction with the receipt of Section 202 or Section 811 capital funds and project rental assistance contract payments.

The use of Section 202 or Section 811 capital funds in an LIHTC project poses financing structuring issues not unfamiliar to those seeking to use federal subsidies for capital costs in LIHTC projects. To the extent federal grant funds are received for capital costs, the consensus among practitioners is that the eligible basis of the project must be reduced by the amount of the grant. While IRC

§42(d)(5)(A) provides that federal grants received during the compliance period reduce basis, it is the position of the IRS and the generally accepted position in the industry that this applies as well to federal grants received during the construction period. In certain projects, based upon the total project costs and the other sources of financing, it may be possible to reduce the project's eligible basis by the amount of the HUD Section 202 or Section 811 capital advance and not have a negative effect on the project's feasibility.

A second alternative is to re-loan the HUD funds from the recipient to the tax credit partnership. Several issues arise when doing so. First, the re-loan must be structured such that it remains true debt. The re-loan must be evidenced by a promissory note, secured by a deed of trust on the property and there must be a reasonable expectation that it will be repaid when due. The interest rate on the re-loan will depend not only on whether the project is a 4 percent or 9 percent LIHTC project but also on what interest rate can be supported by the project revenues such that there is a reasonable expectation that the re-loan will be repaid when due. Note that a HUD waiver will be required for any interest rate on the re-loan other than the applicable Section 202 and/or Section 811 interest rates identified in HUD's mixed-finance temporary regulations.

A second, somewhat more unique issue arising in the HUD Section 202 and Section 811 mixed-finance projects is the treatment of project rental assistance contract (PRAC) payments. As noted above, IRC §42 requires that the eligible basis of a building benefiting from LIHTCs be reduced by the amount of any grant made with respect to the building or the operation thereof funded with federal funds. Absent an exception to this rule for PRAC pay-

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ments, such payments arguably reduce the eligible basis of an LIHTC project receiving such assistance. As PRAC payments are an integral component of Section 202 and Section 811 programs, such a reduction in basis would severely diminish the effectiveness of combining these HUD programs with LIHTCs and run counter not only to the congressional purpose in passing the 2000 Act but counter to the specific provisions of the 2000 Act as well. The 2000 Act amends Section 202(h)(6) and Section 811(h)(5) in each instance titled "Funds from other sources," to add the following statement:

Notwithstanding any other provision of law, assistance amounts provided under this section may be treated as amounts not derived from a Federal grant.

Thus, it appears from the face of the legislation itself that PRAC payments should not be deemed a federal grant. The Treasury, in Regulation §1.42-16(b), identifies certain rental assistance payments that are not considered federal grants for purposes of IRC §42. This regulation section has not been updated to include PRAC payments made under either the Section 202 or the Section 811 supportive housing programs. However, the statement of congressional intent in the 2000 Act should make unnecessary any change in the regulation as a prerequisite to the exclusion of these amounts from characterization as federal grants. The Internal Revenue Service (IRS) has on several occasions confirmed informally that pursuant to the 2000 Act, Section 202 and Section 811 PRAC payments should not be considered federal grants for purposes of IRC §42(d)(5)(A).

A third federal tax issue that may arise in the context of a Section 202 and Section 811 mixed-financing project stems from the requirement of IRC §42(g)(1) that housing units qualifying for the tax credit be rent restricted. IRC §42(g)(2) states that gross rent for an LIHTC unit may not exceed 30 percent of the imputed income limitation for the unit. IRC §42(g)(2)(B) defines gross rent primarily by exclusion. IRC §42(g)(2)(B) excludes from gross rent payments received under "section 8 ... or any comparable rental assistance program," as well as certain supportive service payments and other rental assistance amounts paid to the owner of the facility. While IRC §42(g)(2)(B), last amended in 1993, does not expressly reference Section 202 or Section 811 PRAC payments, the characterization of PRAC payments as gross rent for purposes of IRC §42(g)(2) does not advance the objective of the §42(g)(2) limitation or the utility of mixed-finance programs. In this regard, the legislative history of IRC §42 is important. The Conference Report to the Tax Reform Act of 1986, pursuant to which IRC §42 was initially enacted, states:

"The gross rent limitation applies only to payments made directly by the tenant. Any rental assistance payments made on behalf of the tenant, such as through Section 8 of the United States Housing Act of 1937, are not included in gross rent."

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Similarly, the Senate Report for the Omnibus Budget Reconciliation Act of 1990, states:

The gross rent limitation applies only to payments made directly by the tenant. For example, any rental assistance payments made on behalf of the tenant, such as through Section 8 of the United States Housing Act of 1937 or any comparable federal, state or local program of rental assistance, are not included in gross rent for purposes of the 30-percent limit."

To require rental assistance payments made on behalf of the tenants to be treated otherwise (that is included in gross rent) would be inconsistent with the purposes of the IRC §42(g)(1) restriction.

As a practical matter, in most Section 202 or Section 811 mixed finance projects, even if PRAC payments were deemed gross rent for purposes of IRC Section 42(g)(2)(B), it is unlikely that the rent restrictions of IRC Section 42 will be exceeded, particularly if the tax credit limited partnership elects the 40 percent at 60 percent minimum set aside. In many cases, the combination of the rent charged for the Section 202 and/or Section 811 units, even when combined with the PRAC payment allocated to such unit, falls well below 30 percent of the imputed income limitations allowable for purposes of meeting the IRC Section 42 maximum rent requirements.

As evidenced by the above, as well as our earlier discussion in the June 2005 *LIHTC Monthly Report* of the various HUD issues relating to Section 202 and Section 811 mixed-finance projects, it is clear that such projects involve a myriad of regulatory and tax specific issues. However, with proper planning and flexibility from the project sponsor, state, local and private financing sources, and HUD, such projects can be successful and can meet the goals of the 2002 Act. ❖

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