

New HUD Policy on FHA Insurance Crafted with New Markets in Mind

By Monica H. Sussman and Andrew S. Potts, Nixon Peabody

Amid “credit crunch” woes, the U.S. Department of Housing and Urban Development (HUD) served up a welcome piece of news in March. It announced procedures that promise to expand the construction and permanent debt options available to mixed-use rental projects using new markets tax credits (NMTCs) and historic tax credits (HTCs). The new procedures are designed to facilitate the use of FHA mortgage insurance on projects with master lease ownership structures. These structures, while virtually indispensable to twinning HTC and NMTC investments, had rendered projects ineligible for Federal Housing Administration (FHA) insured mortgages under prior HUD rules. The new HUD procedures spare owners of historic buildings the dilemma of choosing between HTC/NMTC investments and FHA insurance by — for the first time — permitting FHA insured loans on projects utilizing leasing structures.

FHA Mortgage Insurance

The new procedures, often referred to as the “master lease policy,” apply to the Federal Housing Administration’s 220, 221(d)(4) and 231 mortgage insurance programs. These programs are available mainly for new construction or substantial rehabilitation of multifamily rental housing for moderate-income families, the elderly and the handicapped. Section 221(d)(4) is used by profit-motivated sponsors, while the Section 231 program is used for elderly housing. Section 220 mortgage insurance is reserved for new or rehabilitated rental housing located in designated urban renewal areas, as well as in areas with code enforcement and neighborhood development programs. Mixed-use projects that include commercial and community facilities are permitted if certain requirements are met (see page 4).

FHA-insured debt is typically structured as an initial construction loan that converts to a 40-year permanent loan at completion. These loans have level payments, are nonrecourse and are backed by the federal government. HUD requires the property to be operated in accordance with a HUD regulatory agreement. The regulatory agreement addresses property operations and, among other requirements, limits when cash can be distributed to the mortgagor, requires the submission of audited financial statements to HUD, and subjects the property and the mortgagor to oversight by the federal government.

The Master Leasing Structure and Tax Credits

Master lease structures are widely used in HTC transactions. One reason is that certain efficiencies associated with the structures can translate into premium pricing on the HTC equity, thereby reducing the need for debt. In a “conventional” HTC master lease structure, the real estate owner borrows the project debt and undertakes the rehabilitation of the project. The owner also enters into a long-term master lease with a master tenant. The master tenant operates the project, enters into the property management agreement, and enters into subleases with end users/occupants of the dwelling or commercial units.

Although the right to claim the HTC would usually rest with the real estate owner, Section 50(d) of the Internal Revenue Code permits the owner, under certain circumstances, to “pass-through” the HTCs to the master tenant. That is why this approach is sometimes referred to as the credit “pass-through” lease structure. While credit pass-through leases are a popular choice for HTC transactions, the twinning of NMTCs and HTCs all but requires the use of a modified version of this structure in order to address

(continued on page 2)

New HUD Policy

(continued from page 1)

“related party” concerns that otherwise could preclude leveraging the benefits of the two programs.

Under the NMTC program, virtually all community development entities (CDEs) receiving NMTC allocations have committed to lend/invest in qualified active low-income community businesses (QALICBs) that are “unrelated” to the CDE. A CDE will become related to a QALICB to which it lends or invests if it owns more than 50 percent of the profits or capital interest in that business. However, HTCs are allocated in accordance with profits and thus investors need a 99.99 percent interest in profits in order to obtain all the HTCs. This conflict is resolved by the HTC credit pass-through lease structure by allowing the CDE to make NMTC qualified loans or investments directly to the real estate owner/QALICB and at the same time own all or most of the profits interest in the master tenant entity and thus avail itself of the HTCs passed through by the real estate owner.

The New Policy

Previously, HUD policy provided that proper-

ties with master leasing structures were not eligible for FHA insured loans. This was because HUD requires a mortgagor to be a single asset entity and to operate the property subject to the HUD Regulatory Agreement. HUD generally had not permitted a party other than the mortgagor or its agents to have access to or control over rental income or other assets of the property. As discussed previously, in master leasing transactions, the property is operated and leased by a master tenant that is distinct from the real estate owner (the borrower of the FHA insured loan). As demand for FHA-insured mortgages on projects also using HTCs and NMTCs grew, HUD expressed a willingness to review its earlier policy.

In 2006, Nixon Peabody obtained approval from HUD on the first transaction in which FHA formally permitted the use of a master lease structure. The 2006 approval was initially intended to be a template for other master lease approvals, but HUD determined that it would not approve any additional transactions. Since then, Nixon Peabody has been working closely with several clients to help secure the master lease policy, which

(continued on page 3)

New Markets Tax Credit Report Editorial Board

Publisher ♦ Michael J. Novogradac, CPA

Editor ♦ Jane Bowar Zastrow

Managing Editor ♦ Alex Ruiz

Staff Writer ♦ Anne Townsend

Contributing Writers ♦ Monica H. Sussman,

Andrew S. Potts

Production ♦ James Matuszak

New Markets Tax Credit Report Advisory Board

Thomas G. Tracy ♦ Hunter Chase & Company

Frank Altman ♦ Community Reinvestment Fund

Bruce Bonjour ♦ Perkins Coie LLC

Rick Edson ♦ Housing Capital Advisors Inc.

Donald S. Holm III ♦ Farris Mathews Branan Bobango Hellen & Dunlap, PLC

Lewis M. Horowitz ♦ Lane Powell

Scott Lindquist ♦ Sonnenschein Nath & Rosenthal

Benson Roberts ♦ Local Initiatives Support Corporation

John Simon ♦ Sidley Austin Brown & Wood

Ruth Sparrow ♦ Future Unlimited Law PC

Herbert Stevens ♦ Nixon Peabody LLP

Mary Tingerthal ♦ Housing Partnership Network

Joseph A. Wesolowski ♦ Enterprise Community Investment Inc.

New Markets Tax Credit Report Information

Novogradac & Company LLP

246 First Street, 5th Floor

San Francisco, CA 94105

E-mail: cpas@novoco.com

Address all correspondence and editorial submissions to:

Jane Bowar Zastrow

Telephone: 415.356.8034

Address inquiries regarding advertising opportunities to:

Junhee Byun

Telephone: 415.356.8037

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding the low-income housing tax credit or any other material covered in this publication can only be obtained from your tax advisor.

© Novogradac & Company LLP, 2008 All rights reserved.

ISSN 1941-482X

New HUD Policy

(continued from page 2)

is based to a significant degree on the model established in the 2006 transaction.

The master lease policy was issued on March 3, 2008 and contains several key features designed to accommodate the requirements of the master leasing structure. These include recognition of the ability of the tax credit investor/CDE to earn a profit on its master tenant investment and notice and cure rights regarding the FHA insured loan. Master lease subordination is required and HUD has indicated that it will not enter into a non-disturbance and attornment agreement with the master tenant as some tax credit investors might have preferred.

The new policy sets out a variety of other requirements designed to give HUD the ability to ensure operation of the property in conformity with FHA rules. These requirements include limitation on the ability to distribute cash (including preferred distributions to the owners of the master tenant) or pay developer fee until a period (generally two years) of “sustained operations” have been achieved. Even then, these amounts are payable only out of “surplus cash” (a HUD concept that roughly corresponds to net operating income after taking account replacement reserves and setting aside some cash for future bills). An expanded HUD regulatory agreement must be executed at each level of the leasing transaction (the real estate owner, the master tenant and any master subtenants).

Under the master lease policy, local FHA offices must obtain the approval of HUD headquarters before an FHA mortgage insurance transaction may use a leasing structure. Approvals will be granted on a case-by-case basis. The master lease policy was issued in draft form and is meant to be operative for 90 to 120 days during which HUD may further refine its guidance with a view to ultimately issuing more permanent rules. During this interim period, local FHA offices must obtain the concurrence of directors in specified field offices prior to forwarding requests to HUD headquarters.

New Markets Tax Credits and FHA Mortgage Insurance

While the new policy makes FHA-insured mortgages possible on HTC/NMTC transactions, some projects will be affected by remaining impediments. A fundamental tension arises from the fact that these FHA programs are aimed at residential real estate while the NMTC is a commercial program. Both programs allow mixed-use components, but their rules differ. For rental projects to be eligible for NMTCs, the buildings comprising the project must derive at least 20 percent of their gross rental income from commercial units. By contrast, for projects with mortgages insured under Section 220, aggregate commercial floor area may not exceed 20 percent of the gross floor area, and commercial income may not exceed 30 percent of the estimated total gross income. The Section 221(d)(4) program allows for even less commercial space. The opportunity to satisfy both sets of requirements is thus relatively narrow, with Section 220 deals offering somewhat greater opportunity for success. Usefully, the FHA limits are not statutory and HUD may approve exceptions for good cause.

NMTC-enhanced debt can be another source of complexity. In general, HUD prefers non-FHA sources to be equity. Debt other than the FHA-insured loan is possible with HUD approval but these loans must be subordinated to the FHA insured loan. FHA rules do not permit real estate secured subordinated debt (including NMTC debt) unless it is provided by a government agency. Non-FHA debt can be paid only out of surplus cash. CDEs will thus need to navigate between NMTC debt that meets these FHA requirements and equity that does not run afoul of the NMTC related party rules.

While some have wondered about even greater synergies between FHA and NMTCs — such as allowing the FHA loan proceeds to be lent to the CDE investor that in turn invests in a CDE that makes a mortgage loan to the project owner — this so-called “leveraging lending” is not addressed by the new policy.

(continued on page 4)

New HUD Policy

(continued from page 3)

Conclusion

NMTC-advantaged HTC equity has been a popular financing tool and is a product now provided by many CDEs. The principal benefit of HUD's new master lease policy is that it offers the possibility of FHA insured debt to projects utilizing this product. This makes good sense given that the objectives of the FHA insurance programs (and in particular the Section 220 program) are well aligned with that of the NMTC program. As debt markets contract, this new loan option may become even more important for eligible projects. Remember, though, that HUD approval will be granted on a case-by-case basis so project sponsors are advised to start the FHA process early and to compile their approval requests carefully. ❖

Monica Hilton Sussman is a partner in Nixon Peabody's Washington, D.C. office. She is a former HUD executive with nearly 20 years' experience in real estate and housing law. She focuses her practice in all types of real estate transactions and housing and community development law. Andrew Potts is also a partner with Nixon Peabody in Washington, D.C. He has concentrated his practice on the financing of community revitalization. His twin emphases are tax-advantaged private investment, including new markets tax credit advantaged transactions and the syndication and direct placement of low-income housing tax credits and rehabilitation/historic tax credits; and public investment.

This article first appeared in the April 2008 issue of the Novogradac New Markets Tax Credit Report and is reproduced here with the permission of Novogradac & Company LLP.

© Novogradac & Company LLP 2008 - All Rights Reserved.

Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking a transaction should seek advice based on their particular circumstances.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.newmarketscredits.com.