Post-RAD Requirements and Hot Topics

Over the past decade, public housing authorities (PHAs) have converted 1,558 projects, including 206,181 housing units, under the U.S. Department of Housing and Urban Development's Rental Assistance Demonstration (RAD) program, representing more than $14.9 billion of in affordable housing. Michael Novogradac, CPA, and Novogradac partner Rich Larsen, CPA, discuss what PHAs and their RAD consultants need to know about RAD accounting issues, compliance issues, financial reporting and other hot topics.

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Transcript

[00:00:11] **Michael Novogradac, CPA:** Hello, I'm Michael Novogradac, and this is Tax Credit Tuesday. This is the Oct. 18, 2022, podcast. This year marks 10 years since the launch of the U.S. Department of Housing and Urban Development's Rental Assistance Demonstration program or commonly called RAD. Over the past decade, public housing authorities converted 1,558 projects converting 206,181 housing units under the RAD program, representing more than $14.9 billion in affordable housing. The RAD program is a tool that's used by public housing authorities to raise capital to help renovate aging public housing. If you work at a public housing authority, there's a chance that your agency has already converted some of it's public housing units through RAD. Now, whether or not you've recently closed a RAD transaction, you're in the middle of a RAD closing, you're still considering whether or not to apply to participate in the RAD program, or perhaps you've been wondering what RAD is, this podcast will help you make some informed decisions help you avoid some potentially costly oversights.

In today's podcast, we're going to discuss RAD post-closing requirements and various hot-button issues that every PHA and RAD consultant should be aware of. Joining me for today's discussion is my partner and fellow CPA, Rich Larsen, from Novogradac's Toms River, New Jersey, office.

Rich is one of the country's leading public housing authority auditors and advisers, and he's an expert on the RAD program. Rich is a lead author of the Novogradac's RAD Handbook and chair of Novogradac's annual RAD Public Housing Conference. I'm looking forward to having him share his insights with us on Tax Credit Tuesday today. As I say each week, if you're ready, let's get started.

Rich, welcome back to Tax Credit Tuesday.

[00:02:19] **Rich Larsen, CPA:** It is, it's great to be back.

[00:02:22] **Michael Novogradac, CPA:** So before we dive into RAD issues, as I noted in my intro, there may be some listeners that are wondering what RAD is, so it might be helpful if you give a brief overview of what the RAD program is. Now, we don't need to go into too much detail here because we want to focus on post-closing issues, but as a level set for our audience, please explain what the RAD program is and why it matters.

What is RAD and Why Does it Matter?

[00:02:47] **Rich Larsen, CPA:** Sure, Mike. The RAD program was created really to preserve public housing by providing access to more stable funding. Currently there's a minimum of a $40 billion capital need just to bring public housing units up to standard. So specifically, the RAD program provides for a more stable Section 8 rent subsidy and access to capital.

And when I talk about private capital, we're talking about tax credit equity and conventional debt. And the biggest thing about this program is that it's budget-neutral for the federal government, does not cost them any more.

[00:03:26] **Michael Novogradac, CPA:** So thanks, Rich. That's a great overview. For any of our listeners who want to learn more about RAD, I encourage you to order the Novogradac RAD Handbook from our website. It's available in print and in digital form. Now Rich, for context, please share with our listeners the role or roles that you typically play in a RAD transaction.

[00:03:47] **Rich Larsen, CPA:** So RAD is a public housing authority program. So as a PHA accountant and auditor, quite often we're called on as a trusted adviser to consult with PHAs on their best options to which type of RAD conversion to pursue. We assist in recording RAD transactions, we set up and structure the ownership of affiliate entities.

And as well as our bread and butter is, we perform audits and prepare tax returns for the RAD entities. More importantly, I think as a Novogradac partner, I'm able to bring in my partners who are experts in the low-income housing tax credit, in the historic tax credit and in property valuation so that we can make sure that our PHA clients utilize every available resource to maximize financial benefits from a RAD transaction.

[00:04:40] **Michael Novogradac, CPA:** Thank you for that, Rich. So because of your expertise, and your experience, I know that you're very much in demand on the conference circuit and you get invited to speak about RAD at lots and lots of industry events. What are some of the broad categories of issues that you're seeing and discussing?

Categories of RAD Issues

[00:05:01] **Rich Larsen, CPA:** That, that's a great question, Mike. We're seeing a variety of post-RAD issues. Accounting issues is a big issue. Recording that initial RAD closing transaction, that could be very complicated, causing some issues. Post-RAD compliance. We've seen a lot of HUD audits on RAD transactions and a lot of noncompliance, housing authorities not following through with the RAD conversion commitment. Financial reporting causes a lot of confusion. Who gets this financial report of the new RAD entity? Where does it go? Does it go to HUD? Does it go to investor?

A combination of both? And also when I speak at conferences, we get a lot of questions on just the latest notices coming out of HUD or new accounting pronouncements. And of course, everybody likes to talk about recent HUD IG audits. What is the Inspector General doing these days?

So, so that's where we're at mostly.

RAD Accounting Issues

[00:05:54] **Michael Novogradac, CPA:** So that sounds like if I was counting correctly, maybe four categories of issues: one being accounting, one being compliance, one being financial reporting. And a fourth one, which is really two, is maybe hot topics, if you will. So let's march through each of those sort of four categories. So starting with accounting, PHAs that have completed a RAD transaction, as I understand it, can be separated into two categories.

One is a public housing authority that continues to own underlying property that's going through renovation, and the other is the public housing authority that has sold the property to a newly formed entity, a limited liability company, or a limited partnership is most likely financing that acquisition and renovation of the property using low-income housing tax credits.

Now both scenarios, both the continue to own the property scenario and the property scenario have distinct accounting requirements. If you could share for our listeners, what PHAs should know about the differences in those two accounting requirements.

[00:07:03] **Rich Larsen, CPA:** Sure, Mike. So when a PHA retains ownership, the good news is here, there is no sale of the property, so it's just an internal bookkeeping transaction. But the most important thing is you want to make sure that you transfer all the assets and liabilities from your public housing program to a nonfederal program, a business activities fund.

And more importantly, you're closing out that public housing program because by doing that, you're essentially saying, we're not receiving any more financial or federal money. Going forward, the funds that you're going to this new RAD property are going to be nonfederal funds, and that gives you a lot more flexibility to utilize those funds.

There's no gain or loss reported on that transaction. You're just recording the assets and liabilities at book value, and you're bringing them over to a nonfederal fund. The more complicated transaction though is really when tax credits are involved. Because when tax credits are involved, it can get very complicated because the housing authority is in essence selling the building and the improvements to a separate entity and that requires the public housing authority to address some very technical issues: gain or loss on the sale of the assets, recording a land lease, there's a seller take-back mortgage and so forth. And the big issue there, you know, this Mike, you can have a public housing property that's worth millions of dollars, but its book value is zero.

So a housing authority theoretically can sell this property for $25 million, have a book value of something very small, but you know, a couple thousand dollars have this $25 million gain. Well, Generally Accepted Accounting [Principles], well, you can't just recognize that gain unless you can be reasonably assured you're going to collect that $25 million. And with seller take-back financing, it gets very complicated. You may not. And so that's where we see a lot of journal entries, a lot of material mistakes on financial statements that PHA are making, and we've been helping them with that over the last several months.

RAD Compliance Issues

[00:09:23] **Michael Novogradac, CPA:** Great. Thank you for that. Now let's move into compliance issues. Second of my four categories that I've kind of created here. What are some of the most commonly overlooked compliance issues?

[00:09:33] **Rich Larsen, CPA:** So, so great question again. Now, although I said it was very easy to, on the accounting side, when a PHA maintains ownership, the problem is the compliance issues there are very significant. So when a PHA converts its public housing units and ownership, they now are the owner of the property and they are also administering the housing assistance payments to that property.

So there's an inherent conflict of interest there. And HUD says, okay, well that's okay, but you need to do a few things to make sure we, we remedy that conflict of interest or mitigate that risk and the big issue HUD says you need to hire an independent entity that they approve of to perform certain tasks: the rent reasonableness, HQS [Housing Quality Standards] inspections, calculating OCAF adjustments. And, when I say OCAF I mean, the operating cost adjustment factor, the inflation adjustment to the rent. And so those are the biggest things. And we see a lot of housing authorities, although they may say, hey, we have an independent entity doing this, the reality is, number one, that independent entity didn't get approved by HUD. Technically, they're not really independent. You can't just have an affiliate entity do it if you control that entity. So we're seeing those issues there, very significant when a housing authority owns that property. They do need to maintain those separations.

A couple other issues that we see with compliance. Housing authorities need to really close out their capital fund program, and that's done by the auditor putting a certification in the public housing authority audit that it's properly closed out. And the problem is the housing authority may forget to tell the auditor, or the auditor may miss something to that effect.

And three years down the line, HUD's going to send you a letter saying, hey, you never closed out the 2018 capital fund grant to 2019 capital fund grant. It may cost you additional funds to go back and do that certification, go back to those records and make sure everything was closed out properly.

Your public housing program also needs to be closed out properly. HUD has put out a whole PIH [Public and Indian Housing] notice on the proper procedures of doing that. When you convert to RAD and you have no more public housing units, you need to convert. You need to close out that public housing program in accordance with the PIH Notice 2019-3. So those are the major compliance issues, Mike, that we're seeing. We try to, when we come in and do audits, we try to address all those issues with our clients to make sure, going forward, they're in good shape with their RAD property.

[00:12:21] **Michael Novogradac, CPA:** And the issues that you discussed there all relate to where the PHA continues to own the property, correct?

[00:12:28] **Rich Larsen, CPA:** Well, the last two, closing out the capital fund program and closing out the public housing program, that applies to really all entities, when the PHA owns the program and then also when the tax credit entity does. Because if the PHA is out of public housing and out of the capital fund program, they need to properly close it out.

[00:12:49] **Michael Novogradac, CPA:** And are there any compliance issues that are specific to tax credit transactions?

[00:12:54] **Rich Larsen, CPA:** So specific to tax credit cost allocation, proper cost allocation is a huge hot button issue with HUD's Office of Inspector General because what happens is housing authorities have created a lot of nonfederal entities, and they also operate a lot of federal programs. And so HUD's view is, the IG's view and HUD, is if you're not properly allocating costs in a systematic, rational and allocable method, you could be overcharging a federal program and so that is one compliance area for the tax credit property that we've seen a lot of audits with. And then they've resulted in, in significant penalties. You can't just charge a salary. There has to be a basis for charging a cost to a federal program or to a nonfederal program.

RAD Financial Reporting

[00:13:48] **Michael Novogradac, CPA:** Got it. Thank you for that. And now let's turn to our third category, financial reporting. What particular nuances are there to a RAD transaction when you're reporting on your financial statements, as well as the ongoing operations of the property and your involvement with the property?

[00:14:09] **Rich Larsen, CPA:** Sure, Mike. So, so quite often the confusion about financial reporting comes when I see a housing authority utilizes maybe their own internal development team or they hire a development consultant and they kind of keep the finance department out of the loop. Not that they're keeping the out of loop, but the finance department could be busy doing other things.

So the development department will put together this RAD package. They will give us financing, they'll put together the rental assistance and really not fill the finance department in on and all those things. The type of rental assistance that a RAD property gets, whether it's project-based rental assistance or project-based vouchers, has financial reporting requirements. Project-based rental assistance, you have to do a separate electronic submission to HUD, and if it's over $500,000, you need a separate project audit. So if you don't tell or inform the finance department or the finance department doesn't get the RAD binder, they're going to miss that compliance deadline. The type of permanent financing that a RAD property gets could cause a specific financial reporting requirement. If you have a HUD-guaranteed loan, once again, you may have to do a separate audit project audit to HUD.

A lot of state housing finance agencies provide permanent funding and they require their own special financial reporting. For instance, New Jersey has their own basis of accounting. If you get balanced housing funds in the state of New Jersey, they're going to require you to submit a financial statement on their basis of accounting. Also, entity structure has an impact on your financial reporting. A tax credit property at a minimum is going to have reporting to an investor, could have reporting to HUD, could have financial reporting responsibility to the PHA as well. And so there's a scenario with a lot of PHAs, a lot of RAD properties where that RAD property is considered a component unit of the PHA, and so has to report its financial results to the housing authority.

It'll have investor reporting requirements state HMFA [Housing and Mortgage Financing] reporting requirements. And they also may have to do a project audit to HUD. So the important thing is to really understand your reporting requirements. And you really want to understand them before you do the RAD deal because it may change, the components of your financing package.

You may not want that hundred-thousand dollars from the state HMFA if it's going to require you to have separate financial reporting or separate auditors or so forth. But the important thing is also, hey, you really need to maintain compliance. And, after your first year, after your conversion, you don't want to get that letter from HUD that says, hey, you didn't file that audit electronically, and you're now noncompliant and now you have to tell your tax credit investor you're noncompliant. Your state HMFA is going to find out you're noncompliant. So, it is just so important to maintain that, that compliance.

[00:17:17] **Michael Novogradac, CPA:** I mean, it sounds like for these first three, all are very much interrelated to ensuring that there's a broad swath of knowledge across the public housing authority about what's happening so that one particular area isn't caught off guard as to what is occurring in another area. If they are caught off guard, there could be penalties and other issued batched with noncompliance.

[00:17:49] **Rich Larsen, CPA:** That's right. That's right. That's exactly right. And it really is, a lot of it's communication. It's having the development team and the finance department collaborate, and if there's confusion, just call your auditor. That's what we do. And we know exactly who you're going to have to report to.

RAD Hot Topics

[00:18:10] **Michael Novogradac, CPA:** That's great. So my fourth and final category was labeled as general hot topics earlier, but for “Jeopardy!” fans, it would be the potpourri category.

[00:18:23] **Rich Larsen, CPA:** Right.

[00:18:24] **Michael Novogradac, CPA:** They didn't really fit into the other three categories, so I just tossed it into this catchall category, but what are a couple of the other industry hot topics?

[00:18:31] **Rich Larsen, CPA:** So what we're seeing with public housing authorities right now, so this is getting a little bit off the RAD topic, but public housing authorities that now have June 30th year end, starting with year ends June 30th, 2022, have to comply with GASB 87 [Governmental Accounting Standards Board Statement No. 87], which is an accounting pronouncement which requires them to put all their leases on their financial statements to capitalize their leases.

In the past, they have not had to do that. So we're working with a lot of our clients. We're giving them a methodology to do that because the reality is even though the requirement is all leases, you don't have to put the ones on that are immaterial to the financial statements. So what we're trying to do is make the process a little easier, less cumbersome for our clients and say, hey, give us an inventory of your leases and we'll help you calculate a materiality level where you can only put the ones that are material on the books and go through that conversion process.

And of course, we're helping calculate that, that GASB 87 commitment, lease commitment. So, so that's one big that, that's requiring a lot of time for housing authorities, a big commitment on their part. And then, also we've been getting a lot of questions. The HUD's Office of Inspector General recently put out an, an audit report in late August of this year, a couple months ago, where they said a management agreement between housing authorities–now, I don't, I'm getting a little bit into the minutia, but a lot of larger housing authorities manage smaller housing authorities because those smaller housing authorities many times cannot afford a full-time director of finance, a full-time procurement officer, a full-time Section 8 coordinator.

So these larger housing authorities would take on these roles and charge a management fee. Well, the HUD Office of Inspector General said, well, wait a second. There are certain criteria you need to maintain in order for this to be a management agreement. And then in this one particular report, they disallowed the management agreement and said the actual housing authority was a pass-through subrecipient of federal money. So the management fees that it received were not considered management fees in nonfederal money. It was considered federal money, and they were considered a grant subrecipient. So as a subrecipient, you're not permitted to make a profit. And so they owed a lot of, these funds back to the housing authorities, the smaller housing authorities.

And they also owed back a lot of money to HUD and they're currently fighting that. I think we're probably going to assist in that defense. But right now, that is a huge part of revenues that housing authorities are earning performing management services for other housing authorities.

So right now we're putting together a plan on how to avoid being considered a federal subrecipient, grant subrecipient, and to keep those fees considered management fees, nonfederal, and being able to earn a profit.

[00:21:37] **Michael Novogradac, CPA:** Great. Thank you for that. I did want to also ask you one other question, which is a, a bit off topic, but you know, this is about RAD. It's more focused on post-closing issues, but we did get the average income regulations for low-income housing tax credits out recently, and lots of folks are looking at these average income regulations and trying to identify how they'll be used in the broader loan community. We recorded a podcast episode on the topic, so anyone who's listening was not that familiar with the concept of average income for low-income housing tax credits, please go back and listen to that podcast episode. My question for you is, when you think about RAD conversions are using low-income housing tax credits, to what extent do you think these properties may end up adopting the average income set aside?

[00:22:31] **Rich Larsen, CPA:** So that is a great question, Mike. A very current and applicable question. And as you mentioned, those regulations are relatively new. But what I can say is, public housing residents only need to meet the income criteria upon their admission to the program. So if someone was admitted to the program in 1976 or 1996 or 2006, their income could grow substantially and be well over any limit.

Now, obviously they wouldn't get any subsidy for those units, but you know, those participants, those public housing residents could be well over income. And so then when those units convert to RAD, the income averaging would help those tenants qualify for the new project. And so I don't know if that's a short answer or a long answer.

It is a relatively new, the regulations are relatively new. It's a new process, but my gut is, I think it will help.

[00:23:36] **Michael Novogradac, CPA:** I mean, good point because it, the average income regulations, could allow some of those over income tenants from 60% to 80% be eligible such that they be tax credit eligible tenants. Obviously, it wouldn't go if they were above 80% and I'm not sure how often you would see someone in that band, but it's probably additive and probably not harmful.

The regulations themselves, we need to read more and think through a variety of compliance issues and the rest to decide on balance. Does it make sense to adopt the average income set aside? Because it's quite likely that the average income set aside will become the new normal, whereas right now, the 40-60 minimum set aside is, but I would say for our listeners, do go back and listen to the podcast on the average income regulations for more insights. So, thank you Rich. Was there anything else you wanted to add before I move on?

[00:24:28] **Rich Larsen, CPA:** No, Mike, I think you hit it pretty good. I would encourage my clients to go back and listen to that average income podcast as well.

Exit

[00:24:37] **Michael Novogradac, CPA:** So Rich, stick around for our Off-Mike section at the end of the podcast where I'll ask you some fun, off-topic questions to get some tips and words of wisdom from you.

[00:24:47] **Rich Larsen, CPA:** That's always great. I love giving words of wisdom.

[00:24:50] **Michael Novogradac, CPA:** For our listeners, be sure to tune into next week's podcast. If the CDFI [Community Development Financial Institutions] fund announces the new markets tax credit allocation awards this week, then my partners, Brad Elphick and Rebecca Darling will be on the podcast to discuss the announcement and next steps for awardees. Now in the event that the allocation awards are not released this week, then my guest next week will be my partner, Tony Grappone. We'll discuss some very interesting updates from the Renewable Energy Tax Credit Working Group, including the group's planned comments to the IRS on the Inflation Reduction Act's clean energy tax incentives. You can be sure you're notified of that episode and each week's episode by following or subscribing to the Tax Credit Tuesday podcast.

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Off-Mike

[00:25:53] **Michael Novogradac, CPA:** Now I'm pleased to reach our Off-Mike section where listeners can get some off-topic advice and words of wisdom from our podcast guests.

So Rich, let me start with a question that I really enjoy asking guests on the podcast, and that's what part of your daily routine do you most look forward to? And more importantly, why?

[00:26:16] **Rich Larsen, CPA:** Well, the good thing is my college-age kids are all back to school, so now it's, I like to get in the office nice and early, 7 a.m. And I like to try to sneak out around lunchtime and just get back to going to the gym and I just been feeling a lot better doing that. It's kind of, that was my pre-COVID routine. Obviously with COVID, you kind of get away from it. The, the gyms were closed, the kids were home, and so it's, I feel good getting back to that because I'm a morning person, so getting in it about 7 a.m. is normal for me, is not a hard thing to do.

[00:26:54] **Michael Novogradac, CPA:** Great. That's good to hear. I actually was during COVID, I found myself a bit more, because I was home and I'm the opposite. I'm like, I have to get back to my COVID period. So my second question, and I'll just be two this week, what makes you feel inspired or like your best self?

[00:27:18] **Rich Larsen, CPA:** Well, I, that's a great question. Again, Mike, I have some great clients, and they really do some great things for their community and I really feel good when I can help them achieve their goals, whether it be just contributing my time, whether it just be the consulting that I do with the entities, or playing in a golf outing and helping them raise some funds.

When you can participate, when you like what you're doing and you believe in the cause, the affordable housing cause, you kind of, you feel good about yourself and you feel good about the work you're doing, and coming to work doesn't really feel like work.

[00:27:50] **Michael Novogradac, CPA:** Now that's very well said. I similarly feel inspired by the work that our clients do and being able to help them do the work that they do provides lots of inspiration for me as well. Thank you again, Rich. And to our listeners, I'm Mike Novogradac. Thanks for listening.

Additional Resources

Email

Rich Larsen

AIT Podcast

Oct. 11, 2022: Final Regulations for the Average Income Test

Conference

Novogradac 2022 Tax Credit Housing Finance Conference